

December 1999

**Electricity Distribution Licences:  
Initial Proposals on Standard Conditions for  
the Financial 'Ring-fence'  
A Consultation Paper**

## Foreword

The Government has confirmed its intention to introduce legislation, in this Parliamentary session, to modernise the framework for utility regulation. Details of the Government's proposals for legislation in respect of gas and electricity were set out, following consultation, in a paper published by the Department of Trade and Industry (DTI) in October 1999<sup>1</sup>.

On 23 November 1999, Ofgem published a consultation paper setting out its proposals for the standard conditions to apply to the separate electricity supply and distribution licences, provision for which is to be made in the forthcoming Utilities Bill. The consultation paper indicated that Ofgem would be consulting separately on the financial ring-fence provisions to be included in the standard conditions.

The Public Electricity Supply (PES) licences of all twelve Regional Electricity Companies (RECs) in England and Wales contain a number of provisions, initially introduced following take-over, that are designed to help ensure that these licence holders can continue to finance their licensed activities. They are also designed to ensure that Ofgem has access to necessary information. These provisions are collectively referred to as the financial 'ring-fence'. Following the report of the Monopolies and Mergers Commission (now the Competition Commission) on the PacifiCorp/The Energy Group merger reference, further licence modifications have been made with a view to standardising the ring-fence conditions of all PES licences in England and Wales.

Each of the PESs in Scotland has given assurances to the Secretary of State in connection with merger clearances inter alia that it will accept standard ring-fence conditions in relation to its monopoly energy network businesses and will undertake a corporate re-organisation to facilitate this. In February 1999, OFFER announced its intention also to propose modifications to NGC's transmission licence to introduce the standard ring-fence conditions. Ofgem is currently reviewing NGC's transmission-business price control and intends to propose modifications to NGC's transmission licence to introduce ring-fence conditions at the same time as the licence is modified to incorporate a new price control. Analogous conditions have been introduced into BG Transco plc's (formerly BG plc) public gas transportation (PGT) licence following its corporate re-organisation<sup>2</sup>.

At present the standard ring-fence conditions relate to both the distribution and supply businesses of PESs (and in some cases also to their generation businesses). The Utilities Bill is expected to provide that holders of the proposed new electricity distribution licences may not also hold electricity supply licences (and

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<sup>1</sup> "A Fair Deal for Consumers, Modernising the Framework for Utility Regulation, The Future of Gas and Electricity Regulation – The Government's Proposals for Legislation" DTI October 1999.

<sup>2</sup> "BG plc Corporate Restructuring Decision Document", Ofgem December 1999.

vice versa). It will therefore be necessary to revise existing ring-fence conditions to take account of this separation. At the same time, it is necessary to consider what conditions might be appropriate to each type of licence in the future.

Ofgem considers that the financial ring-fence licence conditions are most appropriate to operators of monopoly energy networks. It is less clear that the interests of customers require similar safeguards in the case of competitive activities such as electricity and gas supply. Ofgem therefore proposes that new electricity supply licences should not contain standard conditions equivalent to the present PES ring-fence provisions, which (subject to modification as proposed in this paper) will continue to apply only to distribution licences.

Interested parties are invited to comment on Ofgem's proposals. Responses should be received by 21 January 2000 and should be addressed to:

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Responses will be published by placing them in the Ofgem library in London unless clearly marked "Confidential – Not for Publication".

Drafts of the licence conditions required to implement these changes will be made available on the Ofgem website at [www.ofgem.gov.uk](http://www.ofgem.gov.uk) early in January 2000.

**Ofgem**  
**December 1999**

## Introduction

The present form of standard financial ring-fence conditions of PES licences restricts the activities of the licence holder and the uses for which it may raise and to which it may put financial resources. The conditions impose other duties on the licence holder relating to the conduct of its business, the maintenance of adequate resources and of ready access to additional finance at reasonable cost, the payment of dividends, the basis of transactions with affiliates, the avoidance of cross-default obligations and the obtaining of certain undertakings from its ultimate holding company or companies. They are designed to safeguard the financial stability and viability of a licence holder against pressures that might arise elsewhere in the wider group of which it forms part. They also ensure the regulator has access to necessary information relating to the wider group.

At present, these conditions relate to the entire PES. Thus they encompass both the distribution and supply businesses of a PES, as well as certain other activities that the PES carried on at the date these conditions first took effect, including (in the case of those PESs that are still in compliance with their initial own-generation limits) their generation businesses. In the context of the Government's proposal to license electricity distribution and supply separately, on terms that distribution licence holders may not also hold supply licences (and vice versa), it is necessary to revise the present conditions of PES licences to take account of this separation. It is also necessary to consider what conditions will be appropriate to each type of licence.

## Present PES ring-fence conditions

The standard ring-fence conditions of PES licences may be summarised as follows:

- LC2A<sup>3</sup> restricts the activities a PES may undertake in its distribution business, its first and second tier supply businesses and other (so-called ancillary) activities that in aggregate account for no more than 5% of turnover or of capital and reserves. All other activities carried on at the date this condition first took effect ('pre-existing activities') must within twelve months be transferred to an affiliate or otherwise disposed of;
- LC2A also prevents a PES from acquiring shares in affiliates except for shares in subsidiaries existing at the date the condition first took effect, companies formed for the transfer of pre-existing activities, and in certain other limited circumstances;
- LC2B requires a PES at all times to conduct its affairs so as to secure that it has sufficient management and financial resources to carry on its distribution and supply businesses. In support of this duty, the PES is required to certify

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<sup>3</sup> References are to the numbering of conditions in the general case. The PES licences of London Electricity, Midlands Electricity, SWALEC and Western Power Distribution (previously SWEB) have been modified following the sale of their supply businesses. Different enumeration applies in these cases.

annually to Ofgem whether or not it will have sufficient resources for the ensuing twelve months, and to obtain from its ultimate holding company (or companies) an enforceable undertaking to refrain and to procure that each of its subsidiaries refrains from any action likely to cause the PES to breach its licence;

- LC2C requires a PES that has changed its accounting reference date from 31<sup>st</sup> March nonetheless to provide to Ofgem full financial statements for each twelve month period ending 31<sup>st</sup> March;
- LC2D requires a PES to seek and maintain investment grade credit ratings for all its senior unsecured corporate debt;
- LC27.4 prevents a PES from incurring indebtedness, creating security or guaranteeing obligations of others unless for a 'permitted purpose' (viz. a purpose of its distribution or supply businesses, of its generation business where this is held in a wholly-owned subsidiary, of pre-existing activities, or of a transaction with an affiliate that complies with the provisions of LC27.5) and only if undertaken on an arm's length basis and on normal commercial terms;
- LC27.5 prevents a PES from entering into any transaction with an affiliate except, for instance, for the payment of dividends and, broadly, otherwise only if on an arms-length basis and on normal commercial terms;
- LC27.6 prevents a PES from entering into or permitting to subsist any agreement that contains a cross-default obligation (i.e. a provision, not being a guarantee permitted by LC27.4, whereby the liability of the PES to pay or repay any sum arises, is increased or accelerated as a result of the default of another person apart from controlled subsidiaries that carry on business only for a 'permitted purpose', excluding pre-existing activities); and
- LC28 requires a PES to obtain from its ultimate holding company(ies) an enforceable undertaking to provide or procure the provision of any information the PES may require to respond to a request for information from Ofgem. In the event no such undertaking is given, or if there is a breach of it, the PES may not pay dividends nor enter into any transaction with any affiliate.

### **Proposed new standard ring-fence conditions**

It is necessary to revise the existing conditions to take account of the separate licensing of electricity distribution and supply proposed by the Utilities Bill. At the same time, it is necessary to consider what provisions should apply to each type of licensee. In doing so, it will be appropriate to have regard to the analogous provisions of BG Transco's PGT licence, with a view as far as practicable to standardising ring-fencing provisions across all monopoly energy and appropriate network licensees.

## **Electricity supply**

The allowed revenues of price-controlled monopoly utility companies are set to enable them, if efficiently run, to finance necessary expenditures (including depreciation) and provide a reasonable return on capital employed. A primary purpose of the financial ringfence is to ensure that licence holders do not lose control of these financial resources nor divert them to other purposes. This safeguards the companies' financial stability, for the protection of consumers, who all depend on them, directly or indirectly, for essential services.

Electricity supply is no longer a monopolistic activity. Since May 1999, all consumers have been able to choose their supplier. Competition in electricity supply is developing. Ofgem has recently announced proposals to revise and extend maximum price restraints designed to protect Standard Domestic and Economy 7 customers of the PESs who do not switch to alternative suppliers, but expects that competition will enable most if not all consumers to obtain better prices.

In the light of these developments, Ofgem considers it would in general be inappropriate to impose ring-fencing conditions on electricity supply licensees once the proposed separate licensing arrangements take effect. Nevertheless, it will be important to bear in mind the duty under Section 3 of the Electricity Act 1989 to ensure that licence holders can finance their authorised activities. In the light of this, Ofgem proposes that new electricity supply licences issued in respect of the former first tier supply businesses of PESs should contain a condition analogous to the provisions of LC2B.1 to 7 inclusive and LC28 in existing PES licences.

This would require ex-PES supply licensees to conduct their businesses at all times so as to secure that they have sufficient management and financial resources and facilities to carry on the supply business, and to certify annually to Ofgem whether or not they have sufficient financial resources and facilities for the ensuing twelve months. It would also require such licensees to obtain enforceable undertakings from their ultimate holding companies analogous to those now required in the case of PESs.

These conditions should ensure that there is no loss of access to information necessary for Ofgem to carry out its functions, and in particular that it would have early warning of any developing threats to the financial viability of any licensee.

## **Electricity distribution**

Ofgem is committed to promote the development of competition wherever practicable in the sectors it regulates. Scope may exist to introduce elements of competition in the operation of energy networks, for example through capacity

auctions or outsourcing of service functions, in addition to the separation of intrinsically contestable activities such as metering and data handling.

Nevertheless, ownership of the principal national and regional energy networks seems likely to remain a monopoly activity for the foreseeable future. It is vital for the full development of competition in supply that these are maintained and developed so as to provide the levels of service quality, access and capacity required by users at the lowest possible cost.

Such businesses are by nature capital intensive. The cost of capital is thus an important determinant of overall network cost. In general, the cost of capital is minimised where risks are lowest. The former PES electricity distribution licensees will, when separated, face lower levels of business risk than at present. This will tend to reduce the cost of capital to these businesses. It will be important to ensure that this benefit is not offset through any increase in financial risk. It would therefore be inappropriate for these business to be subject to weaker financial ring-fencing conditions than presently apply to the PESs.

Accordingly, Ofgem proposes that the new electricity distribution licence should contain the ring-fencing provisions set out below. These are proposed as standard conditions, operative in all licences issued in respect of former PES distribution businesses and otherwise only where particular circumstances so warrant. In formulating these proposals, Ofgem has had regard to the desirability of maintaining a consistent approach across both the gas and electricity industries. The proposals therefore reflect certain modifications designed, where appropriate, to bring the distribution licence ring-fencing provisions into line with those of BG Transco's gas transportation licence. In general, the proposals otherwise only reflect changes necessary or appropriate to adapt them for the new electricity licensing regime.

At present, all 14 distribution businesses form parts of wider corporate groups. This reflects the history of the industry, the fact that at present distribution is not separately licensed, and the diversification of PESs since privatisation into new activities. Although the ownership of distribution businesses is likely to continue to change following future mergers and disposals, Ofgem anticipates that in the future distribution businesses are likely to form parts of wider corporate groups.

Where this continues to be the case once distribution has become separately licensed, Ofgem will expect the distribution business to be held in a separate subsidiary of the group, whose activities will be essentially limited to the licensed distribution business (and the financing of that business) only. The proposals described below have been drafted accordingly.

This model reflects the new corporate structure for the BG group, but with one important difference. In the case of BG, BG plc – the original public gas transportation licensee and owner of the Transco business – retained the licensed business. All other activities of the BG group were transferred out of BG plc into new subsidiaries. This process meant that the modified PGT licence

had to allow BG plc to retain some activities and liabilities not connected with the PGT business on a transitional basis. In the case of electricity distribution, the Utilities Bill will allow the distribution business to be transferred into a new subsidiary, and Ofgem expects PESs to follow this course. It will therefore not be necessary to include in the new distribution licence provisions analogous to those in the BG Transco licence which allowed it to retain activities and liabilities not connected with the licensed business on a transitional basis.

## New proposals

It is proposed that the standard distribution-licence ring-fence conditions will retain similar principles and wording to those contained in existing PES licences. The principal changes may be summarised as follows:

- the definition of 'permitted purpose' will be altered so as to refer only to the distribution business of the licensee, to so-called ancillary activities (subject to changed thresholds – see below) and to compliant transactions with affiliates;
- the restriction on activities (LC2A.1) will be amended to refer only to the distribution business of the licensee removing references to a supply business;
- the restriction on acquiring shares (LC2A.2) will be amended to refer to holding or acquiring securities of any kind. The exemption will be amended to permit the licensee to hold or acquire (a) securities issued by controlled subsidiaries carrying on business solely for a permitted purpose, including special purpose subsidiaries formed for the purpose of raising finance for the distribution business, or (b) securities that are quoted or dealt in on a recognised market, are held or acquired solely for investment purposes, and represent in each case no more than 5% of the total amount of securities of that class from time to time outstanding. LC2A.3 will be amended correspondingly;
- the restriction on ancillary activities (LC2A.4) will be amended to refer only to the turnover of the distribution business, and to reduce the threshold percentages to 2½% of the turnover and asset criteria. A 2½% threshold has been included in the modified BG Transco licence. It seems appropriate to reduce the threshold in distribution licences to the same level in future. When distribution businesses are transferred to new subsidiaries, it is expected that most of the activities currently covered by this threshold will not be transferred, so the need for this allowance will reduce;
- the requirements as regards certification of compliance prior to payment of dividends, etc. (LC2B.8) will be amended to require, in addition, confirmation that the licensee has complied in full with any applicable enforcement order or direction made by Ofgem then in force;
- the requirement as regards credit ratings (LC2D) will be amended to require the licensee to seek and at all times maintain an investment grade *issuer* credit rating and to drop the present requirement for *issue* ratings. This



change was previously proposed in the Offer consultation document "Modifications to Public Electricity Supply Licences Following Take-over Response to Consultation by the Office of Electricity Regulation (OFFER, February 1999) and has been adopted in the modified BG Transco licence;

- the requirements as regards transactions with affiliates (LC27.5) will be amended so as to prevent transfers to affiliates of any sum or sums, asset right or benefit by way of loan, lease, conditional sale, or other reservation of title or where consideration of equivalent value is not paid in full on or before the date of transfer unless the counter-party has and agrees to maintain an investment grade *issuer* credit rating or its obligations are guaranteed by another person having and agreeing to maintain an investment grade *issuer* credit rating; and
- the requirements as regards parental undertakings (LC2B.6 and LC28) will be amended to include an additional provision requiring the licensee to comply with any direction made by Ofgem to take enforcement action in respect of the undertakings, and to extend the prohibition on the payment of dividends and entry into agreements with affiliates to include circumstances where such a direction has been made and the relevant enforcement action remains pending. The definition of ultimate holding will also be clarified to ensure it accurately captures those who exert a material influence over the licence holder, and excludes those who do not.

## **Conclusion**

The present ring-fence conditions of PES licences were put in place at take-over and therefore reflect the structures and range of activities that each PES group displayed at that time. They also reflect the structure of the PES licence. Certain modifications have since been made to bring all PES licences into line with the conditions considered and endorsed by the Monopolies and Mergers Commission in its report on the PacifiCorp/The Energy Group merger reference. In comparison, the proposed standard conditions described above are somewhat more restrictive.

The tighter restrictions are required to ensure that each regional monopoly electricity distribution business is held in a separate corporate entity, ring-fenced from all other activities carried on within the licensee's group. This will secure that financial resources generated from the conduct of the distribution business remain securely available to satisfy the requirements of that business and can only be diverted to other uses to the extent they are wholly surplus to those requirements. This will protect capital providers, as well as customers. Together with their lower business risk profile, in comparison to PESs generally, this should ensure that the new electricity distribution licensees enjoy stable finances and a low cost of capital.

After considering the responses to this consultation, Ofgem will propose to the Secretary of State amended standard licence conditions. The Secretary of State

will then be responsible for determining and publishing standard licence conditions in line with the proposed timetable for the Bill.