



*Promoting choice and value for
all gas and electricity customers*

To generators, shippers,
suppliers, network companies,
consumers and their
representatives, the sustainable
development community,
investors and other interested
parties.

Date: 17 December 2012

Dear Colleague,

Formal proposals to modify the ring fence conditions in network operator licences

The ring fence conditions in energy network operator ('NWO') licences provide assurance that consumer funded resources are effectively applied and help to manage the risk that an NWO could be affected by financial distress. Since 2009 we have been consulting on modifications to the ring fence conditions to ensure that they remain fit for purpose for years to come. We have carried out four informal consultation exercises (see associated documents schedule in Appendix 1) in which NWOs have actively engaged. The high quality of responses received has allowed us to refine our proposals and, as far as possible, to address the issues and concerns that have been raised.

The consultation that we published in July 2012 (associated document 'b') contained details of our licence modification proposals. In October 2012 we published an updated consultation (associated document 'a') which, in particular, covered an additional proposal to refer to a new term, "Associate", in our draft licence modifications. The latest informal consultation closed on 30 November 2012 and the further changes we have made to our proposals are summarised below.

Responses to our October 2012 consultation

The points summarised below were raised in responses to our October 2012 consultation. The non-confidential responses have been published on the Ofgem website.

Use of new term "Associate"

In the consultation we referred to concerns about the limited scope of the term "Affiliate" (as defined in licences) in respect of its use in the existing restriction of indebtedness condition and prospective use in the draft requirements relating to sufficiently independent directors and intervention plans. We set out our view that reference should be made to a new term, "Associate" of the licensee, capturing a wider range of parties with a connection to the licensee (see chapter 4 of associated document 'a').

There were no strong objections to our rationale for proposing the use of the new term, although some issues were raised.

One respondent argued that any existing financial arrangements should not be caught by an extension to the range of parties referred to in the restriction of indebtedness condition. Another respondent felt that the draft definition of "Participating Owner" (used within the definition of "Associate") did not make clear whether an unbroken chain of participating owners would be captured. The same respondent suggested that another term used, "Participating Interest", should be defined on the face of the licence instead of by reference to the Financial Services and Markets Act 2000.

With respect to the first of these points we consider that, even if an NWO had previously entered into an arrangement with (what would be) an Associate, that it could not properly enter into with an Affiliate, the position would be unlikely to be affected by the revised drafting. This is because the wording used in the restriction of indebtedness condition does not imply a retrospective prohibition. If, however, the renewal of an arrangement were to be caught by the new restriction, the Authority could consider giving its consent to the situation, based on its merits.

On the second point, whilst agreeing that the use of a more descriptive definition of an unbroken chain of participating owners might appear to be more reader-friendly, it might lack the preciseness of the drafting we have proposed. We are therefore of the view that the proposed drafting should be retained but note that a separate explanatory note could prove helpful. Whilst having some sympathy for the third point, we note that the term Participating Interest is already defined by reference to the Financial Services and Markets Act 2000 elsewhere in the licence, so a similar approach here is most consistent.

Disposal of assets condition

One respondent suggested that we should retain an explicit reasonableness stipulation in relation to consent for the granting of charges over NWO receivables.

We had included this in our earlier drafting with a view to drawing a distinction between consideration of such notices and those relating to charges over network assets. However, in our October 2012 consultation we stated that we had decided to remove the stipulation to avoid any suggestion that the Authority might act unreasonably in relation to a notice received. Having reflected again, we consider that, on balance, the stipulation is best left out of the drafting.

Restriction of indebtedness condition

With regard to the proposed new triggers for the 'cash lock up' mechanism, one of the respondents reiterated a view that the term "formal covenant pertaining to its financial affairs" should be defined within the condition as a "formal covenant contained in any loan agreement, commercial paper, bond issue or committed facility". In commenting on this suggestion in our October consultation, we expressed a view that the existing proposal appeared adequate and interpretable and that the use of a list might mean that relevant items would be excluded.

In light of the latest consultation, however, we have reviewed the following factors:

- the types of financial covenant whose breach would be most likely to represent a precursor of financial distress;
- the assurance provided by the other two triggers which would be applicable to the cash lock up mechanism; and
- the benefits of a more closely defined trigger circumstance with respect to compliance assurance.

Having carefully considered these factors, together with the views of the respondent on this point, we have decided to revise the wording in the draft condition so that it specifies the instruments and facilities referred to above.

Availability of resources condition

One respondent sought confirmation that the existing exemption from submitting a further dividend payment certificate, where payment is made within six months of a certificate having been given, had not been overwritten by the updated drafting presented in our October 2012 consultation document.

The short drafting extract included in the October 2012 consultation document did not show consequential paragraph renumbering and we can confirm that the exemption has been retained. The new drafting sequence can be seen in the full set of proposed modifications attached to the statutory consultation notices published today.

Proposed requirement for sufficiently independent directors

Our proposed requirement for each licensee to have at least two sufficiently independent directors has evolved significantly during our review of the ring fence regime over the last three years. In developing our proposals, we have been able to address a number of the concerns raised in responses to our consultations, although we acknowledge that two NWO groups remain opposed to the proposed requirement. We have continued to consider the concerns they have raised but do not believe that any new points of principle arose from the most recent consultation which focussed on a limited number of specific issues. We are therefore of the opinion that the key arguments in relation to sufficiently independent directors are contained in the consultation documents published in March 2011, July 2012 and October 2012 and the responses thereto (associated documents 'd', 'b' and 'a' respectively). Some issues were, however, raised by respondents to particular matters referred to in the October 2012 consultation.

Appointee eligibility

Several respondents felt that the eligibility criteria specified in the draft condition might exclude suitable candidates, particularly those holding appointments as directors of companies within network business groups but which fall outside the definition of 'qualifying group companies'. It was felt that the introduction of the new term, "Associate" might aggravate this situation.

Whilst we consider that there will be a large pool of suitable candidates available for selection across the wider business community, we acknowledge that there will be strong candidates within network businesses who are sufficiently independent for the purposes of the proposed requirement. However, the practical limitations of drafting mean that we could not widen the 'as of right' eligibility criteria to embrace every category of suitable candidate and network business group, without running the risk of undermining the purpose of the appointments. For that reason, we have embedded a consent mechanism in paragraph 3 of the draft condition which imposes the eligibility restriction on employees and directors of Associates of the licensee (subject to the specified exceptions). In considering applications for consent under this provision the Authority would:

- consider the sufficiency of independence of the proposed appointee with respect to the particular risks which the requirement is intended to address; and
- not consider other candidate attributes which are the proper concern of those making the appointment.

The consent mechanism could be relevant in respect of candidates who only hold non executive appointments with companies within groups which are, in substance, network groups but which fall outside the formal definition of a qualifying group company. We believe that, taken together, the eligibility criteria and the provision for the Authority to give consents where appropriate will mean that appointers will be able to find and appoint good candidates so that the objectives of the proposal will be achieved.

Other matters

Two respondents considered that the revised requirement for a licensee to “use its best endeavours” to fill vacancies for sufficiently independent directors was unduly onerous. Having carefully considered these views, we have decided that the proposed wording should be changed to “use its *reasonable* endeavours”.

In addition, one respondent suggested that there should be a specific price control mechanism to reimburse the costs associated with a requirement for sufficiently independent directors. We have stated that efficient costs should be recoverable on a net present value neutral basis, but consider that the mechanism for this should be considered under relevant price control review arrangements.

We continue to believe that the proposed requirement for sufficiently independent directors is necessary and proportionate because of the risks, and for the reasons, set out in the consultation documents referred to above. We have therefore included an updated version of the proposed new licence condition in our statutory consultation on licence modifications.

Form of ultimate controller undertakings

The existing ring fence conditions requiring each NWO to obtain an undertaking from each of its ultimate controllers provides for the Authority to direct the form of such undertakings. In our 2012 consultation documents we set out our intention to direct updated forms at the same time as making modifications to the ring fence conditions. To this end we have included an updated specimen draft of the form we expect to direct at Appendix 2. It incorporates minor typographical corrections suggested in a response to our October 2012 consultation. The appended example relates to electricity distribution licensees, but the direction and form of undertaking for other licensees would be substantially the same.

Statutory consultation notices on licence modification proposals

Reference should be made to the statutory consultation notices published alongside this letter for full details of our proposed ring fence condition modifications. The proposed modifications incorporate the most recent drafting changes referred to in this letter, together with several corrections and clarifications that are noted at Appendix 3.

The statutory consultation on modifications to the ring fence conditions will run concurrently with the consultation on the Authority's final proposals for the RIIO-T1 and GD1 price controls¹, and associated licence modifications². Although we consider that the two sets of proposals are consistent with, and complementary to, each other, there are no overlaps in the proposed licence modifications³. The closing date for responses to the statutory consultation is 22 January 2013.

¹ Final proposals for SP Transmission Ltd and Scottish Hydro-Electric Transmission plc have previously been made under the 'Fast Track' process.

² Statutory consultation notices for RIIO modifications are expected to be published on 21 December 2012.

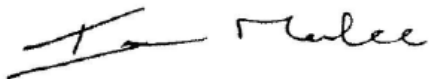
³ Except for the renumbering of Special Condition C1 in the NTS licence for National Grid which would become Special Condition 1B under the RIIO proposals and the possible need to update some cross referenced condition numbers.

Copies of the statutory consultation notices have been sent to:

- each licensee affected by the proposed modifications;
- The secretary of State for Energy and Climate Change;
- The Scottish Executive;
- The Welsh Assembly;
- The Health and Safety Executive; and
- Consumer Focus.

If you have any queries on the, matters referred to in this letter please feel free to contact Paul Darby in Ofgem's Regulatory Finance team (paul.darby@ofgem.gov.uk).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian Marlee', with a stylized flourish at the end.

Ian Marlee
Senior Partner, Smarter Grids and Governance (Transmission)

Appendix 1 to Ofgem's letter:

Formal proposals to modify the ring fence conditions in network operator licences – dated 17 December 2012

List of associated documents (most recent publication first)

- a) Updated Proposals for Changes to Ring Fence Conditions and their Impacts – 11 October 2012 (Ref 129/12) and published stakeholder responses
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=403&refer=Networks/Policy>
- b) Position Paper – Changes to the Ring Fence Conditions in Network Operator Licences – 3 July 2012 (Ref 85/12) and published stakeholder responses
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=392&refer=Networks/Policy>
- c) Regulatory Ringfence Update letter dated 13 March 2012
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=367&refer=Networks/Policy>
- d) Ofgem website page with Consultation on Proposed Modifications to the Ring Fence Conditions (Ref 42/11) and published stakeholder responses
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=268&refer=Networks/Policy>
- e) Ofgem website page with Impact Assessment /Consultation - Review of the „Ring Fence Conditions in Network Operator Licences (Ref 30/10) and published stakeholder responses
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=268&refer=Networks/Policy>

Direction issued by the Gas and Electricity Markets Authority to all holders of Electricity Distribution Licences treated as granted under section 6(1)(c) of the Electricity Act 1989 ('the licensees') under paragraphs 2 and 3 of Standard Condition 6 (Provision of Information to the Authority) and paragraphs 1 and 2 of Standard Condition 31 (Undertaking from Ultimate Controller) of the Electricity Distribution Licence, and

Notice of reasons under section 49A of the Electricity Act 1989 for the decision to issue the direction

WHEREAS

- A. Each of the licensees is the holder of a distribution licence ('the licence') granted or treated as granted by the Gas and Electricity Markets Authority ('the Authority') under section 6(1)(c) of the Electricity Act 1989 ('the Act').
- B. The licence imposes requirements for the licensees to procure certain undertakings from each of their Ultimate Controllers as defined in Standard Condition 1 (Definitions for the standard conditions) of the licences. The requirements are contained in Standard Condition 6 (Provision of Information to the Authority) ('SLC 6') and Standard Condition 31 (Undertaking from Ultimate Controller) ('SLC 31') of the licence (together 'the conditions').
- C. The conditions each provide for the Authority to specify the form of the requisite ultimate controller undertakings on the terms set out in the conditions as follows:
 - (i) Under paragraph 3 of SLC 6 the terms are that the Ultimate Controller ('the Information covenantor'):
 - (a) will give to the licensee; and
 - (b) will procure that any person (including a corporate body) that is a Subsidiary of, or is controlled by, the Information Covenantor (other than the licensee and any Subsidiary of the licensee) will give to the licensee,all such Information as may be necessary to enable the licensee to comply with its obligation under paragraph 6.1 of SLC 6.
 - (ii) Under paragraph 2 of SLC 31 the terms are that the Ultimate Controller ('the covenantor'):
 - (a) will refrain from any action; and
 - (b) will procure that any person (including a corporate body) that is a Subsidiary of, or is controlled by, the covenantor (other than the licensee and any Subsidiary of the licensee) will refrain from any action,that would be likely to cause the licensee to breach any of its obligations under the Act or this licence.

- D. The Authority considers that it is now appropriate to issue a direction specifying the form of undertakings to be procured by licensees for the following reasons:
- (i) to ensure that ultimate controller undertakings obtained by the licensees meet all of the requirements of the conditions;
 - (ii) to provide for consistency in the terms of ultimate controller undertakings across licensees and ultimate controllers; and
 - (iii) to facilitate the provision of undertakings by new licensees or by existing licensees when their ultimate controllers change as a result of corporate transactions

NOW the Authority pursuant to paragraphs 2 and 3 of SLC 6 and paragraphs 1 and 2 of SLC 31 and for the purpose of specifying the forms of undertakings for the purposes of those conditions generally **HEREBY DIRECTS** that any undertakings procured on or after 1 April 2013 to meet the requirements of the conditions are to follow the form set out in the Schedule to this Direction (not to be taken as excluding any further terms that may be necessary or amendments that may be necessary due to the particular circumstances of a case) unless the Authority directs that a different form should be followed and/or varies or revokes this Direction, including its Schedule, in writing upon reasonable notice.

This document also constitutes a notice for the purpose of section 49A(1)(c) of the Act stating the reasons for the Authority's decision to issue the Direction.

Dated: XX XXX 2013

.....
Ian Marlee
Senior Partner, Smarter Grids and Governance (Transmission)

Duly authorised on behalf of the
Gas and Electricity Markets Authority

Form of Ultimate Controller Undertakings:

THIS DEED made on day of between:

(1) [ULTIMATE CONTROLLER] (a company registered in [] with number [] and whose registered office is at []) (the “**Covenantor**”);

and

(2) [Company] (a company registered in England with number xxx and whose registered office is at []) (the “**Licensee**”);

WHEREAS:

(A) The Licensee is bound by certain obligations under the Electricity Act 1989 (the “Act”) and the licence granted under section 6(1)(c) of the Act (the “Licence”).

(B) Standard Condition 6 (Provision of Information to the Authority) and Standard Condition 31 (Undertaking from Ultimate Controller) of the Licence require the Licensee to procure from any person who is an ultimate controller of the Licensee enforceable undertakings in respect of:

- i. the provision of information by the Licensee to the Gas and Electricity Markets Authority (the “Authority”), and
- ii. the conduct of that person in relation to compliance by the Licensee with its statutory and Licence obligations.

(C) The Covenantor is an ultimate controller of the Licensee.

NOW THIS DEED WITNESSES as follows:

UNDERTAKINGS

The Covenantor hereby undertakes in favour of the Licensee:

1. To give the Licensee, and to procure that any person (including, without limitation, a corporate body) that is a subsidiary of, or controlled by, the Covenantor (other than the Licensee and any of its subsidiaries) will give to the Licensee, in such manner and at such times as the Licensee may require, all such information as may be necessary to enable the Licensee to furnish to the Authority such information and reports as the Authority may reasonably require or as may be necessary for the purpose of performing:
 - i. the functions conferred on it by or under the Act, the Energy Act 2004 and the Energy Act 2008; and
 - ii. any functions transferred to or conferred on it by or under the Utilities Act 2000.
2. To refrain from any action, and to procure that any person (including, without limitation, a corporate body) that is a subsidiary of, or is controlled by, the Covenantor (other than the Licensee and any of its subsidiaries) will refrain from any action, which would be likely to cause the Licensee to breach any of its obligations under the Act or the Licence.

GENERAL

3. The undertakings given under this deed shall remain in full force and effect until such time as the Licensee ceases to hold the Licence or the Covenantor ceases to be an ultimate controller of the Licensee.
4. For the purposes of this deed;
 - i. Any reference to an Act of Parliament shall include any statutory modification or re-enactment thereof after the date on which this deed is executed,
 - ii. Any reference to the Licence shall include any modifications to the Licence after the date on which this deed is executed, and
 - iii. words and expressions defined for the purpose of any provision of such an Act or of the Licence held by the Licensee shall have the same meaning when used in this deed.

5. The Covenantor and the Licensee hereby exclude the operation of the Contracts (Rights of Third Parties) Act 1999.
6. This deed is governed by and shall be construed in accordance with English law.

IN WITNESS of which, this deed has been executed and delivered on the date first appearing on page 1.

EXECUTED AS A DEED BY

The Common Seal of

[Name of Ultimate Controller]

was hereunto affixed in the presence of

_____ Authorised signatory

[or]

[Name of Ultimate Controller]

Acting by two directors or a director and the company secretary

_____ Director

_____ Director/Company Secretary

And

EXECUTED AS A DEED BY

The Common Seal of

[Name of Licensee]

was hereunto affixed in the presence of

_____ Authorised signatory

[or]

[Name of Licensee]

Acting by two directors or a director and the company secretary

_____ Director

_____ Director/Company Secretary

Additional correction/clarification changes to drafting following the October 2012 consultation

1) Undertaking from Ultimate Controller

We have added the words "With effect from 1 August 2013" to the start of the proposed new paragraph for this condition to clarify that the first deadline for the new requirement to be met would be 31 July 2014.

2) Requirement for sufficiently independent directors

We have corrected the definition for "Qualifying Group Company" as shown in highlight below:

Qualifying Group Company means:

- (a) an immediate parent company of the licensee that holds 100% of the shares of the licensee and no other shares except for shares in one or more wholly-owned subsidiaries, each of which is the holder of a gas transporter licence or an electricity transmission licence or an electricity distribution licence;
- (b) the parent company of a group whose other members may only include :
 - (i) a company meeting the criteria set out in sub-paragraph (a) or a subsidiary of such a company, of the type referred to in that sub-paragraph; and
 - (ii) intermediate holding companies between the parent company concerned and a company meeting the criteria set out in sub-paragraph (b)(i) provided that such intermediate holding companies:

3) Offshore transmission owner – Condition E8: Availability of Resources

We have corrected the paragraph referencing shown in highlight below:

- 7. Where a certificate under paragraph 6 is to be submitted within 7 days of the date that this condition comes into effect , paragraphs 6(a), 6(b) and 6(c) have effect....
- 9. ~~Subject to paragraph 2, the~~ The licensee must within 7 days of the date that this condition comes into effect and then by 31 July in each subsequent calendar year,....
- 10. The licensee must inform the Authority in writing immediately if:
 - (a) the directors of the licensee become aware of any circumstance that causes them no longer to have the reasonable expectations expressed in the most recent certificate given under paragraph 2(a), 2(b), 6(a) or 6(b); or
 - (b) the directors of the licensee consider that any adverse circumstances that caused them to give the Authority a certificate in form of Certificate 3F

under paragraph 2(c) or Certificate 3R under paragraph 6(c) have materially worsened.

14. The licensee need not give the Authority a certificate of the type referred to in paragraph 11 in circumstances where:
- (a) during the three months preceding the declaration or recommendation of a dividend, the making of any other form of distribution or the redemption or repurchase of share capital, it has given the Authority a certificate in the form of Certificate 1C under the requirement set out in paragraph 9 of this condition; and
 - (b) that certificate includes an appropriate addendum using the wording given at paragraph 12(b) of this condition.

4) Offshore transmission owner – Condition E10: Indebtedness

We have corrected the paragraph referencing shown in highlight below:

7. The circumstance described by this paragraph is that the licensee has:
- (a) given the Authority a certificate in the form of Certificate 3F under the requirement set out in paragraph 2 of standard condition E8 (Availability of resources) and has not subsequently given the Authority a certificate in the form of Certificate 1F or Certificate 2F as set out in the same condition; or
 - (b) given the Authority a certificate in the form of Certificate 3R under the requirement set out in paragraph 6 of standard condition E8 (Availability of resources) and:
 - (i) the opinion expressed in the certificate arises in whole or in part from circumstances affecting an associate of the licensee, and
 - (ii) the licensee has not subsequently given the Authority a certificate in the form of Certificate 1R or Certificate 2R as set out in the same condition;
- or
- (c) informed the Authority of any circumstance of the type referred to at paragraph 10 of standard condition E8 (Availability of resources)