CE Electric UK

REVIEW OF THE 'RING FENCE' CONDITIONS IN NETWORK OPERATOR LICENCES

THE RESPONSE TO OFGEM'S CONSULTATION PAPER FROM CE ELECTRIC UK FUNDING COMPANY

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SUMMARY

1 We agree that the overall objective of Ofgem's review should be that the ring fence conditions are as robust as possible in light of lessons learned from the recent financial crisis.

2 The intention of the ring fence should not be to eliminate the possibility of financial failure of a network company. Such an unqualified protection would be neither desirable nor achievable within the broader regulatory framework.

3 The inherent limitations on the smooth operation of the special administration regime need to be recognised and this implies a policy response that would prevent licensees from adopting highly risky financial or operating structures.

4 Ofgem's analysis and its proposals for change treat the ring fence conditions primarily as an aspect of the special administration regime, whereas these conditions originated before Ofgem had acquired the power to secure the continued use of the assets of an insolvent licensee. Indeed, the Monopolies and Mergers Commission (MMC) concluded that, even without a special administration regime, the ring-fencing arrangements were perfectly adequate.

5 It is neither possible nor would it be desirable for Ofgem to secure changes to the ring-fencing arrangements that would guarantee a problem-free continuity of service in the event of a licensee's insolvency.

6 Ofgem is misguided in supposing that changes to the composition of the licensee's board would strengthen the ring fence. Executive and non-executive directors have precisely the same responsibilities in law. Ofgem has no reason to suppose that the presence of a majority of non-executive directors on the boards of licensees would mean that the boards would focus more on the integrity of the regulatory regime than upon the interests of the owners of the company or, in times of impending financial failure, the creditors.

7 Northern Electric Distribution Limited (NEDL) and Yorkshire Electricity Distribution plc (YEDL) each have an independent non-executive director whose remit includes compliance with the regulatory regime (with special reference to the ring fence). These arrangements are preferable to the stipulations in the water sector that are aimed at preventing the company from taking its instruction from a parent company or controlling shareholder at any time.

8 Any proposals that would require the licensee to conduct its business independently of any controlling shareholder would be unacceptable to our shareholder.

9 The direct involvement of the shareholder in the affairs of a network operator subsidiary has brought benefits for customers. It should be welcomed rather than discouraged or prohibited.

10 Ofgem's proposals to enhance the provisions that aim to ensure that cash remains in the licensee when the licensee may be on the verge of financial difficulties are misconceived and might trigger the sequence of events that Ofgem is concerned to prevent.

11 Ofgem makes a very good case for the extension of the annual availability of resources certificates.

12 Ofgem's discussion of the problems associated with resource adequacy statements that are inaccurate or out of date neglects the important sanctions available under the criminal law that apply to individuals as well as to corporate persons.

13 Ofgem's suggestion that the restriction on granting security/charges incorporated in the disposal of relevant assets licence condition should be extended to cover the licensee's debtors, both trade debtors and other debtors (without retrospection) is too restrictive and could prevent a licensee from efficiently funding its licensed activities.

14 Any use of the special administration regime is likely to increase investors' perceptions of risk and would therefore lead to an increase in the cost of capital in the sector. For this reason it should be used as a last resort.

15 We do not think that ultimate controller undertakings should be resubmitted at specified intervals, but the requirement to certify to Ofgem that the licensee is in compliance in all material respects with the ring-fencing conditions of the licence, including those relating to the ultimate controller undertakings, that presently applies at the time dividends are declared could be made an annual obligation.

16 Ofgem should be more concerned about the capital structures of the licensees and the holding companies that depend upon them. Highly geared capital structures are more likely to fail and, where there is only a thin slice of equity, there is a greater risk of financial distress that may affect the licensee. Ofgem should give further attention to the specification of appropriate capital structures of network companies.

17 Ofgem's proposals appear to reflect the view that it would be no bad thing if a network operator, especially an inefficient one, became insolvent. We appreciate the reasons for this, but we think the emphasis is wrong and that it is contrary to the statutory duties placed upon the Gas and Electricity Markets Authority (the Authority). Instead, we would urge Ofgem to concentrate on prevention. Such an approach would indeed have the benefit of fostering confidence in the financial and operational stability of network

operators and would be likely to be regarded as ‘credit enhancing’ by the credit-rating agencies. In contrast, a focus on dealing with a default may suggest that the bondholders’ interests will not be a major consideration for the regulator and, therefore, may not be viewed as credit supportive.

INTRODUCTION

1 CE Electric UK Funding Company (CE) is the UK-based parent company of the electricity distribution licence holders Northern Electric Distribution Ltd (NEDL) and Yorkshire Electricity Distribution plc (YEDL). This paper is the response of CE, NEDL and YEDL to the *Review of the 'Ring Fence' Conditions in Network Operator Licences* (referred to throughout this response as the *Consultation paper*).

2 In preparing this response we have chosen to provide answers to the numbered questions set out in each chapter of the *Consultation paper*. The chapter headings and the numbered questions (reproduced in boxes in this response) are taken directly from the *Consultation paper.*

CHAPTER 1 - INTRODUCTION AND OBJECTIVES

> **Question 1**: Do you think we have identified the relevant objectives in our review of the ring fence? If not what other objectives should we consider?

3 We agree that Ofgem has identified the relevant objectives in its review of the ring fence. We agree that the overall objective of Ofgem's review should be that the ring fence conditions are as robust as reasonably possible in light of lessons learned from the recent financial crisis. We also agree with Ofgem's overall objective to minimise any impact on the freedom of network operators to organise and finance their businesses efficiently and in a way that provides the best levels of service to their customers. However, we would attach less importance to this consideration than Ofgem appears to do. The inherent limitations on the smooth operation of the special administration regime need to be recognised and, in our view, this implies a policy response that would prevent licensees from adopting highly risky financial or operating structures.

4 We note Ofgem's statement that the intention of the review of the existing arrangements is not 'to eliminate the possibility of financial failure of a network company' and we agree that such an unqualified protection would be neither desirable nor achievable within the broader regulatory framework. However, as we shall explain below, we believe that Ofgem's focus in the *Consultation paper* is disproportionately directed towards the effectiveness of the regulatory regime once a licensee, or a group that includes the licensee, is experiencing financial difficulties. There is in our view merit in focussing on the preventative aspects of the existing ring fence so that Ofgem minimises the risk that a licensee will experience such difficulties rather than concentrating on the role that the ring fence can play at, or immediately before, the point where the special administration regime is applied.

CHAPTER 2 – THE EXISTING RING FENCE AND ISSUES ARISING

Question 1: Have we identified the key risks associated with any limitations of the existing ring fence conditions?

5 Ofgem describes the regulatory approach to managing risk and financial distress as one of 'defence in depth'. The broad objectives of the regime are described at paragraph 2.1 of the *Consultation* paper as follows:

> '• Preventing the onset of financial distress by imposing a range of regulatory requirements to back up the corporate governance arrangements put in place by the managers and owners of NWOs,[1]
>
> • Providing warning signals when symptoms of financial distress appear or potential threats are identified,
>
> • Mitigating the severity and impact of financial distress factors should they arise and reducing any "chain reaction" of adverse financial events, and
>
> • Facilitating price control reopener measures or the special administration process where these are warranted.'

6 In figure 2.1 of the *Consultation paper* Ofgem summarises the ring fence conditions and their underlying purpose. Our only comment on this tabulation is to point out that the licence condition relating to the credit rating of the licensee also performs the function of giving the regulator early warning of impending difficulties.

7 The *Consultation paper* shows little awareness of the origins of the ring fence conditions. An appreciation of the history is relevant to Ofgem's consideration of the ring fence conditions today. The original ring fence arrangements were developed initially as a result of the Trafalgar House bid for Northern Electric plc in December 1994. These conditions derived from the assurances given by Trafalgar House about the changes that it would accept in the public electricity supply (PES) licence of Northern Electric plc once the bidder had assumed control of the licensee. As events turned out, Trafalgar House did not acquire Northern Electric plc, but the model of the ring fence survived and was applied in later acquisitions of RECs. The licence modifications fell into the following categories:

- non-diversification and financial ring-fencing;

[1] i.e. network operator companies.

- availability of resources;
- asset disposals and intra-group transfers; and
- provision of information.

8 The MMC considered the effectiveness of the ring-fencing arrangements in its report *PacifiCorp and The Energy Group plc* in 1997, concluding that:

> 'In our view, the existing controls and the amendments we expect to be included in the licence as regards cross-default and investment grade credit ratings are sufficient to contain the risk that Eastern Electricity will be adversely affected by financial pressures resulting from the structure of the acquisition and to secure the availability of adequate financial resources to Eastern Electricity. In our judgement, the DGES will be in a position to ensure that investment and service standards can be maintained, without higher prices resulting from the merger.'[2]

9 At this point in history the RECs had different ring-fencing conditions that arose from the timing of acquisitions and dealt with the particular concerns that were expressed in respect of each acquisition. The position was regularised in 2001 when the standard electricity distribution licences were issued and the same ring fence conditions were applied to all electricity distribution licence holders.

10 The MMC endorsed the ring-fencing arrangements after very full consideration of these issues in 1997. It is significant that this endorsement was given prior to the change brought about by the Energy Act 2004 that introduced the special administration regime. This is important because the *Consultation paper* treats the ring fence condition as an adjunct to the special administration regime and it focuses on what changes are necessary to improve the likelihood that that regime would operate smoothly. In fact, the ring fence conditions were conceived for a world in which there was no special administration process available to Ofgem. Thus, before Ofgem had acquired the power to secure the continued use of the assets of an insolvent licensee, the MMC had concluded that the ring-fencing arrangements were perfectly adequate.

11 The ring fence has worked well in practice to protect the finances of the licensee where a parent has become financially stressed. Aquila Energy Partners Holdings, the holding company for Midlands Electricity, got into difficulties in 2002 but the ring fencing provisions enabled the regulated business to access capital markets and retain its investment grade rating, while it was being sold as a going concern. In that case Ofgem introduced a bespoke cash lock-up provision (i.e. restricting the ability of the licensee

[2] *Ibid.*, paragraph 2.76.

to pay dividends or make other distributions). In the light of this episode, in 2005, Ofgem added cash lock-up provisions to the licence conditions of all gas and electricity distribution businesses and announced its intention to introduce similar conditions in all other gas and electricity network licences. The ring fence in the water sector similarly enabled Wessex Water to survive the insolvency of its parent Enron. The track record of the existing ring-fencing provisions is one of success, albeit in a limited number of cases.[3]

12 It appears from the *Consultation paper* that Ofgem has conducted a thorough review and stress testing of the existing ring fence conditions and has identified a number of concerns about the smooth operation of the special administration regime. Taken together with the recent *RPI-X@20 Emerging Thinking* consultation papers we have serious concerns about Ofgem's approach to the ring fence. The thrust of the policy changes that are being contemplated is to make it easier for Ofgem to deal with the consequences of a licensee's default rather than to exercise its functions so that such a default is unlikely to occur. That shift in emphasis is in our view ill-advised. We believe it to be neither possible nor desirable for Ofgem to secure changes to the ring-fencing arrangements that would guarantee a problem-free continuity of service in the event of a licensee's insolvency. Ofgem has itself identified many of the obstacles to this in the *Consultation paper* and the remedies that it proposes would not deal with the extreme scenarios.

13 By contrast, those aspects of the policy direction indicated in the consultation paper that aim to give Ofgem greater confidence in the continuing financial health and regulatory integrity of the licensee may be worth implementing. The Authority has a duty to carry out its functions under the Electricity Act in the manner best calculated to further the principal objective of protecting the interests of consumers having regard to the need to 'secure' that licence holders are able to finance their licensed activities. This general duty should steer Ofgem towards ensuring the financial health of licensees rather than towards equipping Ofgem with an enhanced ability to clear up the mess that would result if a licensee became insolvent. An emphasis on prevention rather than cure would be likely to be viewed as credit supportive by the credit-rating agencies. In contrast, a focus on how to deal with a default may suggest to the rating agencies that the bondholders' interests will not be a major consideration for the regulator and, therefore, may not be viewed as credit supportive.

14 Accordingly, we are not averse to Ofgem's proposals that deal with the problems identified in the *Consultation paper* relating to:

[3] We are advised by our parent company that in the USA examples of the successful use of the ring fence include Portland General Electric as a member of the Enron group. In that case the ring-fencing provisions were relatively limited in their scope, but nevertheless effective.

- the lack of focus on operational risks; and
- the limited early warning role

provided by the current ring-fencing conditions. However, Ofgem's rationale for dealing with the weaknesses that it perceives to be present in the indebtedness and transfer of funds restrictions is indicative of our concerns with the policy approach that is signalled in the *Consultation paper*. At paragraph 2.17 of the *Consultation paper* Ofgem states that:

> 'The purpose of these restrictions [i.e. relating to indebtedness and transfer of funds] is to ensure that in the event of financial distress an energy administrator would have access to the essential assets and funds necessary to ensure continuance of operations.'

15 This may now be one potential benefit of the restrictions on indebtedness and transfer of funds, but it was never the principal purpose of these constraints. Indeed, when these conditions were first imposed on licensees there was no special administration regime available for energy network companies. The true principal purpose of these restrictions was, and should still be, to ensure that the licensee uses regulated revenues in pursuit of its regulated activities and that cash does not leave the licensed entity except in the form of dividends payable out of distributable reserves, payment for goods or services provided, or for a limited number of other very narrowly constrained purposes. By placing restrictions on the use of funds *at all times* the ring fence conditions of the licence are directed towards the proper goal of ensuring the continuing financial health of the licensee. Ofgem should regard these conditions as helping to prevent a regulator from needing to use the arrangements for which provision is made in the special administration regime rather than, primarily, restrictions that will enable it to use that regime effectively.

16 At paragraph 2.21 Ofgem states, correctly, that it is able to issue financial penalties against network operators for breaches of the licence, including breaches of the conditions that are part of the financial ring fence. Ofgem then goes on to observe that financial penalties against a company may not act as a significant deterrent for directors who 'face pressure from their parent company during a period of deteriorating financial health'. No doubt directors may face pressure of this kind in the circumstances that Ofgem is describing: however, Ofgem's policy response to this 'problem' is misconceived. We deal with this in our response to the questions posed in Chapter 3 of the *Consultation paper*.

CHAPTER 3 – OUR PREFERRED APPROACH

Question 1: Do you think we have set out enhancements to the ring fence regime that mean it would meet the identified objectives going forward?

17 The policy objective set out in paragraph 3.1 of the *Consultation paper* is to improve the protection the ring fence conditions provide to consumers and to promote the financial and operational stability of network operators. This objective is sensible. Some of the 'enhancements' that Ofgem is proposing might improve the protection offered by the ring fence but other proposals would impact negatively on the financial stability of network operators and would be detrimental to the regulatory regime as a whole and would not be in the long-term interests of consumers.

Question 2: Do you think our preferred approach places the right emphasis on the responsibilities of NWO directors and managers?

Question 4: Do you agree that NWOs should be required to have a majority of independent directors or should the requirement refer to a minimum number? Should any licensees be exempted from such a requirement?

18 We have taken questions 2 and 4 together because they both relate to the role of directors with respect to the ring fence. Ofgem's analysis of the problem identified in paragraph 2.21 that financial penalties against a company may not act as a significant deterrent for directors who face pressure from their parent company during a period of deteriorating financial health is muddled.

19 Ofgem states that there is at present no licence requirement for network operators to have any 'independent directors' on their boards. Ofgem appears to suppose that there is something undesirable about a situation where:

> 'The directors of the licensed entity are often managers within a wider corporate group and may routinely work to implement objectives and strategies set by more senior corporate managers. None of the licensed entities are themselves listed companies. Consequently they are not subject to the Combined Code on Corporate Governance.'

20 Ofgem then proceeds to examine the 'problem' using the language of 'conflicts of interest'. It concludes with the following statement:

> 'Independent non-executive directors may be better placed to challenge any management decisions that prejudice the interests or conflict with the

obligations of the particular company on whose board they sit, particularly at times of exigency. It is important to note from high profile corporate failures, however, that independent directors have not always been able to spot or prevent financial predicaments. Their influence should nonetheless enhance the overall efficacy of the ring fence regime.'

Ofgem's analysis is confused and the policy response is, therefore, misconceived.

21 A proper understanding must be based on a true representation of the role of a director of *any* company. Section 172 of the Companies Act 2006 sets out the relevant duty:

'(1) A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

(a) the likely consequences of any decision in the long term,

(b) the interests of the company's employees,

(c) the need to foster the company's business relationships with suppliers, customers and others,

(d) the impact of the company's operations on the community and the environment,

(e) the desirability of the company maintaining a reputation for high standards of business conduct, and

(f) the need to act fairly as between members of the company.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interest of creditors of the company.'

22 The duty placed on directors by company law to act in the way that promotes the success of the company for the benefit of its members as a whole applies to directors whether they are directors of holding companies or subsidiaries and applies irrespective of whether the company is a listed company. The duty is owed *to* the members of the

company and, except in cases of impending insolvency (where the director owes a duty to the creditors), the director does not owe any duty to any other body and neither has he any obligation to promote other interests.

23 Executive and non-executive directors have precisely the same responsibilities in law and, therefore, potentially the same liabilities for their actions. The concept of the role of a non-executive director has evolved to be one where such a director is seen as being in place to help ensure that the board fulfils its main objectives. However, the board of directors acts as a whole and, although some of its members may be given additional powers by the Articles of Association or by resolution, the general and statutory duties and responsibilities are the same for each director. There is no distinction in law between the position of executive and non-executive directors.

24 The role of non-executive directors has received considerable attention in recent years.[4] The Higgs Review made the following observation:

> 'Executive and non-executive directors have the same general legal duties to the company. However, as the non-executive directors do not report to the Chief Executive and are not involved in the day-to-day running of the business, they can bring fresh perspective and contribute more objectively in supporting, as well as constructively challenging and monitoring, the management team.'

25 This view saw the non-executive director, therefore, as an independent check upon the possibility of a conflict of interest arising in relation to directors who owe their first duty to the members of the company as a whole but who may also have interests as managers of the company. In other words, the non-executive director is a useful means by which to deal with the problem of 'agency' and to ensure that the board of directors acts appropriately in fulfilment of its duties to the members.

26 It is understandable that the media should be a little confused, sometimes portraying non-executive directors as having duties to groups that are perceived to be more worthy than mere shareholders or creditors. Perhaps this error stems from the fact that non-executive directors often have a role in remuneration committees, which may lead some to suppose that in discharging that role they are performing a duty to society as a whole rather than a duty to the shareholders in the company. Nothing could be further from the truth. The duty of the non-executive director is the same as that of the executive director; that is, to act in good faith to ensure that the management of the company and its board are more accountable to the members of that company for the conduct of the company for the benefit of its members as a whole. The non-executive director simply

[4] See especially: *Financial Aspects of Corporate Governanc*e (1992); (the Cadbury report); the *Greenbury Report* (1995); and *Review of the Role and Effectiveness of Non-Executive Directors* (2003) (the Higgs Review).

provides a different perspective on, or brings a different expertise to, the exercise of that duty.

27 Although it may be understandable that the fundamental purpose and *raison d'être* of a non-executive director are often misunderstood in the media, Ofgem should proceed on the basis of a more informed understanding. Any non-executive directors appointed to the boards of network operating companies would still owe their primary duty to the members as a whole under the statutory provisions of the Companies Act noted above. Ofgem should not suppose that the presence of non-executive directors would place more emphasis on the integrity of the regulatory regime than on their statutory duty to promote the success of the company for the benefit of the members of the company as a whole or, in times of impending financial failure, the creditors under the regime provided by the Insolvency Act.

28 Moreover, unless the terms of the appointment of the non-executive directors were entrenched, the non-executive directors could simply be removed by the action of the shareholders in general meeting. It follows that a requirement to appoint independent non-executive directors to the boards of licensee companies would interfere with the property rights of the shareholder during the ordinary course of events without offering any protection at times of financial stress.

29 We note that Ofgem's advisors, CEPA, have reached a similar conclusion to our own about the absence of any real benefits that would flow from such requirements.[5]

30 Ofgem's view that non-executive directors as a class would be more likely to observe the ring fence lacks any underlying rationale. *All* directors, whether executive or non-executive, must recognise the importance of complying with the requirements of the licence and the statute because failure to do so would not generally be in the interests of the members. However, it remains the case that a director has the overriding statutory duty to promote the success of the company for the benefit of its members as a whole.

31 Independent non-executive directors are not unknown on the boards of wholly-owned subsidiaries; indeed CE, NEDL and YEDL each have an independent director whose remit is described below. However, the reason why the literature relating to non-executive directors is primarily concerned with the operation of the boards of directors of companies that are not subsidiaries is because that is principally where the potential conflict between the interests of management and the interests of shareholders can arise. This is rather fundamental. Where a network operator is a subsidiary of another company it is very easy indeed for that other company to make clear to the subsidiary what its interests are and how the subsidiary should serve its interests. Ofgem's prescription is based on the premiss that appointing a majority of non-executive

[5] CEPA, *Assessment of Ofgem's Financial Ring Fence Conditions: A Report for Ofgem*, October 2009, p62.

directors to the boards of the subsidiary licensee companies would be desirable precisely because it would inhibit the ability of the shareholder to exercise influence or control over the subsidiary. This is to borrow from the literature on corporate governance, which is about *ensuring* that the interests of shareholders and the company are aligned, and to turn it on its head to try to *prevent* the shareholder from making that influence felt. This is neither possible nor desirable, particularly given the nature of the statutory duties to which a director is subject.

32 Ofgem's analysis is therefore misconceived and its policy prescription could not work to achieve the purpose that Ofgem has in mind. The directors, whether non-executive or executive, of a licensee company owe their primary responsibility to the members. In other words, if the non-executive directors of a subsidiary discharge their duties conscientiously they will do their absolute best to ascertain what the shareholder wants and do all that they can to achieve this within the limits of the law. CEPA seem to understand this point:

> 'UK corporate law also places restrictions on the actions of directors of [Protected Energy Companies], who must act in the interests of their own company. However, in the case of wholly owned subsidiaries in particular, this may not provide any practical limitation on directors acting only in the interests of their Ultimate Controller (where there is only one shareholder), rather than the company because [of] the duty of directors towards the interests of its shareholders (where there are two or more shareholders the interest of the company and its shareholders may be different). Even where insolvency is imminent and the duty of Directors switches to the interests of creditors, it could also mean that related parties get repaid.'[6]

33 Great as the powers of Ofgem are it does not have the ability to change company law in the UK. If Ofgem really has a problem with directors of subsidiary companies behaving in the interests of the members (rather than as Ofgem would appear to wish them to) this implies a problem with the model of a profit-seeking company pursuing the interests of its shareholders within the limits of the law. If *that* is what Ofgem objects to, then the remedy is not to try to introduce rules that would require non-executive directors to outnumber executive directors in network operator companies, but to move to a different model of ownership altogether, such as the Scottish Water, Glas Cymru or Network Rail approaches to the provision of regulated services. We do not believe that this is Ofgem's preferred ownership model.

34 Following the acquisition of Northern Electric plc by CE Electric UK Limited in 1996 an independent non-executive director, with special terms of reference, was appointed

[6] *Ibid.*, p21.

to the board of the licensee. We have benefited from these arrangements since that date and, indeed, our owner chose to accept a recommendation from the President and Chief Operating Officer of CE to extend the role of the independent director so that he now also serves as a director of YEDL. There are a number of observations that we would make about these arrangements:

- In our case the independent director (Mr Ron Dixon) is a former employee and current pensioner of Northern Electric plc and he would therefore not satisfy the test of 'independence' proposed in the *Consultation paper*.

- Mr Dixon has terms of reference that give him a special responsibility for overseeing compliance by the licensee companies with their licence obligations and the undertakings pertaining to the ring fence.

- Mr Dixon has special voting powers with respect to certain 'reserved matters' that he is to exercise so as to ensure that the company's debt maintains an investment grade rating.

- The reserved matters in respect of which Mr Dixon's specific approval is required encompass the following:

    a) provision of any guarantees, indemnities, loans or other forms of financial or credit support in favour of a shareholder or any of the shareholder's affiliates;

    b) any resolution providing for the liquidation or winding up of the company;

    c) engagement in any material business or activity other than the business and activities engaged in by the company at the date of his appointment;

    d) any merger or consolidation of the company, or the transfer, lease or other disposition of assets above a threshold of £25 million;

    e) the purchase or redemption of any equity interest in the company or any securities convertible into or exchangeable for such equity interest;

    f) the incurring of debt, or the entering into of a contractual commitment, other than in the ordinary course if the principal amount of such debt or amount of contractual commitment would exceed £25 million;

    g) any adoption of or material modification to any dividend or distribution policy other than pursuant to existing financing documents or ratings agency requirements; and

h) the entering into of any material transaction or agreement between the company and its shareholders or affiliates.

35 The presence of an independent non-executive director with Ron Dixon's experience and terms of reference was regarded as useful by the providers of debt finance who, we understand, attached importance to the integrity of the regulatory ring fence. Rather than introduce requirements that would preclude someone with Mr Dixon's experience from fulfilling this role and, indeed, look to introduce requirements that the majority of directors of the licensed entity should be 'independent' (within the meaning of the Combined Code on Corporate Governance), we would commend the arrangements that our shareholder has voluntarily applied for more than a decade.

36 The proposal to introduce a requirement that boards of network operators have a majority of non-executive directors also risks creating an environment where those boards are too large and find decision-making difficult and time-consuming. Indeed, the Combined Code includes the principle that

> 'The board should not be so large as to be unwieldy. The board should be of sufficient size that the balance of skills and experience is appropriate for the requirements of the business ...'.

The current boards of NEDL and YEDL each have five directors providing the appropriate level of expertise to run the company effectively and efficiently and, therefore, are in line with that principle of the Combined Code.

37 By contrast, at paragraph 3.23 of the *Consultation paper*, Ofgem makes reference to the requirement placed on the holders of Appointments in the water sector to have a majority of independent directors on their boards. We understand that such provisions do not apply to all Appointees but we have examined the terms of the Northumbrian Water Appointment that includes the following provision:

> 'The Appointee shall, at all times, conduct the Appointed Business as if it were substantially the Appointee's sole business and the Appointee were a separate public limited company. The Appointee should have particular regard to the following in the application of this Condition:
>
> (a) the composition of the Board of the Appointee should be such that the directors, acting as such, act independently of the parent company or controlling shareholder,
>
> (b) the Appointee must ensure that each of its directors must disclose, to the Appointee and the Director, conflicts between duties of the directors as directors of the Appointee and other duties;

(c) where potential conflicts exist between the interests of the Appointee as a water and sewerage undertaker and those of other Group Companies, the Appointee and its directors must ensure that, in acting as directors of the Appointee, they should have regard exclusively to the interests of the Appointee as a water and sewerage undertaker;

(d) no director of the Appointee should vote on any contract or arrangement or any other proposal in which he has an interest by virtue of other directorships. This arrangement should be reflected in the Articles of Associate [sic] of the Appointee;

(e) the Appointee should inform the Director without delay when:

(i) a new director is appointed;

(ii) the resignation or removal of a director takes effect; or

(iii) any important change in the functions or executive responsibilities of a director occurs.'

38 There is a further provision to the effect that the board of directors of the Appointee must contain no fewer than three independent non-executive directors:

> 'who shall be persons of standing with relevant experience and who shall collectively have connections with and knowledge of the areas within which the Appointee provides water services and an understanding of the interests of the customers of the Appointee and how these can be respected and protected.'

39 We are unable to comment on how effectively these provisions work in the water sector but their purpose is clear. They are aimed at preventing the water company from taking its instruction from a parent company or controlling shareholder not just at times of financial stress, but at all times.

40 We have consulted with our own shareholder and we can confirm that it is very strongly opposed to any such provisions being introduced into the electricity distribution licence and would regard this as a serious infringement of its rights. The shareholder acquired NEDL and YEDL on the basis that these companies would operate as wholly-owned subsidiaries of the shareholder. At the time it made these acquisitions it expected, and it continues to expect, to be able to run those licensee companies in the ways that it considers to be appropriate, always of course acting within the constraints of the law and observing the requirements of the regulatory regime. Our shareholder finds it very difficult to understand that Ofgem might be

contemplating licence modifications that would be specifically designed to prevent it from controlling the activities of its subsidiaries. This comes perilously close to what is called in the USA a 'regulatory taking' without compensation. It is not clear why anyone would invest in the acquisition of a wholly-owned subsidiary, or continue to deploy capital in that business, if it could not take an active part in ensuring that the company was run in its own best interests. Furthermore, we believe that Ofgem has valued the direct engagement that our shareholder has brought to the conduct of the licensed activities of NEDL and YEDL. We feel sure that Ofgem would not therefore wish to follow this example from the water sector.

41 Moreover, where a holding company owns more than one licensee (as is the case with CE), under Ofgem's proposals CE would not be able to run those licensees as a single efficient operation because the directors of each licensee company would have to ensure that the company operated independently of any affiliates and free from the interference of the shareholder. It is precisely the presence of a common controlling shareholder (i.e. CE) that has enabled NEDL and YEDL to be run as a single efficient operation.

42 Moreover, we are not sure about the legitimacy or efficacy of a provision that is based on the premiss that, through the '*composition*' of the board of directors, the regulatory regime can prevent the company from acting in accordance with the wishes of the parent company or the controlling shareholder. As far as we can see the *composition* of the board of directors should have no bearing upon the duties of the directors in relation to its members. However, even if the provision is based upon a legal *non-sequitur*, it is still undesirable because it clearly interferes with the long-established and unfettered right of shareholders to determine the constitution of the company and the composition of the board of directors. Indeed, in that respect, all directors must comply with the company's constitution (its articles of association) and only exercise their powers for the purposes for which they were conferred. The rules enshrined in the articles are decided by the shareholders.

43 The provision in the water regime that requires that three independent non-executive directors shall be persons of standing with relevant experience and have connections and knowledge of the area served by the appointee suggests that Ofwat subscribes to a stakeholder model of the regulated firm. Stipulations of this kind may just be window dressing, but if they have any effect they will make the mistake of introducing a confusion of objectives into the British system of incentive regulation. The regulatory framework established at privatisation was based on the assumption that the privatised firms would behave like any other companies. Thus, Catherine Waddams Price observed:

> 'The fundamental model was of a text book profit-maximising company supplying a commodity just like any other, responding to market forces where these existed and constrained by regulation where they did not.'[7]

44 Originated by Stephen Littlechild and Michael Beesley[8], the RPI-X approach paid no heed to the softer notions of the stakeholder model of the firm and, indeed, it was assumed that one of the principal virtues of privatisation was that it would replace the confusion of objectives so evident in the practical expression of the Morrisonian nationalisation model with the clarity of the profit-maximising firm.[9] Thus Littlechild wrote:

> 'In a privately owned company, the actions of the decision makers are likely to be orientated towards the maximisation of the stock market value of the company, at least insofar as the shareholders (and potential take-over bidders) are able to exercise control.'[10]

45 Similarly, Philip Booth, Professor of Insurance and Risk Management at Sir John Cass Business School, City University, makes the observation:

> 'If corporations that use the property of shareholders find that they have to be accountable to a range of different interests, the security of property is undermined fundamentally. Also, if the corporation is accountable to a range of groups whose legal interest cannot possibly be defined the corporation is, in reality, accountable to nobody. This is a licence for management to pursue its own objectives.[11]

46 Ofgem should reflect upon the benefits of clarity of purpose advanced by the authorities that we have cited in this response. The direct involvement of the shareholder in the affairs of a network operator subsidiary should be welcomed rather than discouraged or prohibited. We conclude that there is nothing to be gained and much to be lost from the kind of change that Ofgem is contemplating.

Question 3: What are your views on the changes we have suggested to the various ring fence conditions? What additional costs might they impose on licensees?

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[7] Catherine Waddams Price, 'Gas: Regulatory response to Social Needs', in *Regulating Utilities: New Issues, New Solutions,* p166.
[8] See especially, *Regulation of British Telecommunications' Profitability: A Report by Stephen C Littlechild, Professor of Commerce, University of Birmingham* (February, 1983).
[9] CD Foster, *Privatisation, public ownership and the regulation of natural monopoly,* 1992 pp 92, 236, 237 and 242.
[10] *Ibid*., p16.
[11] *Ibid*., p11.

47 Ofgem's proposed approach is summarised in Box 1 at paragraph 3.6 of the *Consultation paper*. Our views on each of the proposals are set out below:

(a) *Strengthening of the cash lock up provision under the restriction of indebtedness by increasing the likelihood that the mechanism is triggered at a sufficiently early stage. This would be done by widening the trigger for lock up.*

48 The current cash lock-up arrangements for electricity distributors are triggered when any of the circumstances set out in part C of Standard Condition 41 of the electricity distribution licence occurs, namely:

- the licensee does not hold an Investment Grade Issuer Credit Rating;
- the licensee holds more than one Issuer Credit Rating and one or more of the ratings so held is not Investment Grade; or
- the licensee holds the lowest grade of rating that is an Investment Grade Credit Rating but the rating is under review for possible downgrade, or the licensee is on negative credit watch.

49 Ofgem correctly notes that the cash lock-up restrictions are intended to prevent any plundering of a network operator's cash flow by a related party facing financial difficulties and that, since the lock-up takes effect if the credit rating is under review for possible downgrade to speculative grade, it is to some extent forward looking. At paragraph 3.20 of the *Consultation paper* Ofgem sets out its proposals to introduce two additional triggers alongside the existing credit-rating trigger. The cash lock-up provision would also be triggered by:

- any report by the licensee of adverse circumstances under the availability of resources condition; and
- any breach of a formal financial covenant entered into by the licensee or any renegotiation of such a covenant for the purposes of avoiding a breach.

50 Whilst we agree that Ofgem should consider proposals that are designed to ensure that cash is not improperly diverted from the licensee when the licensee may be on the verge of financial difficulties, the proposals that Ofgem is contemplating would be too inflexible and far-reaching. Indeed, the circumstances where a licensee may be renegotiating a covenant to avoid a breach may not indicate any risk about which Ofgem ought to be concerned; for example the breach might be remote, unrelated or trivial. Moreover, imposition of a cash lock-up could trigger the very sequence of events that Ofgem is concerned to prevent. We therefore urge Ofgem to avoid being too prescriptive in this respect. Consequently we propose that Ofgem might construct

an enhanced information provision requirement based upon this trigger, which would enable it to enter discussions with a licensee about its financial circumstances and how it intended to meet all its regulatory obligations (including adequacy of resources) in the near future.

(b) Extension of the annual availability of resources certificate submitted to the Authority to cover operational as well as financial resources. In addition, we would incorporate a requirement to produce and maintain (but not for submission to Ofgem) a formal and up to date record of key financial and contractual arrangements which could be used by an Energy Administrator either to wind up such arrangements or to maintain them as appropriate (a 'living will').

51 Ofgem makes a very good case in the *Consultation paper* for the extension of the annual availability of resources certificates in the way that is proposed here.

(c) Clear sanctions where resource adequacy statements are found to be inaccurate or out of date.

52 The only reference that we can find in the *Consultation paper* to any discussion of the sanctions available to Ofgem where resource adequacy statements are found to be inaccurate or out of date is the very brief discussion that appears at paragraph 3.9 of the *Consultation paper*. However, we have found no recommendations to change the sanctions or specific proposals that would improve the clarity of the sanctions that would apply where resource adequacy statements are found to be inaccurate or out of date.

53 The discussion in the *Consultation paper* is incomplete in two respects. The first is straightforward; a failure to make statements properly required under any condition of the licence would be a breach of the licence and would trigger the remedies that are available to Ofgem when such a breach occurs. These include enforcement powers and financial penalties. Ofgem has published a *Statement of policy with respect to financial penalties* and we can see no obstacle to Ofgem's including in that statement a specific section clarifying the approach it would take where statements upon which the ring fence relies have been found to be inadequate. We recognise, however, the limitations of such an approach because Ofgem's enforcement powers and its ability to impose financial penalties relate to the *licensee*. They do not, and indeed cannot, apply to anyone else. Since the circumstances about which Ofgem is concerned relate to a licensee that is in financial difficulty, the ability to impose financial penalties for a prior breach of the reporting requirements may not be particularly apt to achieve Ofgem's policy objective. The *Consultation paper* might recognise more explicitly the consequences that flow from the fact that Ofgem is legally incapable of applying any sanctions to anyone other than to a licensee. This is important because, with the

exception of Ofgem's power to require information under Section 28 of the Electricity Act 1989 (which applies in respect of 'any person'), Ofgem's powers do not act directly upon any manager or director of the licensee. Moreover, Ofgem cannot do anything to enlarge its powers in this respect without a change to primary legislation.

54 We appreciate that Ofgem could introduce conditions into the licences that would require the *licensee* to take steps to ensure that directors, managers, or those with a controlling interest, provide certain undertakings or behave in a particular way. There are precedents (including in the ring fence provisions) for requiring that licensees obtain legally enforceable undertakings, for example, but the important point is that a regulator can only enforce these obligations acting through its enforcement powers over the licensee. Under the current law, if a licensee's directors do not respond to the requirements of the regulatory regime, including the requirements of any enforcement orders that Ofgem might make that require the licensee to take action in accordance with the undertakings that it has received, Ofgem can impose an enforcement order, impose financial penalties or, in the extreme, take steps to revoke the licence. These are important sanctions and there is no reason to suppose that in most situations they will not be effective. This is because all the interests concerned will recognise that compliance with the regulatory regime will generally bring about a more preferable end result than would a continuing breach of the requirements of that regime. However, the circumstances of financial distress of the licensee with which the ring fence is concerned and which the *Consultation paper* is trying to address are the one set of circumstances where Ofgem may not be able to rely upon an alignment between the interests of the owners, directors and managers of the company on the one hand and the interests of the regulatory regime on the other. For this reason we believe that Ofgem would be better advised to look upon the ring fence conditions of the licence as preventative rather than curative.

55 The second observation we would make in this context is that Ofgem's discussion of the problems associated with resource adequacy statements that are inaccurate or out of date fails to mention one of the remedies that is available under the Electricity Act.[12] Section 59(1) of the Electricity Act provides as follows:

> '(1) If any person, in giving any information or making any application under or for the purposes of any provision of this Part, or of any regulations made under this Part, makes any statement which he knows to be false in a material particular, or recklessly makes any statement which is false in a material particular, he shall be liable -

[12] A similar provision applies in the Gas Act.

(a) on summary conviction, to a fine not exceeding the statutory maximum;

(b) on conviction on indictment, to a fine.'

56 Furthermore, section 108 of the same Act [13] provides as follows:

'(1) Where a body corporate is guilty of an offence under this Act and that offence is proved to have been committed with the consent or connivance of, or to be attributable to any neglect on the part of, any director, manager, secretary or other similar officer of the body corporate or any person who was purporting to act in any such capacity he, as well as the body corporate, shall be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

(2) Where the affairs of a body corporate are managed by its members, subsection (1) above shall apply in relation to the acts and defaults of a member in connection with his functions of management as if he were a director of the body corporate'.

57 The resource adequacy statements are provided for the purposes of the licence that is granted under Part 1 of the Electricity Act and we have always supposed that criminal liability would therefore attach to any director, manager, secretary or other similar officer of the licensee who consented to or connived at the provision of a false statement in an adequacy of resources certificate or whose recklessness led to such a false statement being made.

58 Knowingly or recklessly making a false statement under the resources certification regime is therefore already a criminal act and it is surprising to us that Ofgem's discussion of the remedies makes no reference to this. There are relatively few aspects of the regulatory regime where criminal sanctions apply[14] and it is surprising to us that Ofgem seems not to have noted this in its discussion of the issues to which these remedies are clearly pertinent.[15]

[13] Again there is a similar provision in the Gas Act.

[14] Other important duties that are subject to the criminal law include the obligations placed on distributors by the Electricity Safety, Quality and Continuity Regulations 2002 (see regulation 35). Since these Regulations are made under Part 1 of the Electricity Act 1989, by the reasoning set out above, the individual director, manager or similar officer who causes, or through recklessness allows, the offence to be committed is liable to be proceeded against.

[15] By contrast Ofgem's advisors, CEPA, mention the offences relating to the making of false statements. See, CEPA, *op.cit.*, p59.

(d) Extension of the restriction on granting security under the disposal of relevant assets condition to cover current/future revenue streams and other debts held on the licensee's balance sheet (but not retrospectively).

59 Ofgem argues that the restriction on granting security/charges incorporated in the disposal of relevant assets licence condition should be extended to cover the licensee's debtors, both trade debtors and other debtors (for example in respect of loans made by the licensee). Ofgem states that the change would mean that network operators would have to exclude debtors from the terms of fixed or floating charges granted to banks or other creditors. The intended purpose would be that the level of 'free' assets available in the event of special administration would be likely to be higher and the current debtor receipts would be able to be used as working capital by a special administrator.

60 Ofgem's proposals in this respect are too restrictive and could prevent a licensee from efficiently financing the conduct of its licensed activities. The ring fence already makes provision for the use of revenues by the licensee for permitted purposes only and it already requires that the licensee must ensure that it has adequate resources available to it. We do not think that Ofgem has made a case for further restrictions within the ring fence.

(e) We would seek to strengthen and clarify the duties of the board of a licensee suffering financial distress by introducing a requirement for there to be a majority of independent directors and make clear that we would seek penalties against managers who had provided inaccurate or insufficient information to Ofgem through bad faith or through not taking due care.

61 For the reasons set out above we do not believe that Ofgem should introduce a requirement for there to be a majority of 'independent directors', neither do we believe that this would materially change the circumstances that would face Ofgem if a licensee were suffering financial distress. Moreover, when Ofgem says that it would 'make clear that we would seek penalties against managers who had provided inaccurate or insufficient information' we would observe that penalties are a matter for the criminal law and it is not possible to change the criminal law through alterations to the licences of network operators. Enforcement of the criminal law in relation to the making of false statements is a matter for the Secretary of State and the Director of Public Prosecutions by virtue of section 59(3) of the Electricity Act 1989.[16] Ofgem can of course make representations urging that these bodies should institute criminal proceedings against any person who has made a false statement but there are no licence modifications that are possible that, within the state of the existing law, would change that position to give Ofgem a more direct power over the individual.

[16] Again there is a similar provision in the Gas Act.

62 Ofgem asks what additional costs might be imposed on licensees by the proposed approach. Although the administrative arrangements described in the proposals would impose only minor additional costs on licensees, Ofgem's substantive proposals can do nothing other than reduce the attractiveness of the regulatory regime for providers of finance, both debt and equity, and this will find its way into a higher cost of capital.

Question 5: Do you think that ultimate controller undertakings should be re-submitted at periodic intervals?

63 The *Consultation paper* correctly states that the nature of the undertakings given by the ultimate controller is essentially negative, i.e. to refrain from doing things that would cause the licensee to be in breach of its obligations rather than to take any particular steps or to secure a particular outcome from the behaviour of the licensee. The existing certification regime requires the licensee to notify Ofgem if the undertakings cease to be effective and, especially in view of the passive nature of the undertakings, we see no merit in having to renew these on a periodic basis. It is more important that the licensee knows that the ultimate controller has undertaken not to behave in particular ways than it is for the ultimate controller itself to be reminded of this fact, because it is the licensee that will have to enforce that undertaking in any circumstances where it is relevant. The licensee is also under an obligation to report to Ofgem if the undertaking has ceased to be legally enforceable or if its terms have been breached. Furthermore, before making any dividend payment the licensee is required to certify to Ofgem that the licensee is in compliance in all material respects with the ring-fencing conditions of the licence, including those relating to the ultimate controller undertakings. There might be merit in making this an annual reporting requirement as opposed to a reporting requirement that is triggered only when a dividend payment is made, but the focus should remain upon reminding the licensee (rather than the ultimate controller) to be vigilant about the undertaking and we can see no merit in requiring the ultimate controller to renew this on a periodic basis.

Question 6: Do you think that the arrangement of ring fence conditions ought to be consolidated within/across licences?

64 We seen no particular merit in this proposal but neither do we object to it.

Question 7: Do you agree that changes to ring fence requirements should not be retroactive?

65 We agree with Ofgem that none of the changes should have retrospective effect.

Question 8: Do you think that any of the proposals should be varied for different types of licensee, in particular for independent distributors?

66 We see no reason why different classes of distributor should be treated differently for these purposes.

CHAPTER 4 – ALTERNATIVE OPTIONS CONSIDERED

Question 1: Do you agree that these are the other broad options for change which could be considered or do you think there are additional options?

67 Ofgem has examined options ranging from retention of existing provisions, through reforms that would imply a less intrusive approach, to reforms that would be more intrusive. We think that Ofgem has considered most of the sensible options for change (as well as some that are not sensible), but we believe that Ofgem's consideration has been unduly focussed on facilitating the smooth operation of the special administration regime rather than on steps that could be taken to make it less likely that the special administration regime would have to be utilised in the first place.

68 In this respect we wonder whether Ofgem should be more concerned about the capital structures of the licensees and their holding companies than it appears to be. Highly geared capital structures (which were not discouraged at the last electricity distribution price control review) are more likely to fail and, where there is only a thin slice of equity, either in the licensee or in a holding company of the licensee, there is obviously greater risk of financial distress that may affect the licensee. In this respect prevention is better than cure and we recommend that Ofgem gives further attention to the specification of appropriate capital structures as in the financial services sector rather than to maintaining its current *laissez faire* approach to the financing of licensees. We appreciate that the consequence of this would be that Ofgem would become involved in matters that it has traditionally sought to avoid, but many commentators would say that a lesson of the financial crash is that regulators need to be more active with respect to these matters and Ofgem might be well advised to follow the recent change in policy orientation of the Financial Services Authority (FSA). Our reasoning is based on the analysis in Ofgem's *Consultation paper* and the further analysis provided in this response, from which we conclude that none of the changes that Ofgem is contemplating would be adequate to secure a regulatory regime that would be able to deal adequately with all of the possible circumstances of a network company experiencing financial stress.

69 In some ways Ofgem has side-stepped the issue by effectively relying on the credit-rating agencies to comment upon the soundness of the capital structures of the

licensees. The service provided by the credit-rating agencies is not designed to serve an economic regulator's purpose with respect to financeability and we suggest that Ofgem may therefore need to take a more direct interest itself in these matters.

70 CEPA make reference to the provisions in the regulation of Network Rail that place limits on securitised debt as a percentage of the regulatory asset value (RAV) and the limits on total borrowings as a percentage of RAV.[17] The governance and ownership of Network Rail differ from those of the energy network companies, but we would commend a more prescriptive approach to capital structure that effectively guarantees the presence of a worthwhile slice of equity in the network company. The presence of equity would be a much better protection than reliance on the availability of the special administration regime in guarding against the problem of moral hazard to which CEPA rightly draw attention.[18]

71 In addition, we would commend the approach that we have taken whereby *a* non-executive director is appointed to the board of the licensee with terms of reference that give him a special role with respect to regulatory compliance.

> **Question 2**: Do you think we have attached appropriate weight to drawbacks which might be associated with the 'back-stop' measures of price control reopening and special administration?

72 Ofgem has not gone into a lot of detail on either of these processes that are available to the Authority. However, we think the drawbacks associated with price control reopening are well understood in the sector and by commentators. Moreover, it may be difficult to distinguish a price control reopener that is necessary despite the company's operating economically and efficiently from a price control reopener that bails out an inefficient business.

73 The mechanics of the special administration regime are perhaps less well understood and in other parts of the *Consultation paper* Ofgem sets out a number of obstacles that might operate. Clearly, other powerful interests and agencies are in play at such a time and their presence should make Ofgem very wary of believing that this mechanism could work smoothly to achieve the objectives that Ofgem has in mind.

> **Question 3**: Do you think we have attached the right cost/benefit arguments to the less/more intrusive options?

[17] CEPA, o*p.cit.*, pp52-4.
[18] *Ibid*., p24.

74 In its assessment of the costs and benefits associated with the less/more intrusive options, Ofgem has failed to take into account the impact on the cost of capital of its preferred approach. No account is taken of the implications for attracting continued equity investment in circumstances where the owner is prohibited from exercising a controlling interest, and no account is taken of the changed position of creditors where greater reliance is being placed on the special administration regime.

75 Changes to the ring-fencing arrangements that make them a little more intrusive, that would be focussed on early warning and preventative measures, are to be recommended. Changes to the ring-fencing arrangements, whether more or less intrusive than the current arrangements, that have as their purpose the smoother and more effective operation of the special administration regime might be beneficial but we have been unable to see in the Ofgem proposals anything that would materially help Ofgem in those circumstances.

76 Ofgem's advisors point to the consequences of too great a reliance being placed on the use of the special administration regime in terms of the consequential costs for customers:

> 'Compared to 'ordinary' forms of administration, creditors have fewer rights under Energy Administration. Other things being equal, this leads to increased risks for investors, with an associated increase in the cost of capital. This, together with the potential damage to investor confidence and customers from an Energy Administration order means that it should be a last resort, with very low probability of being required.'

We agree with CEPA in this regard.

Question 4: Do you have any comments on the more stringent regulatory possibilities identified in this chapter?

77 In paragraph 4.19 to 4.34 of the *Consultation paper* Ofgem considers a number of more stringent possibilities for augmenting the ring fence. We give brief comments on each of these using the same headings that Ofgem uses in the *Consultation paper*.

Tightening of the cash lock-up

78 We think the discussion of the possible further tightening of the cash lock-up is well balanced and that Ofgem has properly understood that some of the proposals might actually exacerbate a situation of financial distress or might inhibit the efficient operation of a treasury function. However, CEPA's discussion of the issues that could arise where group treasury arrangements are used suggests that this aspect of the ring

fence merits further consideration. At CE we have gone to some lengths to ensure that our corporate treasury arrangements meet the requirements of the ring fence and we believe that our approach substantially addresses the concerns that Ofgem may have. We can provide further details on request.

79 Ofgem has considered whether it should be equipped with a degree of discretion to impose a cash lock-up if circumstances warranted this; for example, if one network operator in a group had lost its credit rating, the cash lock-up could be applied to any other related network operators. We agree with Ofgem that this would introduce a degree of uncertainty and regulatory discretion that would be unhelpful and such a power should not therefore be introduced.

Availability of resources licence condition

80 Ofgem should be concerned that there is a sufficient amount of equity in the capital structures of licensee companies. Ofgem's consideration of this may involve it in looking at matters such as the percentage of debt facilities due to expire within a given time period, although any direct constraint on our freedom in this respect might lead to an increase in our debt costs. We agree with Ofgem that it would be undesirable for the industry regulator to involve itself directly in discussions between network operators and finance providers, but we would not object to Ofgem's discussing network operator issues in general terms with credit rating agencies. Our position in this respect is entirely consistent with the comments that we have made about the need to recognise efficiently incurred embedded debt as part of a long-term stable financing structure.

Financial resource indemnity

81 We do not think it should be necessary for Ofgem to impose cash-in-escrow requirements or the holding of guarantees from highly rated parent companies or an industry-wide rescue fund based on levies. We agree with Ofgem that this would be an expensive way to address the risks that have been identified.

Restrictions on disposal of additional categories of assets

82 We do not think the ring fence should concern itself with assets that lie outside the current definition of 'relevant assets' (which are essentially the assets that comprise the distribution system in the case of an electricity distributor). Ofgem is right that such restrictions would impose serious constraints on organisational management and would bring Ofgem into decisions about operational efficiency that are best left to licensees.

Restriction of activity

83 We see no real merit in proposals to prohibit risky activities by network operators and we do not believe that the sector is plagued by problems to do with speculative derivatives trading. The current ring fence already prohibits the licensee from diversifying beyond its licensed activities. This should be sufficient.

84 Similarly we are aware of no concerns about the network operator sector that suggest that Ofgem should scrutinise director bonus schemes to see whether undue risks are being encouraged. Whilst we would not particularly object if Ofgem merely wished to be assured that this problem was not manifesting itself in the network operator sector, we believe it would not then be long before Ofgem would be drawn into all sorts of aspects of pay and remuneration that are best left to the owners of the company to settle.

Ultimate controllers and boards

85 The suggestion that the undertaking required from ultimate controllers could be made positive – i.e. could be changed to take the form of an undertaking to *take* any actions necessary to ensure that the licensee would not breach any of its licence obligations - would be unacceptable to the companies and individuals that own NEDL and YEDL. The ultimate controller of these two entities is Berkshire Hathaway Inc. and we know that this company has no wish to become involved in the day-to-day supervision or the management of its subsidiaries. Whilst it is acceptable that the ultimate controller is asked to give an undertaking that it will take no action to cause the licensee to breach its licence, it is unacceptable to seek to impose a positive duty upon the ultimate controller to take an active supervisory position. We agree with Ofgem that this should not be implemented.

86 We do not think that there is any merit in any new provisions that would require certain conditions to be met before a change of ownership of a network operator could occur or that would impose restrictions in the event of a change in the ultimate controller. The ring fence arrangements need to be robust irrespective of changes of ownership. Similarly, we do not agree that Ofgem should impose requirements with regard to the qualifications and experience of network operators' boards of directors or that it should become involved in 'suitability' interviews of the kind carried out by the FSA.

General points

87 Ofgem says that it could consider varying the ring-fencing arrangements from one network operator to another based on risk factors. In order to do this we expect that the information provided to Ofgem would have to become more extensive so that Ofgem could make judgements about whether those risk factors applied in the particular case.

We would commend a regime in which the obligations placed on the licensee are clear and where any regulatory discretion relates to the investigation of possible breaches of those obligations and the judgements about enforcement and to the application of financial penalties.

CHAPTER 5 – IMPACTS, COSTS AND BENEFITS

> **Question 1:** Do you agree that the measures suggested in Chapter 3 (Our preferred approach) are proportionate in relation to perceived risks?

88 Our concerns about Ofgem's proposals do not relate to the proportionality of the proposals with respect to the risks. We believe the risks that Ofgem is considering are significant: whatever the likelihood of financial distress may be, the impact, should it occur, could be very large. This makes it appropriate for Ofgem to consider seriously the risks involved and we do not think there is anything disproportionate about the remedies that it is proposing. However, that is not to say that we think the remedies are appropriate or likely to achieve their intended objective.

> **Question 2:** Do you agree that our proposals would be positive for competition in the provision of energy networks and for energy supply markets?

89 We do not agree with Ofgem's statement that its proposals will foster confidence in the financial and operational stability of network operators. On the contrary, we think that Ofgem's proposals are based on the mistaken premiss that it would be no bad thing if a network operator, especially an inefficient one, became insolvent. The approach signalled in the *Consultation paper* is directed at making the special administration regime work more effectively precisely because Ofgem wishes to send a signal that the regulatory regime is not there to ensure the survival of inefficient companies. We appreciate the reasons behind this policy preference but we think it is misdirected and contrary to the statutory duties placed upon the Authority. Instead, we would urge Ofgem to concentrate on prevention; such an approach would indeed have the benefit of fostering confidence in the financial and operational stability of network operators which Ofgem rightly declares to be one of its objectives.