

# **Northern Ireland Energy Holdings Corporate Governance Review**

## **Utility Regulator Decision Paper**

**May 2009**

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## **Executive Summary**

In March 2009, the Utility Regulator issued a consultation paper to inform interested parties of the corporate governance structure in place within Northern Ireland Energy Holdings (“NIEH”). The consultation paper set out the findings of the review carried out by Ernst & Young and the Utility Regulator and recommendations on potential improvements to the NIEH corporate governance structure including remuneration and regulatory processes.

The purpose of the review was to ensure NIEH has an appropriate corporate governance structure in place for a company of its size and nature and that the appropriate regulatory arrangements are in place for Moyle Limited, Premier Transmission Limited (“PTL”) and Belfast Gas Transmission Limited (“BGTL”). As part of the consultation process for the NIEH acquisition of Moyle Ltd, PTL and BGTL we stated how we would continue to monitor NIEH closely to ensure the risks of higher operating expenditure are minimised while ensuring the benefits of a lower cost of capital are maximised. The corporate governance review is therefore an important part of the ongoing monitoring of NIEH and mutualisation.

In total there were nine recommendations from the review, three on governance, three on remuneration and three regulatory recommendations.

On governance, Ernst & Young recommended:

1. NIEH give consideration to implementing a Board Charter to outline roles, responsibilities and terms under which they operate;
2. that the existing terms of reference for each of the sub-committees of the Board are made available through the NIEH website; and
3. that the NIEH Members Selections Committee considers developing an assessment criteria for Members’ performance.

On remuneration, Ernst & Young recommended:

4. the assessment of whether bonus targets set are appropriately stretching;
5. due consideration be paid to the “all or nothing” approach to bonus payments; and
6. the absence of a long term incentive plan to be taken into consideration when setting future bonus levels.

In terms of the regulatory review, the Utility Regulator recommended:

7. that the corporate governance conditions contained in the PTL and BGTL gas conveyance licences should be used as a basis for the Moyle Interconnector Licence.
8. that the Moyle Licence be modified to formalise the process of monitoring the Moyle controllable operating expenditure in the form of a shadow price control; and
9. that NIEH undertake a review of their NIEH Membership Policy to ensure that the document is up-to-date.

The Utility Regulator received six responses to the consultation paper. The main issues raised by respondents concerned:

- The BETTA Rebate
- Assessment of Member Performance
- Sub-Committee Terms of Reference
- Ernst & Young Comparator Companies
- Utility Regulator Nominees to Membership Selections Committee
- Risk Management

After consideration of the responses received, our conclusions on the recommendations made in the consultation paper are as follows:

On governance, NIEH has published the sub-committee terms of reference and is in the progress of developing a Board Charter. Although NIEH has highlighted the difficulties in developing assessment criteria for their Members they have agreed to consider this further following this consultation process and feedback from existing Members.

On remuneration, the Remuneration Committee has already moved away from an “all or nothing” bonus scheme and has agreed to consider the options to them with regards to the assessment of bonus targets and the introduction of a long term incentive plan for staff.

As regards the regulatory recommendations, NIEH has agreed to the modification of the Moyle licence to include the corporate governance and shadow price control conditions contained in the PTL and BGTL gas conveyance licences. These licence changes will be introduced via the formal licence change process. In terms of the Membership Policy review, NIEH is in the process of carrying out this review and following consultation with its Members, will seek approval for any changes from the Utility Regulator and at its AGM in September 2009.

## 1. Summary of Consultation Paper

In March 2009, the Utility Regulator issued a consultation paper entitled ‘Northern Ireland Energy Holdings Corporate Governance Review – Utility Regulator Consultation Paper’<sup>1</sup>. The purpose of the consultation paper was to inform interested parties of the corporate governance structure in place within NIEH. The paper set out the findings of the review carried out by Ernst & Young and the Utility Regulator and any recommendations on potential improvements to the NIEH corporate governance structure including remuneration and regulatory processes. Views were sought on all aspects of the paper but in particular on the recommendations and conclusions.

The purpose of the review was to ensure NIEH has an appropriate corporate governance structure in place for a company of its size and nature and that the appropriate regulatory arrangements are in place for Moyle Limited, Premier Transmission Limited (“PTL”) and Belfast Gas Transmission Limited (“BGTL”). As part of the consultation process for the NIEH acquisition of Moyle Ltd, PTL and BGTL we stated how we would continue to monitor NIEH closely to ensure the risks of higher operating expenditure are minimised while ensuring the benefits of a lower cost of capital are maximised. This corporate governance review is therefore an important part of the ongoing monitoring of NIEH and mutualisation.

As part of the review we procured Ernst & Young to assess the appropriateness of the Combined Code on Corporate Governance (the “Code”) for NIEH and whether it is implemented in practice; to benchmark the remuneration of NIEH’s senior management and to make a number of recommendations on potential ways to improve NIEH’s current corporate governance structure. The Utility Regulator also took the opportunity to review the regulatory corporate governance arrangements in place for the three subsidiaries of NIEH.

Ernst & Young’s conclusions from the review were very encouraging in that they concluded that the Code is an appropriate benchmark for NIEH and that current practices are in line with the provisions of the Code. A small number of recommendations for potential improvements to current corporate governance arrangements within NIEH were made but only with the intention to enhance the existing processes, rather than to address any deviation from the Code. On governance and remuneration, Ernst & Young recommended:

1. NIEH give consideration to implementing a Board Charter to outline roles, responsibilities and terms under which they operate;

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<sup>1</sup> [http://www.niaur.gov.uk/news/view/utility\\_regulator\\_consults\\_on\\_nieh\\_corporate\\_governance\\_review](http://www.niaur.gov.uk/news/view/utility_regulator_consults_on_nieh_corporate_governance_review)

2. that the existing terms of reference for each of the sub-committees of the Board are made available through the NIEH website;
3. that the NIEH Members Selections Committee considers developing an assessment criteria for Members' performance;
4. the assessment of whether bonus targets set are appropriately stretching;
5. due consideration be paid to the "all or nothing" approach to bonus payments; and
6. the absence of a long term incentive plan to be taken into consideration when setting future bonus levels.

In terms of the regulatory review, the Utility Regulator concluded that the corporate governance conditions contained in the PTL and BGTL gas conveyance licences should be used as a basis for the Moyle Interconnector Licence. The PTL and BGTL licences also include a licence condition which allows the Utility Regulator to monitor their controllable operating expenditure in the form of a shadow price control and, although monitoring of Moyle operating expenditure is currently possible, it was recommended that we modify the Moyle licence to formalise the process.

In addition to this and on completion of our corporate governance and regulatory review we requested NIEH to undertake a review of their NIEH Membership Policy to ensure the document is up-to-date and reflects any changes that may arise as a result of our review.

## **2. Responses Received and Utility Regulator View on Responses**

In the consultation paper we sought views on all aspects of the review but in particular comments were sought on the recommendations and conclusions of the review.

The Utility Regulator received six responses to the consultation paper, one of which was confidential. The five non-confidential responses were submitted by:

1. Phoenix Energy Holdings Limited;
2. Northern Ireland Electricity Energy Supply;
3. Northern Ireland Electricity plc;
4. Northern Ireland Energy Holdings; and
5. The Consumer Council.

We would like to thank the respondents for their time and input into the consultation process. All of the non-confidential responses have been published in full alongside this paper on the Utility Regulator website.

The general consensus from respondents was that they acknowledged and welcomed our commitment to the monitoring of NIEH's corporate governance arrangements and noted NIEH's compliance with the Code. Respondents generally welcomed the findings of the review while supporting the proposed recommendations.

As part of their response, NIEH welcomed our commitment to providing regulatory oversight of the NIEH group of companies to ensure all aspects of the structure are performing satisfactorily. NIEH was pleased that the review had concluded that the Code is the most appropriate model for the governance structure of the company and that compliance with the Code had been demonstrated through the review. With regards to the recommendations made to NIEH, if they have not already been implemented they have agreed to consider the options available to them in order to implement them. They have however noted the difficulty in member assessment but agreed that the NIEH Membership Selection Committee will consider the options further following this consultation process and discussions with existing Members. With regards to the remuneration recommendations, NIEH has stated that their Remuneration Committee will consider the options available to them with a view to addressing the issues. They have also agreed to the recommendations made as part of the regulatory review.

In terms of the other responses to the consultation, some of the key issues raised and our view on these issues are as follows:

## BETTA Rebate

- Three of the respondents made reference to the fact that the review did not include the issue of the investment of the BETTA rebate by NIEH. The respondents stated how there was a lack of transparency surrounding this rebate and the governance arrangements relating to this investment. One of these respondents added that they would have expected the review to comment on whether the investment is delivering the expected benefits.

**Utility Regulator View** - the purpose of the review was to ensure that NIEH have a suitable corporate governance structure in place. The review did not undertake to look at all the decisions made by NIEH including the issue of the investment of the BETTA rebate.

## Assessment of Member Performance

- A number of respondents referred to the recommendation regarding the development of assessment criteria for Member's performance. One respondent welcomed the recommendation whilst noting how Ernst & Young had not suggested a detailed proposal nor were they aware of any comparisons used elsewhere.

One respondent felt that a fundamental flaw in the mutual model for utility assets is the absence of any real economic interest by the Members in the performance of the company and without this there is no guarantee that the structure will work in a rigorous and effective manner.

Another respondent felt that the difficulties in implementing a formal assessment process for Members should not, in itself be a reason not to proceed with implementation of this recommendation.

**Utility Regulator View** – as stated in the consultation paper Ernst & Young themselves were not aware of any comparisons used elsewhere for Member assessment and did not suggest a detailed proposal for the recommendation. Although some of the respondents supported the implementation of this recommendation they were also not aware of any comparisons nor did they make any proposals as to viable methods for assessing the performance of Members. On the basis of this there is nothing to suggest that our initial thought that the current process whereby Member attendance at formal meetings is recorded and NIEH assess their Members at re-appointment is in fact the most appropriate option for NIEH. We note from the NIEH response that the Members



Selection Committee has agreed to consider this recommendation further following this consultation process and feedback from existing Members.

#### Sub-Committee Terms of Reference

- One respondent agreed that it was a good idea to publish the existing terms of reference for each of the sub-committees of the Board but proposed that the minutes from these sub-committee meetings should also be published.

Another response stated how it was not clear from the consultation paper whether the scope of the review considered if the terms of reference for the Audit Committee followed the guidelines set out for listed companies under the “Guidance on Audit Committees”. This respondent also sought assurance that there is a sufficient audit function in place to ensure that NIEH are duly following their internal processes.

**Utility Regulator View** – as it is not a requirement of the Code to publish the minutes of sub-committee meetings, it is unusual that sub-committee minutes of a private or public company are published. In addition to this, the rules surrounding quoted bonds restricts NIEH in releasing information that may affect the bond prices, for example audit committee deliberations on accounts, risk registers, audits etc. Sub-committee minutes might also contain information of a personal or restricted nature. For these reasons we do not feel it appropriate that the minutes from the sub-committee meetings be published.

In terms of the response regarding the Audit Committee, the scope of the review included consideration of whether the Code was an appropriate benchmark for NIEH and to assess consistency with the Code. Guidelines for listed companies in “Guidance on Audit Committees” are supplemental to the Code and are intended to assist Boards with implementing the Code rather than provide any additional requirements.

The consultation paper set out the overall conclusions on consistency with the Code and additional comments on areas for enhancing current processes. Each section/sub-section within the Code was included in section 5 (c) of the consultation paper. While not specifically commented on, existence and content of the terms of reference of all sub-committees, including Audit Committee, was considered and concluded on as part of the “Board Constitution and Responsibilities” section.

### Ernst & Young Comparator Companies

- In terms of the benchmarking of the NIEH remuneration, two respondents made reference to the organisations that Ernst & Young had used as a comparator. One stated that the comparator companies should have been publicised in the interests of transparency and openness while the other questioned whether Ernst & Young had also considered benchmarking NIEH against companies operating at a similar level of risk.

**Utility Regulator View** – a benchmarking exercise would typically consider the size of the organisation (review and market capitalisation); type of organisation; business sector; and level of responsibility of the posts. The unique structure of NIEH as a mutual company meant that comparison could not be made based on market capitalisation. In addition, limited data exists on small listed utility companies, so market data on general companies of similar revenues was used. Comparators were companies based in UK and Ireland.

### Utility Regulator Nominees to Membership Selections Committee

- One respondent sought clarification on the Utility Regulator's role in their selection of the two independent representatives for NIEH's Membership Selections Committee. While another was interested to learn of the measures the Utility Regulator takes in ensuring and assessing the independence of its nominees in an open and transparent way.

**Utility Regulator View** – as part of the review Ernst & Young looked at the Utility Regulator's role in the selection of Members. They confirmed that the Utility Regulator is able to nominate two representatives for the Members Selections Committee who along with two Non-Executive Directors and two Members, form the Committee and it is this Committee who select the Members, not the Utility Regulator nor the Members themselves. The Utility Regulator does not therefore have any direct influence or final decision in either the selection or appointment of Members. Ernst & Young's opinion was that "the Utility Regulator has an independent role in the process, which does not currently enable direct influence or decision making in membership selection. In the Utility Regulator's role as regulator, it is critical that this independence is maintained and provided that the involvement remains limited to nominating representatives to the Membership Selections Committee, this should be achieved."

As part of the review of the NIEH Membership Policy we can ensure that the independent role of the Utility Regulator in this process is maintained.

## Risk Management

- In response to the comment that in relation to risk management, Ernst & Young would not expect a formal training programme or communications strategy based on the size of NIEH, one respondent felt that systems for Health & Safety and risk management should be consistent with the value and importance of the asset that the company manages and the strategy consequences of that asset not operating effectively on Northern Ireland as a whole. The respondent stated how they would therefore expect the Utility Regulator to ensure that the appropriate procedures are in place irrespective of how NIEH chooses to manage its resource structure.

**Utility Regulator View** – part of the Ernst & Young review was to assess the risk strategy and risk management processes within NIEH. Ernst & Young concluded that NIEH is operating at a standard it would expect them to be for a company of its size and nature and ultimately determined NIEH to be operating in the lower end of leading indicative practice for both ‘Risk Strategy’ and ‘Risk Management Processes’.

In terms of Health & Safety, the NIEH companies have legal obligations to meet numerous Health & Safety requirements including the approval of a safety case by the Health and Safety Executive Northern Ireland (“HSENI”) which all of the NIEH companies have had approved and reviewed annually. As Health and Safety is the responsibility of the HSE NI the systems for risk management of Health and Safety ultimately fall under their remit.

## Other Issues Raised by Respondents

- One respondent stated that the terms of reference for the review should have been widened to include firstly, a comment on the decision on NIEH seeking our approval for the engagement of a management company to undertake consultancy work as part of the PTL acquisition and secondly, a comment on whether NIEH’s actual performance to date is delivering the anticipated NPV benefits of mutualisation.

**Utility Regulator View** – as stated above for the BETTA rebate issue, the purpose of this review was to ensure that NIEH had a suitable corporate governance structure in place and not to look at all the decisions made by NIEH nor was the purpose to determine whether or not NIEH was delivering the NPV benefits forecast at the time of the acquisitions. We will continue to monitor Moyle, PTL and BGTL performance as we

have done in the past and this will include analysis of the benefits forecast at the time of the acquisitions.

- One respondent questioned whether mutualisation set in a monopoly context is the correct road to follow especially if additional regulatory oversight and control is necessary to act as a substitute for the absence of market based incentives found in proprietary firms. This respondent felt that with the increasing emphasis placed on an all-island solution, now might be a good time to re-examine the case for mutualisation and whether it is indeed the best model to drive efficiencies, support innovations and to further enhance competition.

**Utility Regulator View** – The benefits of the mutualisation of Moyle, SNIP and BGTL have been substantial and have kept Northern Ireland energy prices lower than they would otherwise have been. Moyle's mutualisation in 2003 resulted in NPV savings to consumers of £19m as a result of the lower financing costs and the mutualisation of PTL in March 2005 resulted in NPV savings of £41.5m. The more recent completion of the acquisition of the regulated gas transmission utility, Phoenix Natural Gas Limited by NIEH will deliver financial benefits to the Northern Ireland gas customers in the region of £25m over 40 years. Although these benefits have been substantial, further work would be needed to determine whether benefits can be achieved for customers from future mutualisations.

### 3. Final Recommendations

Following the consultation process and having taken into account the responses, our decision on the recommendations made is as follows:

#### Governance Recommendations

1. NIEH give consideration to implementing a Board Charter to outline roles, responsibilities and terms under which they operate;

Decision – this has been accepted by NIEH and they are currently developing a Board Charter.

2. that the existing terms of reference for each of the sub-committees of the Board are made available through the NIEH website;

Decision – this has been accepted by NIEH and they have since published the sub-committee terms of reference on their website ([www.nienergyholdings.com](http://www.nienergyholdings.com)).

3. that the NIEH Members Selections Committee considers developing an assessment criteria for Members' performance.

Decision – in our consultation document we highlighted the difficulty in implementing this recommendation due to the fact that the Members are not remunerated for their participation and they are equivalent to shareholders who themselves have no assessment requirement. We also stated how Ernst & Young were not aware of any comparisons used elsewhere for Member assessment and did not suggest a detailed proposal for the recommendation.

A number of respondents to the consultation supported the implementation of this recommendation. No respondent however suggested a mechanism for assessing the performance of Members nor were they aware of any comparisons elsewhere for Member assessment. On the basis of this there is nothing to suggest that our initial conclusion that the current process whereby Member attendance at formal meetings is recorded and NIEH assess their Members at re-appointment is in fact the most appropriate option for NIEH. We note from the NIEH response that the Members Selections Committee has agreed to consider this recommendation further following this consultation process and feedback from existing members.

## Remuneration Recommendations

1. the assessment of whether bonus targets set are appropriately stretching;

Decision – the NIEH Remuneration Committee is responsible for setting the performance targets and to ensure they are appropriately stretching. This Committee has agreed to consider the recommendation going forward.

2. due consideration be paid to the “all or nothing” approach to bonus payments;

Decision – this recommendation has been accepted by NIEH and the bonus scheme has been changed away from the “all or nothing approach”.

3. the absence of a long term incentive plan to be taken into consideration when setting future bonus levels.

Decision – the NIEH Remuneration Committee has agreed to consider this recommendation with a view to addressing the issue.

## Regulatory Recommendations

1. that the corporate governance conditions contained in the PTL and BGTL gas conveyance licences should be used as a basis for the Moyle Interconnector Licence.

Decision – NIEH has accepted this recommendation while noting that apart from the provision of an undertaking from the holding company, Moyle already complies with the proposed new licence requirements. A licence modification will be taken forward in order to implement this recommendation.

2. That the Moyle Licence be modified to formalise the process of monitoring the Moyle controllable operating expenditure in the form of a shadow price control;

Decision – NIEH has accepted this modification and the licence change will be introduced via the formal licence change process as highlighted in the NIEH response.

3. That NIEH undertake a review of their NIEH Membership Policy to ensure the document is up-to-date.

Decision – NIEH has accepted this recommendation and is preparing to carry out the review of the Membership Policy with approval of changes by Members in September 2009 following approval by the Utility Regulator.