The proposed acquisition of Premier Transmission Limited facilitated by Team Northern Ireland Limited

A consultation paper by the Northern Ireland Authority for Energy Regulation

September 2004

Section one: Introduction and Summary

This paper sets out the issues raised by the proposed acquisition of the regulated gas transmission utility, Premier Transmission Limited (PTL[1]) and the transfer of the business to a not-for-profit 100% debt financed company. The acquisition will be facilitated by Team Northern Ireland (TNI), which successful delivered the acquisition and mutualisation of the Moyle electricity interconnector (Moyle) in 2003. Although this transaction is between two private companies, it will require a new regulatory framework and hence the consent of the Northern Ireland Authority for Energy Regulation (Authority).

The Authority invites views of all interested parties on the proposal and particularly seeks comments on whether the proposals set out in this paper are adequate to protect consumers' interests.

Section two explains the proposals in detail. Section three explores the potential benefits and additional risks for consumers from this acquisition and section four considers the regulatory issues raised by it. Section five covers the acquisition timetable and actions.

Background to acquisition

The relatively high energy costs facing Northern Ireland place our industry at a competitive disadvantage and contributes to the highest incidence of fuel poverty in the UK. One approach to tackle such high costs has been through reducing the long-term cost of financing energy infrastructure. In pursuit of this objective in September 2002 the Authority issued a consultation paper entitled "Paying for Energy Interconnectors", which set out the proposed mutualisation of the Moyle interconnector and the Scotland to Northern Ireland Pipeline (SNIP).

Mutualisation involves the transfer of a private sector company (funded by mixture of equity and debt) to a not-for-dividend company limited by guarantee (CLG), which has no shareholders and instead has a group of Members. CLGs are often referred to as mutuals. Significant cost savings can be made from such transfers, as CLGs are typically financed solely with debt. Given the absence of equity, and, therefore, the need to distribute profits, and the alignment of the CLG's interests with those of consumers, the overall financing costs can be significantly lower. However, achieving these benefits also entail transferring to consumers certain risks normally retained by the shareholders. Those risks are described in this paper.

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[1] PTL owns and operate the Scotland to Northern Ireland Pipeline.

TNI is a Northern Ireland company, which was created with the purpose of helping to facilitate a reduction in the cost to consumers of essential energy service infrastructure in Northern Ireland. TNI was instrumental in facilitating the transfer of the ownership of Moyle Interconnector Limited (the company which owns Moyle) from Viridian Group plc to a newly created, not-for-dividend CLG, established for the purposes of being the ultimate owner of Moyle.

TNI is not the owner, nor is it involved in the management of, Moyle, nor will it be of the SNIP CLG. Its function is to facilitate the acquisitions and develop the necessary support structure.

The associated 100% debt refinancing of Moyle, which was closed in April 2003, has achieved to date significant reductions (over £1 million per annum) in cost to consumers of electricity.

TNI and its advisers have been engaged in negotiations with the current owners of PTL, subsidiaries of the BG Group and KeySpan (the Owners) since July 2003, in connection with a transfer of the ownership of PTL to a special purpose vehicle created for the purpose of financing the acquisition of PTL (the Purchaser). The Purchaser will in turn be owned by an intermediate holding company, which will be a CLG (referred in this paper as the "SNIP CLG").

Following commercial negotiations between TNI and the shareholders of PTL, a Heads of Terms (HoT) was signed on 13 February 2004. The HoT contains an agreement in principle for the sale of the PTL shares by the Owners to the Purchaser. The following are the key terms of the HoT:

- The Purchaser will pay a consideration of £85.9 million, inclusive of outstanding debt based on an assumed completion date of 31 December 2004, subject to an adjustment in the event of a different completion date, and to reflect both the working capital within PTL at completion, and the value of certain tax losses used by BG through group and consortium relief.

- The Purchaser will put PTL in funds, in order that it can repay its outstanding long term debt, cancel certain interest rate swaps and pay the transaction costs including pre-funding of a debt service reserve, with the balance of the consideration paid to the Owners.

- Completion of the transaction is conditional on obtaining third party consents and on the Purchaser obtaining long-term funding on reasonably acceptable terms.

Since agreeing the HoT, TNI continues to conduct due diligence on PTL and its assets on behalf of the Purchaser, and has commenced negotiations with the Owners on various matters which, it is expected, will lead to completion of the sale and purchase.

In order to permit PTL and TNI to proceed with developing the proposed transaction and related financing, in April 2004 the Authority authorised an amendment to the PTL Licence, to permit it to pass through all costs, fees and expenses reasonably and properly incurred by TNI, PTL and their respective advisers, in developing and implementing the proposed transaction as approved by the Authority.

Key issues for consideration

The proposed acquisition raises important considerations for consumers and regulatory issues for the Authority, which can be summarised as follows:

- Are the benefits to consumers outlined in the paper sufficient to offset the potential risks?

- Are there any significant risks and benefits to consumers in the proposed structure which we have not assessed in the paper?

- In the absence of shareholders, are the proposals for efficiency incentives/corporate governance sufficient to protect consumers?

- Is the process for appointing Members robust enough to prevent undue influence by any one interest group or insufficient monitoring?

- Should support from the electricity consumer via the proposed collection agency arrangements/levy be used to decrease the financing costs of this transaction?

The Authority's preliminary analysis of the proposed acquisition

The Authority must assess any proposed transfer of ownership against its legal duties as outlined in the Energy (Northern Ireland) Order 2003. Its principal objective (in relation to its gas functions) is to promote the development and maintenance of an efficient, economic and coordinated gas industry in Northern Ireland, and (in relation to its electricity functions) is to protect the interests of consumers of electricity wherever appropriate by promoting effective competition between relevant industry participants. A critical question facing the Authority is, therefore, whether the interests of consumers are prejudiced by moving from the current equity financed model of ownership of SNIP to a new CLG ownership structure. In analysing any potential risks to consumers, the Authority will have regard to the extent of the compensating benefits for consumers.

The Authority has identified the following key benefits of TNI's proposals:

- Lower financing costs will be achieved, delivering a lower cost of capital which will lead, all other things being equal, to substantially lower cost of gas transmission through the Postalised system, in turn benefiting all gas consumers.

- TNI's proposal that PTL be restructured notably by relocating its operations to Northern Ireland, will also achieve tangible cost reductions, thereby potentially further lowering cost to consumers.

Against this, in a typical CLG, given the absence of profit-motivated shareholders, there is the concern that incentives for efficiency may be weaker than they would be, were the owners motivated by maximising profits, and this may lead to higher operational expenditures.

The performance of the Moyle business, following a similar acquisition facilitated by TNI, provides comfort that the 100% debt funded structure will work. In addition, the Authority has held productive discussions with TNI, and considers that its proposals address the Authority's concerns within the constraints of the debt-financed model of a CLG.

The views of respondents on the issues raised are critical and will inform the Authority's final assessment in due course. At this stage, its preliminary assessment is that TNI's proposals will deliver significant consumer savings, provided that appropriate licence conditions are developed for PTL, and the appropriate investment grade rating secured. The Authority would welcome the views of interested parties on this preliminary analysis.

How to respond

The Authority invites views on any aspects raised in the paper especially on the specific issues raised for consideration.

The deadline for responses is **8th October 2004.**

When responding please state whether you are responding as an individual or representing the views of an organisation. Please submit any response to:

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Responses to these consultations will normally be made public unless respondents request that they should remain confidential. Respondents should clearly mark any part of their response (or the whole response) which is to remain confidential. If this is the case, where possible, any confidential material should be assigned to an appendix.

Section two: The PTL Acquisition – the Proposed Structure

There will be no equity investment in the SNIP CLG, and the acquisition of PTL by the Purchaser will, therefore, be 100% debt funded. This is possible from a creditworthiness perspective, because the borrower operates in a corporate structure which does not include shareholders operating the company for a profit motive, and where the borrower's revenues are derived from a supportive regulatory environment. In this case, PTL's entire cost base – including the cost of debt – is permitted, by Licence and applicable regulation, to be passed through to end-users.

With the SNIP CLG having no equity and therefore no shareholders, it instead has "Members". These Members carry out the same functions as shareholders in a typical company. A further key difference with a CLG is that instead of operating with the purpose of returning a profit for the benefit of shareholders through dividends, it Members have the responsibility of ensuring that any profit/surpluses generated from the CLG's operations are used solely for reinvestment in the business, or, more specifically in this case, in reducing charges to consumers. In other examples of CLGs (Network Rail, Welsh Water, The Learning Trust, etc., and, of course, Moyle) Members tend to be broadly representative of the community, for example: government representatives, trade unions, service users, consumer groups, independent experts and financiers.

The SNIP CLG Members are selected by an Appointments Board. The Members in turn appoint and hold to account a Board of Directors, which will be responsible for the strategic direction, corporate governance and performance of the company. Members will not be entitled to receive dividends and, other than their liability to pay £1 upon a winding up of the company, have no financial interest in the CLG. The appropriate appointment process for both Members and Board Directors is discussed in section four.

The sale and purchase will be effected by the sale of the entire issued share capital of PTL by the Owners to the SNIP CLG. Thus, the licence holder will continue to be PTL itself, and the change of ownership of the licensee that will need to be approved by the Authority and DETI. A new Licence will be issued to PTL to reflect the new regulatory framework required for a CLG, with a simultaneous revocation of PTL's current Licence.

The formation of a Single Energy Holding Company

TNI facilitated the Moyle transaction and the formation of the Moyle CLG. As part of the SNIP transaction, a possible option is the bringing together the two interconnectors companies and potentially future energy assets under a single holding company to be called Northern Ireland Energy Holdings (NIEH), which would also be a CLG. TNI is also proposing that there is significant overlap between the SNIP CLG Board and NIEH Board.

The Authority does recognise possible benefits from placing the two CLGs under one company, including cost savings from joint outsourcing and certain shared management and administrative functions. However this proposal raises potential conflict of interest concerns.

The question whether the proposed appointments address the appropriate corporate governance principles is addressed in section four. Furthermore, bringing together Moyle and SNIP under a common management/Board structure in theory could work against the consumers' interest. As the electricity interconnector displaces the need for local gas-fired generation, it could be a potential competitor to the SNIP pipeline. However, in practice, the Authority believes there is no conflict of interest as currently the revenues of both interconnectors are assured independently of their usage.

Licence conditions and/or applicable law place an obligation on both the Moyle operating company and PTL Boards to act solely in the interests of their respective businesses, and to behave independently.

If it is decided to create NIEH as a holding company above the SNIP CLG, then the discussions and proposals on appropriate corporate governance would equally apply to the NIEH CLG.

The Authority requests views on whether there should a minimum difference in the Membership and Board Directors between Moyle and SNIP. Also should the parent energy holding company be created?

Proposed Operation of the new PTL (under ownership of the SNIP CLG)

The day-to-day operations of PTL are currently managed by four professionals (covering General Management, Operations Management, Commercial Operations and Finance & Administration functions). These personnel are BG employees, who are seconded to the PTL operation. The PTL operating centre is currently located at BG's Headquarters at Reading in Berkshire.

The bulk of PTL's existing operations and maintenance activities are currently undertaken by service providers. The day-to-day physical and commercial operations are outsourced to Transco plc. Maintenance and emergency response services are the subject of a separate longer-term contract with Transco. In addition, certain IT functions and systems maintenance and development are also outsourced. It is TNI's intention to relocate the PTL operation to Northern Ireland, and in large part to continue with the existing internal staffing complement and outsourcing arrangements.

The Owners and TNI have made considerable progress in recruiting suitably qualified Northern Ireland based staff to manage PTL after completion of the sale. Appointments of a new General Manager and Operations Manager are expected to be made shortly. In addition, to ensure operational continuity, BG has agreed to continue to provide operational staff currently on secondment to PTL. The existing complement of BG seconded staff may (at the SNIP CLG Board's discretion) continue on secondment for a transition period of up to 12 months after completion, with the exception of the General Manager, who will be replaced by the new appointments.

During this transition period, the new General Manager and Operations Manager, in consultation with the seconded team, will be responsible for developing and implementing permanent Northern Ireland based staffing arrangements. It is expected that these will include a number of shared internal services with Moyle.

Certain of the current service contracts expire in mid/late 2005[2]. It is intended that PTL, under new ownership, will re-tender for such services under the direction of the new PTL management, assisted as appropriate by the BG secondees.

Postalisation Implementation Issues

The sale and purchase of PTL will be undertaken against the background of the implementation of Postalisation, a new regime introducing a common gas transportation tariff in Northern Ireland. Postalisation will effectively remove the concept of the distance gas is transported from the calculation of the tariff which gas suppliers pay for transporting gas. The arrangements for implementing Postalisation are undergoing public consultation by the Authority during August and September 2004, and are due to be implemented with effect from 1st October 2004.

The proposal to transfer the ownership of PTL into a mutualised corporate structure, and the associated financing, will have no impact on the implementation of Postalisation. Indeed, the introduction of Postalisation, which will occur on 1st October 2004, and provides for a large element of revenue security, will be a condition precedent to closing the financing.

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[2] Excluding the long term maintenance and emergency response contract

Section three: Risks and Benefits of the Acquisition to Consumers

This section assesses the value in economic terms of re-financing SNIP via a 100% debt financed CLG weighed against the potential additional risks to consumers. The amount of savings to consumers depends on the assumptions made for the alternative option, which is to maintain the status quo.

Savings are likely to accrue from two sources

- capital savings (lower cost of capital)
- operating cost savings

There is also the scope for inter-temporal re-distribution of costs. Extending the period of debt beyond the current capital recovery period (2021) allows lower costs in the short-term which would require to be offset by greater costs at a later stage. Current consumers pay less at the expense of future consumers.

Savings can be measured in a number of ways:

- net present value (NPV)
- annual savings year by year
- average annual savings

The NPV approach is the standard method for reducing future benefits to a present value. However this is a function of the discount rate chosen[3] and the inter-temporal distribution of savings, that is the extension, if any, of the debt recovery period relative to the current capital recovery period in PTL's licence.

Capital Savings

Under its current licence PTL is entitled to recover a monthly charge from gas suppliers, based upon the original capital expenditure of the pipeline and associated facilities and licensee operating costs. The licence formula recovers the invested capital by 2021 at an 8% real post-tax rate of return. This translates to an annual payment of £10.6m (Jan 2004

[3] The Authority's NPV analysis in this context uses "social time preference rate" to discount future benefits. Social time preference is defined as the value society attaches to present as opposed to future consumption. 3.5% is the UK treasury current estimate of the social time preference (Green Book). Using a 3.5% discount rate £1 benefit today is considered twice as valuable as £1 in 20 years or 4 times that in 40 years.

prices) up to Sept 2021. Given this allowed rate and the current level of long-term interest rates it should be possible to refinance at a considerably lower rate of interest, thereby achieving significant gains to consumers.

However, off-setting the lower interest costs savings will be the premium on the regulatory asset value which PTL receive as part of the deal together with any potential risks transferred to the consumers. In the absence of an equity buffer to absorb cost/demand shocks, a reserve account to cover debt service (DSRA) is pre-funded as part of the finance raised. Furthermore, the transaction costs associated with the acquisition (e.g. legal, technical, financial consulting and financial guarantee fees, are estimated at about £5.5m) will also need to be funded from this source.

The estimated total amount of debt to be raised is made up as follows:

	Amounts in £	Notes
Repayment of Existing PTL Debt	41,880,000	
Consideration to BG/Keyspan for PTL Shares	44,065,000	
Swap Breakage Costs	1,200,000	1
Stamp Duty	207,745	2
Transaction Costs	5,454,114	
Monoline fee	2,000,000	
DSRA Pre Fund	4,320,000	3
Working Capital	238,000	
	99,364,859	

Notes:

1. Swap breakage costs cover the costs of early termination of fixed rate swaps entered into by PTL. This will depend upon the interest rates at the time of the acquisition.
2. Charged at 0.50% on the consideration for shares.
3. Account pre-funded at 6 months debt service, in accordance with market practice

The annual cost of servicing this level of debt over different tenor compared with the current annual capital payments to PTL of £10.6m pa gives a value of the annual savings in capital costs. Discounting the difference between these gives the present value of savings. The estimated net present value of these savings under a range of assumptions on interest rates and length of bond are outlined in the table below and suggest a NPV of savings in the range £ 27.4m to £ 40m.

These estimates are based upon the current long term fixed rate and the table below shows the sensitivity of consumer savings to a 0.50% movement in the interest rate (up or down) from the current estimated financing rate of about 6.20%. If, in the event that

interest rates move adversely to the extent that consumer savings are significantly eroded, then the terms of the acquisition will need to be reviewed.

Table one: Estimated consumer savings in capital expenditure recovery from the acquisition

Tenor of debt	Acquisition interest rate	NPV of consumer savings(1)	Annual Savings to 2021	Extra annual payment after 2021(2)
	nominal %	£m	£m	£m
Current licence 2021(17 years)	6.20%	35.2	2.78	-
	5.70%	38.6	3.05	-
	6.70%	31.7	2.5`	-
Extra 11 years 2032 (28 years)	6.20%	34.4	4.97	5.68
	5.70%	39.7	5.27	5.38
	6.70%	28.9	4.66	5.99
Extra 23 years 2044 (35 years)	6.20%	33.9	5.61	5.04
	5.70%	40.4	5.94	4.72
	6.70%	27.4	5.28	5.37

Notes:

(1) Savings are in 2004 prices and are discounted at 3.5% real. Figures are based upon a fixed annual repayment of the debt.

(2) These figures are the price reduction foregone due to extending the payment period. They ignore the potential savings of avoiding payment to PTL for operating the pipeline post 2021 (see below).

Operating Cost Savings

On top of these savings generated from recovering the capital expenditure at a lower cost of capital, the Authority believes that there are further savings in operational expenditure from the proposed acquisition. Currently PTL operational expenditure is about £9m to £10m. This is comprised of £2.5m for BGE operational expenditure, £2m for predictable, and £5m for unpredictable expenditure. The BGE expenditure which covers PTL's share of the costs of operating the BGE Scottish pipeline should not be affected by the acquisition. However significant savings will be generated in predictable and unpredictable expenditure. For example, as indicated in section two, it is the intention to relocate the PTL operation to Northern Ireland. Relocating the administration and operations of the pipeline from England to NI is estimated to generate savings of about £0.5m p.a.

Under the current PTL Licence, a component of PTL's allowed operational expenditure is calculated on the basis, not of actual expenditure, but as a percentage of the capital cost (defined in the PTL Licence as "Predictable Operating Costs"). It is estimated that PTL's actual expenditure in those areas covered by this definition is less than the fixed amount allowed, and the agreed purchase price includes an allowance for some of the future profits to PTL of this component. Even with the extra allowance in the purchase price, it is forecast that the actual operational expenditure under the ownership of the CLG will be low enough to generate net savings to consumers.

PTL's implied licence recovery period for capital expenditure ends in 2021. However, the physical asset life of the pipeline is projected to continue beyond 2050. This raises a question concerning the appropriate payment to PTL for owning and continuing to operate the asset beyond 2021. During the negotiations between TNI and the Owners, it was agreed that PTL could expect to earn an "Owners' fee" of up to £3 million p.a. to compensate it for continuing to manage and operate the pipeline beyond 2021, without enjoying the benefit of an equity return. It was agreed that some of the present value of this annual fee for operating the pipeline should be accounted for in the purchase price. As the CLG has no profit motive, it would not be expected to require such a fee, and therefore this is a further potential operating cost saving realised from the change in ownership.

The ability of the new owners and management to deliver these various operating cost savings will depend upon the management and Board being appropriately incentivised to control costs and to operate SNIP in an efficient manner. These incentives are described in Section four.

Risks

A Soft budget constraint on operational expenditure

To improve the rate at which the proposed acquisition can be financed, TNI has proposed the removal of the normal regulatory control over allowed operational and maintenance expenditure. The financial markets are sensitive to risk of regulatory intervention. The possibility of the Authority disallowing the CLG from recovering from consumers certain incurred costs is likely to substantially increase the cost of finance. Furthermore, if this possibility remained, the CLG would be required to increase its available liquidity facilities and reserves, to protect it against any regulatory disallowance.

To prevent these additional costs being placed on the cost of acquisition the Authority, as with the Moyle arrangements, accepts the removal of regulatory control over operational expenditure. The Authority believes that the resulting transfer of risk onto consumers through potential inefficient costs can be protected through corporate

governance licence conditions (discussed in section four). With most of the operations being out-sourced the potential for significant inefficiencies will be minimal with appropriate procurement arrangements.

To put this risk into context the current average annual operating costs of PTL are £ 7m (net of BGE costs). With the annual capital expenditure financing savings forecast at between £ 3m and £ 6m, it would require operating costs on average to overshoot by between 40% and 85% to offset the estimated savings.

B Extending the finance over a longer period

The Authority must be satisfied that the chosen form of financing is consistent with its statutory duties and that it will not adversely affect the SNIP CLG's longer term ability to carry out and finance its relevant activities and meet the reasonable requirements of both consumers and funders. A key factor for the Authority will be the duration of the debt financing option selected (bond or bank debt).

In light of Northern Ireland's current relatively high cost base for energy, there may be a good case for maximising savings now, in return for higher charges later, when other cost pressures, especially those associated with the essential expansion of the gas transmission and distribution networks, have been absorbed. This approach also has the advantage of maximising the stimulus for the take-up of gas in the non-power generation sectors, including domestic heating, which will reduce average costs for all users, including electricity consumers, over the longer term.

However, increasing the period of financing is likely to be regarded by the financiers as being accompanied by an increase in risk, which will require a higher interest rate. The Authority will need to balance any such increase in financing costs against the benefits of a longer debt repayment period. In any event, the possible additional support from electricity consumers through the collection agency arrangements (addressed in section four) may largely mitigate such costs.

The outlook for the Northern Ireland gas industry is very strong, with the imminent completion of the Northwest pipeline from Belfast to Derry, and the proposed construction of the South North pipeline from Dublin to Belfast in 2006, due to bring natural gas into the regional towns along these pipelines. However, it is inevitable there is some long term risk to the industry. The cost of gas transmission will continue to be dependent upon the volume of gas consumed by gas-fired electricity generators. The two recently installed combined cycle gas turbine generators at Ballylumford and Coolkeeragh have an operational life of at least 20 years.

The ultimate choice of debt tenor will take into account the Authority's view of the relative merits of the different consumer savings profiles and the risk factors involved in a longer financing period.

Conclusion

In August 2004, TNI issued a Preliminary Information Memorandum to a number of financial institutions which had expressed an interest in potentially arranging the required debt finance, seeking initial structuring proposals and pricing quotes on a range of funding options. The options sought included bond or bank finance, and, in the case of bond finance, the choice between index-linked or fixed rate interest, and between an issue wrapped with a financial guarantee from a monoline insurance company, or unwrapped. After a similar funding process, the Moyle financing was concluded with a monoline-wrapped, index-linked bond issue.

The Authority seeks views on whether there are there risks and benefits to consumers in the proposed structure which we have not assessed in the paper and on the length of financing, which may be up to 35 years.

Section four Regulatory Issues to be decided

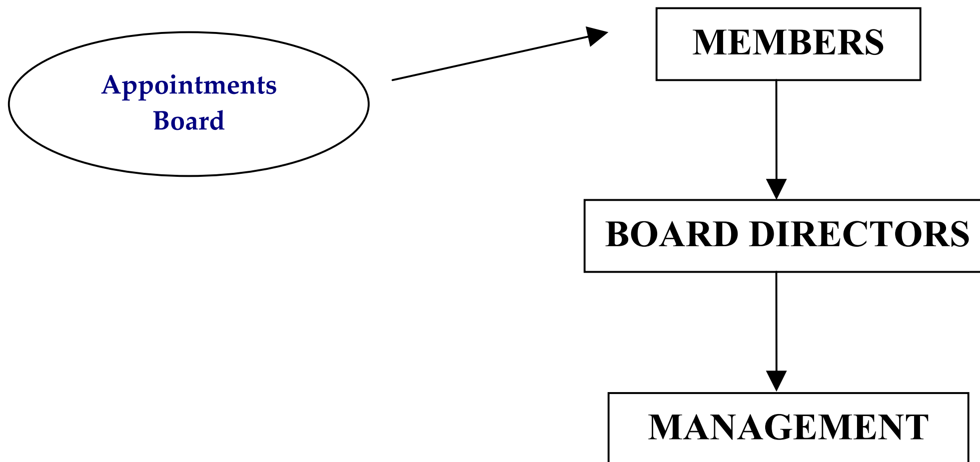
A: Regulatory Framework - Appropriate Corporate Structure

The 100% debt funded company CLG will a very different corporate and financial structure from its predecessor. The CLG structure has proved to work very well as long as it is designed in the interest of consumers. The disciplines and incentives on the SNIP CLG Board and its staff must be at least as strong as they would be in a more conventional, equity-owned company. This section discusses how the new structure should be designed.

With a 100% debt funded (not for profit) company, the Board will remain accountable for the efficient conduct of the business, and to ensure a strong monitoring role in the interests of consumers rather than shareholders. The Authority must ensure that the benefits from the removal of the profit motive are not eroded through insufficient control of costs and manager performance. This is especially important with the removal of the regulatory control over operational expenditure.

Appointment and Responsibilities of Members and Board Directors

As outlined in section two, the corporate governance structure which will be used for the SNIP CLG is:



The Appointment Board appoints the Members, whose role is to act in a similar way as shareholders of an equity based company. The Members in turn appoint the Board Directors. The Members oversee the Board Directors' performance and the Board monitors and is responsible for management performance. Members are not entitled to receive dividends and, other than their liability to pay £1 upon a winding up of the company, have no financial interest in the company.

It is crucial that this corporate governance structure is aligned to consumers' interest thereby ensuring the benefits from the acquisition are maintained. Licence conditions are possibly necessary to ensure proper corporate governance and this section identifies the options that the Authority is currently exploring. There are three layers to the safeguards:

1. Appointment of the Members and the Board Directors
2. Motivation of the Board Directors to monitor management
3. Incentives to Management to work in consumer interests

The similar experiences of the Glas Cymru (a GB water company), Network Rail and, of course, Moyle, provide a helpful benchmark for appropriate safeguards. When designing such safeguards for the SNIP business the Authority will take a realistic approach to the nature of the business activity and have regard to the need to keep the level of regulatory burden on the CLG to an appropriate level. PTL is a single function company, and it would not be in the interests of consumers to create a bureaucratic, complex corporate governance. Hence it may be sensible for some of the Members to also become Board Directors.

Members have a responsibility to ensure that the company is performing according to its objectives – in the SNIP CLG case the principle of providing safe and reliable transmission service at the efficient cost. They are therefore responsible for monitoring Board performance.

As it is consumers who have the strongest interest in the financial performance of management, the transparency involved in a CLG structure with its Members could be argued to have much greater accountability than the conventional shareholder model.

The Directors must take responsibility for monitoring management performance. Weak corporate oversight could allow staff to pursue goals, which may not coincide with the interests of consumers who ultimately are the bearers of risk in a non-share capital company. Developing management incentives to link rewards to the interests of consumers, which are discussed below, can help to avoid this.

To ensure the appointment of a competent group of Members which is motivated to ensure effective management, there are probably three requirements which are in many ways inter-related:

- transparency in the appointment process;
- diversity of Membership with adequate representation of users/consumers; and
- accountability.

The appointment process for the SNIP CLG Members must be transparent, to ensure both public confidence in the acquisition and the appointment of a high calibre team of Members who are motivated to achieve the efficient operation of the business.

The Authority is interested in views on the process for the appointment of SNIP CLG Members. For example, should there be a public recruitment process? What role should the Authority have in this?

It is important to include, among the Directors, those who have a direct stake either as consumers or users of SNIP in achieving the SNIP CLG's objective of the safe and reliable transmission of gas at an efficient cost. It is also important to include some who have knowledge of the business. A diversity of backgrounds and interests should ensure good quality decision making and help protect the interests of consumers. Any appointment process must ensure diversity and direct stakeholders' involvement.

<u>Motivation of Directors to monitor management</u>

To ensure the appointment of a competent Board, which is motivated to ensure effective management, there are probably three requirements which are in many ways inter-related:

- transparency in the Board's activities;
- diversity of composition of the Board with adequate representation of users/consumers; and
- incentives to work to further consumers' interests.

Public exposure to the activities and decisions of the SNIP CLG will help to allow monitoring more generally by users and the public at large. The potential of suffering damage to their reputations will also incentivise the Members to monitor business performance diligently.

In addition the Authority has a responsibility to monitor PTL's performance to ensure that it remains compliant with its licence obligations. However due to the asymmetry of information between the business and the regulator, the mere existence of a regulator is not sufficient to ensure the business will act in the public interest. Therefore regulation should act as a complement to, and not a substitute for, internal monitoring. It is important that the appointment process creates the proper incentives for internal monitoring.

It might be expected that the financiers will play an effective governance role. The Authority recognises that the debt markets do provide incentives for companies to act efficiently and adopt good management practices, but believes that these may not be as

strong as those provided by shareholders. Lenders are concerned to ensure that their investment and interest is secure, but are not necessarily concerned to incentivise management to seek further efficiencies over and above this. Thus lenders may well provide pressure to improve in a deteriorating situation but not necessarily in a neutral one and would be unlikely to drive company performance in the manner of equity shareholders.

A concern has been raised that the Board could become dominated ("captured") by one interest. Having a diverse Board should protect against this. In addition with the present policy of determining transmission charges remaining with the Authority there will be no scope for sectoral interests or certain consumer groups to obtain preferential treatment through any position they may have on the Board or in the Membership.

Mechanisms for ensuring the removal by the Members of poorly performing Directors will also be required.

In light of these issues, the Authority is considering the following licence conditions[4]:

i. The placing of a key public objective on the SNIP CLG Board and the Members that it must adhere to the principle of providing safe and reliable transmission service at efficient cost.

ii. Robust, transparent reporting requirements in an Annual Report and Accounts, for public accountability.

iii. The Board to comply with Principles of Good Governance and Code of Best Practice (or any successor document) as approved for the purposes of the requirements for listed companies of the UK Listing Authority; and

iv. Consultation with the Authority on any proposed changes to its Memorandum and Articles of Association.

Company Incentives

Although the CLG is a not for dividend company, it should still seek to maximise its surplus for the benefit of consumers. The absence of a conventional profit motive in the CLG could be considered a weakness in the drive for economic efficiency. The SNIP CLG will however be made up of Members who have a direct interest in minimising the cost of energy in Northern Ireland. Moreover, it is envisaged that the Board will include

[4] The corporate governance protections will be enshrined in the Memorandum and Articles of Association of each of the relevant companies, and, if appropriate, in the licence conditions.

individuals with a proven track record in developing business and wealth generation. TNI have suggested to the Authority that the CLG should use this expertise to allow the Board to seek and create additional surplus which it could then - subject to suitable arrangements for transparency and accountability - invest in other energy projects that would provide greater overall benefit to energy users in Northern Ireland.

In the case of a SNIP this "company profit incentive" could work by setting a target reduction in SNIP transmission costs against an established benchmark and agreeing that further surplus would be split with - say - half going in additional reductions in charges and the rest being available to the CLG for investing in even more projects aiming to reduce energy costs in Northern Ireland.

In a fully liberalised energy market, entrepreneurialism that works in the public interest is certainly to be encouraged and the Authority, which intends to encourage the SNIP CLG to put forward its ideas on how this might be managed, would be interested in views on how to incentivise the CLG to maximise its surplus.

Incentives on Management to work in the interests of consumers

In a CLG, it is essential that the incentives on individuals improve efficiency, to deliver obligations and contractual commitments to consumers, and to meet regulatory licence commitments should be no less effective than in a more conventional corporate structure with equity shareholders. The above section discusses how best to incentivise the Board and Members to monitor managerial performance. These must be complemented by mechanisms establishing a direct link between management remuneration and performance. Management incentive schemes in other mutuals are being explored by the Authority.

Performance-related pay based upon quality, safety, service delivery and financial performance will align the managerial interests with the interest of consumers and efficient business operation. The more these targets are well-defined and measurable the better the incentives and the easier for the Board to monitor. However regarding the SNIP operation, such targets may be difficult to define. We see four possible performance targets:

- Safety
- Reliability
- Fulfilment of Contractual (Transportation Code) obligations and licence obligations
- Maximising available capacity
- Operational expenditure performance

The Authority is keen to seek views on alternative targets for setting management remuneration

Performance–related pay works through a basic fixed level salary and with bonuses for good performance against defined targets. The extent of the bonuses may be up to 40%. In the event of poor performance there should be no annual salary increases. The ultimate discipline of removal must exist in this structure and therefore the importance of incentivising the Board to actively monitor the management performance.

The Authority will consider a licence condition requiring the Board to develop a management incentive plan linking pay to performance and a requirement for the plan to be published in the Accounts.

Protecting against the soft budget constraint on operational expenditure

As explained in section three, the Authority is minded to relax the normal regulatory control over the licensee's operational expenditure allowance to capture additional savings through lower financing costs. This is subject to the SNIP CLG continuing to demonstrate by its performance that it is managing the operational costs efficiently.

The Authority believes that the incentives on the CLG to be seen to generate surpluses in order to reduce energy costs are strong. These incentives are reinforced by the incentives on management and by the accountability of the Directors to their Members, who will have a vested interest in lower energy costs.

It will in any event be incumbent on the Authority to scrutinise and, if necessary, challenge each year PTL's forecast revenue requirement, as it will do with the other pipeline operators in the Postalised system.

The Authority would welcome comments on the corporate governance arrangements proposed here and particularly views on whether these will ensure that the SNIP CLG will be commercially focussed in order to drive performance in the regulated business.

Other licence conditions:

Service Procurement Provision

Since the start of operations in 1996, PTL has out-sourced a number of activities connected with the maintenance and operation work. This is common practice in the industry and will be continued under the new CLG ownership.

The Authority notes that licence conditions of existing energy infrastructure companies contain provisions in respect of economic procurement of services, operation and maintenance standards, availability and quality of service. Similar conditions are proposed for the SNIP licence, with the addition of a requirement that the licensee should inform the Authority if it becomes aware of any circumstances which could materially affect its ability to deliver these licence obligations, plus an option for the Authority to request a report explaining the SNIP CLG procurement arrangements.

Ring fencing provision

For transparency and to increase the robustness of the CLG financial structure, there needs to be clear ring-fencing between the regulated CLG and other companies. Hence the Authority believes that a licence condition is required to prevent any funding or revenue intended for the regulated activity being diverted into other affiliated companies/activities. Any revenue recovered by the CLG must be spent on the activities of the business permitted by the licence.

B: Collection Agency Arrangement support from electricity consumers

TNI has proposed that the financing structure be underpinned by a guarantee from electricity consumers, in the form of a contingent collection agency arrangement (CAA). This arrangement will enhance the credit rating thereby securing a reduction in the cost of financing, in turn increasing the consumer savings delivered by the acquisition. The financing of the acquisition is thought not be to dependent upon the CAA support mechanism, however it is initially estimated that without it, the bond financing rate will increase by 0.3% to 0.5%. From the figures in table one, increasing the finance rate from 5.7% to 6.2% adds about an extra £200,000 per year. In the example of a bond tenor to 2021, the CAA would generate NPV savings of over £3m. Furthermore, the CAA support will also make longer term financing more achievable, thereby increasing the inter-temporal savings by consumers. This could generate positive gains by lower gas prices today to encourage a higher uptake by consumers.

The CAA improves the financing structure by underpinning the strong assumption that PTL's costs are always recovered, even upon the occurrence of an adverse regulatory event. As mentioned above, the viability of the Northern Ireland gas industry provides the security to attract the debt to finance the acquisition. The support from electricity consumers through the CAA gives the financiers a form of insurance against unexpected and material deterioration in the fundamentals of the gas industry over the financing period.

With the CLG not having a conventional equity buffer, it will need to have adequate cash reserves and liquidity credit facilities to deal with shortfalls and interruptions in its ability to recover its costs through the Postalised system. The cash reserves and

liquidity facilities will be sized to protect PTL against any unforeseen shocks, including under-recoveries due to lower volumes of gas being shipped, or the default or insolvency of one or more shippers of gas on the Postalised system. The CAA provides additional comfort to the financiers against extreme scenarios and in no way does it act as a substitute to these liquidity reserves. Furthermore the SNIP CLG will continue to take out normal commercial insurance.

For the foreseeable future, approximately 85% of gas transported through the Postalised system will be delivered to gas-fired power plants serving the franchise and merchant electricity markets. This is estimated to fall to about 60% by 2020 due to the growth in the towns. The guarantee of last resort is to be provided by electricity consumers throughout Northern Ireland, the most diversified group of consumers, and, therefore, the group in the best position to give such support. In turn, the bulk of the financing benefit will flow to these consumers.

Triggering Events for the CAA

There are two possible triggering events:

Firstly, it is proposed that the CAA would be triggered by the occurrence of an Adverse Regulatory Event (ARE). The definition of an ARE will be any conduct of a relevant regulator (or the preparation of any draft legislation/regulation) which has the potential to undermine the robustness of the financing structure (including the CAA structure, the protections for financing parties included in licences, comfort letters, and other contractual protection etc.).

Secondly, if the SNIP CLG Board, having consulted the Authority, determines after taking account of its projected cash requirements in the short-medium term, unless it receives revenues from the CAA, it is likely that its reserve liquidity facility will be overdrawn at the end of the gas year.

The need for this second trigger arises because, without it, the SNIP CLG would have no means of raising any additional cash (i.e. additional to that which it is receiving from the Postalised system) which it needs in order to meet its cash requirements at the levels prescribed in the CLG financing documents and, if already drawn, to replenish its liquidity facilities. The only scenario envisaged where this trigger is required is the disappearance of all gas consumers; very unlikely with both power stations having long term financial commitments to the gas network[5].

[5] Each CCGT procures gas from suppliers , which have a ship-or-pay contract to ship gas on the Postalised system. The existing ship-or-pay obligations account for over 70% of the gas projected to be shipped on the system until 2011, reducing to 25% thereafter until 2024

The SNIP CLG Board will be required to consult with the Authority before any action is taken, although the Authority will have no veto over the triggering of the CAA.

If the CAA is triggered, the additional charges which will be imposed on electricity suppliers will fund the SNIP CLG costs (operation, maintenance, repair and financing) during the period, thus enabling the CLG to build up and reserve cash received from gas suppliers via the Postalisation system during such periods.

The Authority supports the insertion of the CAA into the financial structure. The CAA event is likely to be triggered only in the extreme event that all gas consumers disappear, including, the two gas-fired power generators. The power generators have both recently installed new gas–fired technology which have an estimated operational life of at least 20 years. Therefore the Authority believes that its support for the CAA is consistent with its principal duty under Article 12 of the 2003 Energy Order, to protect electricity consumer interests. As electricity consumers are the principal beneficiaries from the reduction in gas transportation costs, they have the clear interest in any measure which further reduces costs. Electricity consumers will receive over 80% of the resulting additional NPV savings of £3m from providing this support.

The CAA support mechanism, is consistent with the Authority's obligations under the EU Directive of achieving a competitive, secure and environmentally sustainable industry with no discrimination.

Moreover, the reduction in the cost of the gas transportation for all users of the Postalised gas network, associated with a CAA, would be in furtherance of the Authority's principal objective in carrying out its gas functions, which is "to promote the development of an efficient economic and co-ordinated gas industry in Northern Ireland" (Article 14 of the Energy Order 2003).

Design of the CCA

The Authority is in discussion with Northern Ireland Electricity plc (NIE) on the structure and mechanics of the CAA. It is intended that the CAA be structured in a manner to make NIE neutral. A number of issues in connection with the CAA are yet to be resolved.

It is envisaged that the CAA would be imposed on suppliers of electricity in Northern Ireland through the system support services ("SSS") charges of SONI (the electrical transmission system operator in Northern Ireland). It is expected that under the CAA, SONI will only be responsible to pay amounts to PTL that it actually collects from electricity suppliers. The cash built up by the CLG during an triggering event (in excess of the amount required to be held in reserve accounts pursuant to the financing documents and/or to replenish liquidity facilities) would be refunded to SONI after the

date upon which the circumstances giving rise to the triggered have been rectified, thereby allowing SONI to reduce its charges to electricity suppliers in the subsequent years.

The Authority requests views on whether it is appropriate for electricity consumers to support this acquisition via the CAA.

Section five Timetable and the Authority's Actions

10th Sept:	NIAER consultation on the proposed consultation
8th Oct:	Deadline for consultation responses
mid-Oct:	Completion of the NIEAR-TNI discussions
22nd Oct:	NIAER Issue of the draft licence for the CLG for consultation
22nd Oct:	DETI issue of the draft designation notice for the CLG
19th Nov:	Deadline of consultations
Late Nov:	Financial Close/Acquisition completed

The Authority's principal roles in this acquisition can be summarised as follows:

- review and approval of the financing structure proposed by TNI, with particular regard to the quantum and deliverability of consumer savings;
- design the appropriate corporate governance licence conditions;
- issuance of a new conveyance licence to PTL, incorporating conditions consistent with the requirements of both Postalisation and the financing, including a minimum expiry date reaching beyond the end of the financing period that is finally adopted;
- implementation of various changes to transmission licence of NIE, in order to introduce a supporting CAA to enable a reduced cost of financing PTL. If SONI is later licensed as the system operator of the Northern Ireland electricity system, then these functions will be transferred to SONI; and
- issuance of a comfort letter to TNI, PTL, the Owners and the financing parties, in terms to be agreed, addressing certain matters, including:
  - consultation with PTL prior to proposing any modifications to the PTL licence or the applicable condition in the electricity transmission licence (or other appropriate form of licence if SONI is licensed);
  - consideration of any eventual application for a new conveyance licence for the SNIP network by a person nominated by the security trustee under the financing in the event of a revocation of the PTL Licence or other default under the financing; and

– provision for the CAA to be written into SONI's future TSO licence, and the licence of any successor TSO if SONI's licence is revoked.