Call for input

Energy Networks ring fence review

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We are seeking input from stakeholders on proposals to review the networks ring fence in light of the challenges of net zero and the emergence of new financial and operational risks.

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Introduction

Ofgem's[1] principal objective under the Gas Act 1986 and under the Electricity Act 1989 is to protect the interests of existing and future consumers.

The transmission and distribution networks, which carry gas and electricity to domestic and commercial users are a vital part of our national infrastructure. It is in consumers' interests that we ensure that the companies which own and operate these networks ("licensees")[2] have the financial and operational resources necessary to meet their obligations and carry out their regulated activities while restricting the improper use or diversion of those resources, which have been funded by consumers.

Network licences contain a suite of regulatory "ring fence"[3] conditions, which form an important part of our regulatory approach to managing the risk of a licensee getting into financial distress and which protect the regulated asset base and therefore consumers.

The ring fence is a key component of our financial resilience measures, which more broadly seek to ensure that licensees have sufficient financial safeguards or headroom so that they can avoid and/or manage the risk of financial distress.

Broadly, the objectives of the ring fence conditions are to protect the regulated asset base in the following ways:

- minimising the likelihood 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 network companies,
- providing warning signals when symptoms of financial distress appear,
- mitigating the severity and impact of financial distress factors and reduce any "chain reaction" of adverse financial events,
- facilitating the special administration process where warranted; and
- ensuring network assets remain under the operational control of the licensee.

The primary responsibility for the financial resilience of a network company lies with that company's management and shareholders. We expect licensees to act responsibly and to

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[1] References to "Ofgem", "the Authority", "we", "us" and "our" are used interchangeably in this document to refer to the Gas and Electricity Markets Authority.
[2] References to "licensees", "companies" and "network companies" are used interchangeably in this document.
[3] Unless otherwise specified, we use the term "ring fence" to refer to the regulatory ring fence throughout this document.

inform Ofgem at the earliest stage possible of any potential or actual financial distress. The earlier that a case of financial distress can be identified, the more response options we have available that may help to mitigate and/or contain the situation for consumers.

In light of recent issues in the energy retail and regulated water sectors, we consider it important to review the ring fence to identify whether there are any areas for improvement. This is also in line with Ofgem's objective to implement monitoring to ensure regulated network companies are financially resilient in the Multiyear Strategy.[4]

Objective

The objective of this review of the networks' ring fence is to ensure that our regulatory arrangements in this area are fit for purpose. We are actively looking at the financial resilience of network companies and have already introduced some additional measures to help monitor this.[5] Through our initial assessment, we have identified further areas, which may require strengthening and recognise that the ring fence conditions are part of this.

While Ofgem has a legal duty to have regard to the ability of licensees to finance their regulated activities when making regulatory decisions, primary responsibility for the financial health of a licensee lies with its directors and owners. We expect companies to manage their own financial risks and for shareholders, not consumers, to gain or lose from their choices. We therefore recognise the importance of licensees having the freedom to organise and finance themselves efficiently in and in a way which provides the best levels of service to their customers.

Nevertheless, there may be situations in which a company running critical infrastructure gets into financial difficulty, which results in costs for consumers. This requires appropriate regulation in the consumer interest to keep those potential costs sufficiently low and unlikely, while accepting that it would not be efficient to create a sector in which no licensee could ever fail. The intention of reviewing the existing arrangements is, therefore, to assess and potentially reduce risks to consumers. It is not to remove the possibility of financial failure of a network company altogether.

[4] See objective 10.2 in [Ofgem's multi year strategy]
[5] See "Issues identified" on page 8 of this document.

Context

Background

The ring fence conditions were introduced in the mid-1990s in the wake of energy industry privatisations and adapted for electricity and gas networks licences in 2000. They were designed to ensure that network companies have the financial and operational resources necessary to fulfil their obligations. To date, these have been a broadly effective part of the regulatory framework, however we consider it necessary to review and strengthen the regime to reflect changes both in the corporate structures of network companies and in the economic landscape in which they operate, which we set out further in the paragraphs below.

Risk areas

There are several potential areas of risk to the ring fence, which we outline below and these areas are in part why we consider it appropriate and prudent to undertake this review now.

Changes in corporate structures

When the ring fence conditions were first introduced, network companies were structured as listed plcs with strict transparency requirements. Many of the networks have since been acquired by private equity or large conglomerates and as such are no longer subject to the same level of scrutiny. Such a change in ownership could result in undue influence from a smaller number of controlling parties over the vital infrastructure that the network companies operate, which may lead to suboptimal outcomes for the consumer.

Financial engineering

The corporate structures of the energy network companies have become more complex with intermediary companies above the licensee (a Midco or Holdco[6]), which are used to raise debt on behalf of the group. Our policy intent in this area is that the licensee should be "ringfenced" from activity that takes place above it in the corporate structure, and thus consumers should be indifferent to that activity. There is a risk that high levels of Midco or Holdco debt may negatively impact decision making and the resilience of the licensee particularly where the licensee is required to make distributions to service that debt.

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[6] By 'Holdco' and 'Midco' we refer to the holding company and the middle company that sits above the operating company in a group structure.

Challenges in other sectors

Thames Water Utilities Ltd ("Thames") has suffered financial difficulties, which have resulted in a higher cost of debt for Thames compared to other water and energy companies. If a network company were to get into financial distress, this would likely increase its cost of borrowing, impact the wider sector and could distract the company from providing the best levels of service to consumers. This would likely be to the detriment of consumers.

Each of the above challenges poses a risk to the effectiveness of the ring fence and may expose the licensee to the riskier activities of the wider group and could ultimately harm consumers.

Current ring fence arrangements

The following is a list of the existing ring fence licence conditions:[7]

- Restriction on activity and financial ring fence;
- Availability of resources;
- Credit rating of the licensee;
- Restriction on indebtedness and transfer of funds;
- Ultimate controller undertaking;
- Restriction on the disposal of relevant assets;
- Prohibition of cross-subsidies;
- Network Independence; and
- Sufficiently independent directors (SIDs).

Issues identified

Known issues and proposed resolutions

We have already identified several issues with the ring fence conditions through our Financial Resilience work, which we are proposing to amend in the RIIO-3 Sector Specific Methodology Decision (RIIO-3 SSMD)[8], as follows:

- amend the Availability of Resources requirement to require a certificate from the board stating that the licensee has sufficient financial resources to cover the entire price control period or a minimum of three years ahead,
- modify the Credit rating condition to require companies to maintain more than one investment grade rating, and
- strengthen the dividend lock-up trigger in the Restriction on indebtedness condition from 'BBB- with a negative outlook' to the earlier of 'BBB- with a negative outlook' and regulatory gearing of 75% or greater.

We have also introduced the following additional reporting requirements to the guidance licensees must follow when submitting their annual regulatory returns[9]:

- Increased disclosure around distributions along with narrative explanations,

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[7] This list is not standardised across all sector licences and some sectors may contain additional sector-specific conditions.
[8] For more detail on each of these measures and the rationale for introducing these, see Chapter 6 of the RIIO-3 Sector Specific Methodology Decision – Finance Annex
[9] See the 28 June 2024 Direction to amend the Regulatory Instructions and Guidance ("RIGs") for RIIO-2

- Disclosure around debt covenant trigger events, and
- Disclosure around MidCo or HoldCo financing including any implications this may have on the licensee.

Further potential issues in the licence conditions

While we have already done some work through the RIIO-3 SSMD, we have identified several areas for further improvement and set out some examples, below.

Strength of dividend lock-up

The licence contains a dividend lock-up mechanism, which is triggered in the event of a material breach of covenant or where the licensee is at risk of losing its investment grade credit rating, among other things. However, the current conditions provide for numerous exceptions. For example, distributions made to repay interest on loans from intercompany entities, shareholders or related parties are exempt where the interest is on normal commercial terms. We want to better understand which exceptions are relevant in practice today and ensure that they are in the consumer interest.

Clarity of restrictions on disposals

Asset disposals represent another transfer of value from within the ring fence. If a licensee transfers assets to a related party or another group entity, it may be incentivised to undervalue the asset at the point of transfer, which may be to the detriment of consumers.

In general, licensees are required to notify Ofgem of any asset disposals, however there are numerous exceptions, and the requirements and definitions used in the licence could do with clarification. This is particularly relevant in the context of net zero, where gas assets are likely to be repurposed and transferred to low carbon operators.

Inconsistencies across sectors

The Gas and Electricity Transmission licences contain an obligation for licensees to submit a Financial Resilience report if a rating agency downgrades or considers downgrading the licensee's credit rating, however this obligation is not present in the Electricity Distribution licence.

Obligations may be open to interpretation

Some ring fence licence conditions contain limited or no guidance and we note that neither the purpose of each ring fence condition nor the purpose of the ring fence itself are stated in the licence or in any guidance. We have also found that there are terms lacking clear definitions. Much may therefore be open to interpretation, which could result in activity that may follow the letter of the licence but is not within the spirit of the ring fence.

Options

We outline three potential options below. In the event we are minded to take action, we may choose a combination of these options.

1. Maintain existing approach
2. Higher intervention approach to strengthening the ring fence
3. Detailed review and targeted approach to strengthening the ring fence

Maintain existing approach

Maintaining the current provisions may be an option, considering that the licensees have weathered the financial crisis and more recent volatility in commodity markets relatively unscathed. However, these crises highlight that even seemingly well-capitalised businesses can quickly face insolvency pressures. While these events have primarily impacted the retail and water sector so far, we have seen some evidence of the potential for consumer harm in the networks sector through our initial assessment. Given the issues identified, a 'do nothing' approach is not considered appropriate.

Higher intervention approach to strengthening the ring fence

There are several additional requirements we could consider bringing into the licence that would allow us to more closely scrutinise the financial health of network companies.

Reserve requirements

We could introduce a requirement for licensees to hold specified sums in reserve facilities to provide funding for the network business if other sources of funding became unavailable. Similar liquidity requirements exist in the banking sector and have recently been introduced by Ofgem to apply to the retail sector.

Further tightening of dividend lock-up

As noted above, we are proposing in our RIIO-3 SSMD to amend the dividend lock-up trigger, but we could consider further tightening the dividend lock-up by prohibiting certain interest payments on loans from intercompany entities, shareholders or related parties once the lock-up is triggered, where such payments are structured as forms of distribution.

Additional restriction of activity

We could put forward proposals to prohibit specific risky activities if we conclude these may be contrary to the consumer interest such as whole business securitisations and structures with debt issued above the licensed entity which is reliant on dividend flows for servicing.

Closer scrutiny of ownership structures

We recognise that, as ownership structures become more complex, they may also become less transparent. In some instances, there may be multiple controlling interests including limited partnership funds with undisclosed investors. Transparency around the ultimate owners may promote accountability, which could be in the interest of consumers so we may consider requesting the disclosure of all investors rather than just those with a controlling interest.

Detailed review and targeted approach to strengthening the ring fence

We recognise that adopting a suite of more intrusive measures across the board may provide us with greater assurance as to the effectiveness of the ring fence but could be perceived as placing an increased regulatory burden on networks. At the same time, the evidence identified so far indicates that it would not be appropriate to continue to rely on the existing provisions.

A third option is to take a more targeted approach by reviewing the existing licence conditions for any gaps or inconsistencies and proposing modifications to improve their effectiveness and clarity and introducing new requirements that are proportionate and appropriately address our concerns.

As well as looking at our existing framework we would perform a review of the licensees' corporate structures, statutory accounts and request additional information where required. Through this review we would engage closely with licensees to better understand their current financing practices and details of any transactions or activities that could impact the ring-fence.

We would also like to engage closely with consumer groups, investors and any other interested stakeholders to understand their perspectives.

We would then consider if there are areas which may benefit from increased monitoring and/or the need to develop clear guidance to accompany the licence conditions.

Questions

1. Have we identified the issues and challenges network companies are facing accurately? (Yes/No)
2. Are there any other issues that may pose a threat to the regulatory ring fence that we should consider?
3. Are there any weaknesses within the current ring fence conditions that we should consider?
4. Which would be your preferred option of the three outlined and why?
5. What are your views on the three options outlined and the associated benefits and risks of each?
6. Tell us if you have suggestions on how we can improve our proposed options.
7. Tell us about any alternate options we should consider.

Next steps

We are keen to engage with a wide range of industry and interested parties during this process and draw on your experience and expertise. This includes consumers, network companies, investors, rating agencies, consumer bodies, suppliers, generators, system operators, government, regulators and other bodies.

To start this process and help us shape the considerations on this issue, we have set out specific questions regarding the networks ring-fencing arrangements in this document. We would welcome written comments on these questions, or any other issues you believe we should address in the review, by **11 November 2024**. Please email responses to RegFinance@ofgem.gov.uk. Unless clearly marked as confidential, we will publish responses on our website after the response deadline.

Subject to consideration of the responses we receive, and if we are minded to explore policy options further, we intend to publish a follow-up letter on this issue to provide stakeholders with further detail around policy options, proposed modifications and timelines for further consultation.