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Dear Paul

**Review of the "ring fence" conditions in network operator licences**

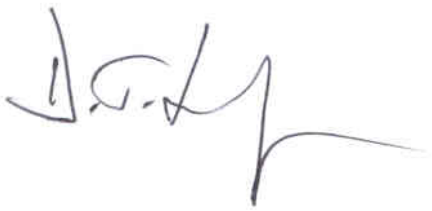
Thank you for giving us the opportunity to respond to Ofgem's proposals. I can confirm that this response may be published on Ofgem's website.

While we agree that it is sensible for Ofgem to review the ring fence conditions and to learn any lessons from the recent credit crisis, we do not believe that Ofgem has been able to make a case for significant change. The review has highlighted some areas where improvement is sensible; however, in general we do not see a need for major change of a regime which has a proven track record.

Our detailed responses to your questions are set out in the attachment to this letter.

Should you wish to discuss any of the issues raised in our response or have any queries please contact my colleague Paul Delamare on 07875 112317, or myself.

Yours sincerely,



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**Attachment**

**Review of the "ring fence" conditions in network operator licences**

**EDF Energy response to your questions**

**Chapter 1**

**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 be considering.**

The degree of protection provided to consumers through the ring fence should be based on a combination of the probability of NWO insolvency and the impact on consumers of any adverse consequences that follow from this. We therefore believe that Ofgem's objective "to ensure [the ring fence conditions] are as robust as possible" is not justified. However, we agree that a review is sensible – and particularly whether any lessons can be learnt from experience during the recent credit crisis.

**Chapter 2:**

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

**Lack of focus on operational risks** – we believe that even where a NWO has contracted out all or part of its operations there is little risk of those resources being unavailable to an Energy Administrator. Even if such a contractor were to fail, it would be very likely that its staff would be transferred to the new entity. There are many examples for this, for example in the rail industry, where there has been continuity of service despite the failure of Railtrack (and the ending of some TOC franchises). We regard the risk to NWO services from such a failure as very low.
**Limited early warning role** – we believe that the credit ratings of NWOs would actually respond at a pace which ensures consumers are effectively protected. We are aware of no case in any UK energy network where the deterioration has been so rapid that the credit rating agencies have not been able to respond effectively. We point out below that this is largely because NWOs have real physical assets rather than financial ones.
**Weakness in the indebtedness and transfer of funds restrictions** – we believe that the ability for NWOs to use trade debtors as security is a defect in the existing arrangements which could usefully be addressed.
**Weak sanctions on directors** – we agree that it is sensible for Ofgem to review the robustness of NWO governance arrangements in the light of the credit crisis. We note below that the independent directors on the boards of banks seemed to have been unable (or unwilling) to act effectively to prevent failures in the banking sector.

## Chapter 3

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

We agree that it is sensible for Ofgem to review the existing NWO ring fence obligations in the light of lessons learnt from the recent financial crisis. However, Ofgem has not been able to establish any substantial or meaningful read across from the drivers of the financial crisis – a fundamental mispricing of assets by banks and other financial institutions as a result of an equally fundamental mispricing of risk – to the circumstances facing the NWOs. We do not therefore accept the need for significant policy changes in this area, although we do agree that some sensible improvements to the existing ring fencing provisions are justified.

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

We support some of Ofgem's proposals, but not all of them. We comment on each proposal in turn below in our response to question 3.

**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?**

We address each of Ofgem's proposals below:

1. *Widening the trigger for lock-up to include "any report of adverse circumstances under the availability of resources condition", and "any breach of a formal financial covenant"*

   We believe these proposals are sensible provided the relevant trigger "circumstances" or "breaches" are genuinely material and result in a substantial increase in the risk of failure over the licensee's ability to carry on its regulated distribution activities.

2. *Extending the annual availability of resources certificate to cover operational as well as financial resources*

   We note above that the risk to NWO services of contractor failure is low. We therefore do not believe that it is necessary to enlarge the availability of resources regime to include operational resources. We also believe that the focus of the current obligation on financial resources lends itself to testing the impact of any dividends or other financial distribution, and to the identification of any inconsistencies with the licensee's regulatory accounts (and the auditors' reporting thereon). Introducing a non-financial aspect to this would unnecessarily complicate the requirements and pose a challenge as to how such a certificate could be subject to any form of meaningful audit opinion. For this reason, we believe that it would not be sensible to use the availability of resources conditions as a vehicle for assessing operational resources. Introducing some reporting on contracts permitted under the disposal of relevant assets general consent provisions (i.e. those permitting the relinquishment of operational control) would be a more sensible approach.

3. *NWOs to maintain an up-to-date record of key financial and contractual arrangements (what Ofgem refers to as a "living will")*

   We believe that the risk of an Energy Administrator being unable rapidly to identify these matters is low and therefore Ofgem's proposal is not justified. Although we agree that a well run business maintains records of this type as part of its disaster recovery planning, we do not support an enlargement of regulatory obligations without justification.

4. *Clear sanctions where resource adequacy statements are found to be inaccurate or out of date*

   We expect Ofgem to use the existing sanctions available.

5. *Restrictions on granting security to cover future revenue streams and other debts*

   We believe that Ofgem's proposals are sensible provided they:

   - Relate only to balance sheet assets such as debtors and deferred income (i.e. which excludes all values not yet recorded in the balance sheet such as future income)
   - Only apply to only new fixed or floating charge granted to banks or other creditors (i.e. from the date of the relevant licence condition).

6. *Strengthening and clarification of licensees' boards through (a) introducing a requirement for a majority of independent directors; and (b) making clear that Ofgem would seek penalties against managers who provide inaccurate or insufficient information to Ofgem (through bad faith or not taking due care)*

   We are sceptical of the value of having independent directors on licensee boards. We note that such individuals seemed to have played little part in ensuring that banks and other financial institutions effectively managed their portfolio of risk on the run up to the credit crisis. Unlike the finance industry, it is most unlikely that a DNO would go straight from investment grade to junk credit rating in one step [due to the ownership of the physical network assets], and because of this customers will be protected by the (credit rating triggered) cash lock-up mechanism. Where lock-up is triggered effectively Ofgem would provide the protections envisaged by the proposed independent directors.

7. *Other provisions remain unchanged*

   We strongly support the retention of the requirement for NWOs each to hold an investment grade credit rating. This is a crucial protection for the providers of finance and any weakening of it would raise the cost of capital to the detriment of consumers. We are also pleased to see no proposed changes to the licence conditions relating to the ultimate controller undertaking.

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

Our views on the merits of requiring independent directors on licensee boards are set out above. We note that Ofgem makes reference to comparable provisions regarding independent directors in water supply licences. We note that in water, the ultimate holding company must ensure that "at all times the Board of the Appointee contains not less than three independent non-executive directors". We note that water supply companies are not required to have a majority of independent directors as Ofgem proposes. We would not support any proposals for a majority of independent directors, as this implies a splitting of ownership and control. Furthermore, we believe that interfering with the ownership rights in this way is arguably not within the Ofgem vires.

**Question 5: Do you think that ultimate controller undertakings should be resubmitted at periodic intervals?**

We do not support the suggestion for the deeds to be updated and resubmitted to Ofgem at periodic intervals. Our existing deed of undertaking is included as an integral part of our compliance procedures as if it were a licence condition. There is no need to update it, and resubmitting it periodically would serve no purpose and would simply increase our costs.

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

Such a review has already taken place as part of the overall review of DNO licences undertaken in 2007/08. Other network licences should follow this model both in terms of review process and legal drafting.

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

Yes. Retroactive changes are likely to increase perceptions of regulatory risk amongst investors and over time increase the costs of finance to the detriment of consumers.

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

Given that each connected consumer has no choice of distributor once connected, it would seem sensible to apply equally the ring fence protections to DNOs and IDNOs (i.e. the IDNOs enjoy a local monopoly which requires consumers to be protected from their failure).

**Chapter 4**

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

We have not identified any other matters not included in Ofgem's analysis.

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

Yes.

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

We do not agree that Ofgem has made a case for change. It is not sufficient to note that companies in the financial sector can succumb to insolvency pressures and then assert, without analysis, that in respect of the NWOs "we do not consider a do nothing approach to be appropriate". DNO assets are real and are backed up by regulated income streams and cash flows. They are not, as was the case in some financial institutions, comprised of complex financial derivative instruments which concealed high risk (sub-prime) debts. To demonstrate a case for change (and be proportionate within its better regulation duties) Ofgem would need to show how risk to consumers has increased.

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

They would represent an unnecessary and unjustified increase in the regulatory burden on the NWOs.

**Chapter 5**

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

No. As we note above, we do not believe that Ofgem has established that the insolvency risks faced by NWOs have changed.

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

A common set of rules which apply equally to DNO/GDNs and IDNO/IGTs would facilitate competition in energy networks. We also believe that the current (i.e unchanged) ring fence arrangements adequately protect energy suppliers from the risk of a NWO becoming insolvent