

Northern Ireland Electricity plc

**The proposed acquisition of
Premier Transmission Limited**

**NIE's response to
Ofreg's Consultation**

October 2004



Introduction

1. The proposed acquisition of Premier Transmission Limited (PTL), owner of the Scotland to Northern Ireland gas pipeline (SNIP), and the transfer of the business to a 100% debt financed company raises important public interest issues. The issues are similar to those which have arisen out of the financial re-structurings in other parts of the UK where companies owning infrastructure assets have adopted highly geared structures. These have prompted UK regulators, DTI, parliamentary committees and expert commentators to examine the issues. Key concerns include (i) the extent to which risk is transferred to customers, (ii) the impact on incentives for efficiency and (iii) the robustness of corporate governance and accountability.

No track record

2. Ofreg acknowledges similar concerns over the SNIP proposal, but suggests that 'the performance of the Moyle Interconnector business provides comfort that the 100% debt funded structure will work'. It is true that the transfer of the Moyle Interconnector from Viridian Group via a similar arrangement to that contemplated in the SNIP proposal demonstrates that this type of transaction can be effected. However, for reasons indicated in the following paragraphs, caution should be exercised in concluding that the structure adopted in the case of Moyle will deal adequately with these concerns. The financial re-structuring of Moyle, which was the first instance in NI of a strategic energy asset being financed in this way, was only completed in 2003.
3. To a significant degree the nature of the assets involved in Moyle and SNIP distinguishes these financial re-structurings from those that have taken place in the water industry in GB. Moyle and SNIP are in essence single, discrete assets, with relatively simple business models, well-defined maintenance regimes and limited capital expenditure programmes. By contrast, the financial restructurings within the GB

water industry involve companies which are characterised by having a diversity of assets, extensive maintenance programmes and large capital investment requirements. Certainly, in the latter context the concerns about debt-only structures are more legitimate. Indeed, the view generally held by GB regulators and other informed experts is that the economic case for the application of the 100% debt model to utility-type assets in general remains unproven.

4. More specific to this proposal in the NI context is the question of the accumulation of strategic assets financed and managed in this way. If this very important component of Northern Ireland's energy infrastructure is to follow Moyle, then great care must be taken to avoid any increase in the potential for systemic energy industry failure by incrementally adding to the basket of assets which are financed based on a model whose long term sustainability has yet to be demonstrated. It would be imprudent strategically at this time to accept Team NI's suggestion for the formation of Northern Ireland Energy Holdings to hold both Moyle and SNIP assets.

Risk transfer

5. Ofreg acknowledges that the refinancing would transfer to customers risk normally retained by shareholders and asks whether there are risks that have not been assessed in the paper.

Efficiency

6. The proposed regulatory framework for SNIP is a departure from conventional RPI-X regulation in which the efficiency of operating expenditure is subject to 5-yearly regulatory review. Under what is termed the 'soft budget constraint on operational expenditure' Ofreg's paper explains that, as with Moyle, the Authority accepts the removal of regulatory control over operational expenditure. The Authority believes that the resulting transfer of risk onto consumers (via the potential for

inefficient costs to arise) can be protected against through corporate governance licence conditions.

7. It will be difficult to confirm the extent to which corporate governance arrangements can be equally effective as conventional RPI-X regulation in driving costs to their efficient level. The application of relevant benchmarking evidence would provide a useful regulatory tool. Although the regulatory arrangements will commit to allowing full cost pass-through, the licence holder should be required to participate regularly in a review exercise undertaken by the regulator to determine how costs are performing against relevant benchmarks, the results of which should be published.

Cost shocks

8. The corporate governance arrangements cannot protect customers against the risk of cost shocks since there is no equity buffer within the 100% debt financed model. Relatively recent examples of cost shocks within utility industries include expenditure incurred by companies in responding to water shortages and storm damage to electricity networks. Ofreg's paper does not address whether there is the potential for cost shocks associated with SNIP, but to the extent that there is, the full cost would be borne by customers.

Security rights

9. There is no discussion within the paper as to the arrangements which the financiers will require in terms of their security rights over SNIP assets in the event of PTL becoming insolvent (notwithstanding the underpinning of revenues provided by postalisation and the proposed levy on electricity customers). To the extent that the arrangements require the Authority to grant security over a gas transmission asset (a similar concession was a feature of the Moyle transaction) then that

may restrict the options open to the Authority to take steps to maintain supplies to customers if PTL suffers financial distress.

Term

10. By extending the term of the financing beyond 2021 (the year by which the capital costs would have been recovered under the current arrangements) the risk of the gas pipeline having become a stranded asset is transferred onto a later generation of customers. Making the term of the refinancing coincident with the expiry in 2024 of the 'ship or pay' commitment by Coolkeeragh ESB (which is backed by ESB, and which mitigates this risk for customers for the duration of the commitment) would limit this element of risk transfer.

Savings

11. The debt-only model (with no equity) is recognised as being inherently more risky for customers. The question is whether the reward, in the form of a marginally lower cost of capital, is sufficient to compensate the risks to customers of having to bear the full cost of unexpected events, any increased risk of asset unavailability, or potentially greater operating cost than would otherwise have been delivered.
12. It is not clear from the paper what steps have been taken or what incentives have been applied in order to increase customer savings through a reduction in the total amount of debt to be raised which is a function inter alia of the premium required by the existing owners and advisers' fees. The transaction costs which are described in the consultation paper as "eg legal, technical, financial consulting and financial guarantee fees" and estimated to be £5.5m should be scrutinised to ensure they represent value for money.
13. The paper acknowledges that the ex-ante calculation of the expected savings available to customers to offset the transfer of risk depends on

a range of assumptions including, crucially, the discount rate and the term of the financing. In addition, there is the question as to whether the inclusion within the sale premium of the expected future outperformance of the operating cost allowance under the existing arrangements overstates the customer savings.

Corporate Governance

14. Ofreg asks whether the corporate governance arrangements proposed will ensure that the SNIP CLG will be commercially focussed in order to drive performance in the regulated business. Ofreg contends that the CLG structure has proved to work very well as long as it is designed in the interests of consumers - but this is not substantiated in the paper.

CLG vs conventional ownership model

15. The conventional ownership model which supposes a mix of debt funding and equity within a normal commercial trading company structure overlaid by a price control has been tried and tested over decades in a way that the proposed arrangement for SNIP has not. Furthermore, the checks and balances inherent within the conventional ownership model which drive efficiency and accountability are not easily translated to the 100% debt/CLG structure. Thus the effort to replicate these checks and balances creates a 'best guess' regulatory environment which may or may not deliver efficiency and accountability over the life of the asset.

16. Only with the benefit of sufficient hindsight will it be possible to determine whether the proposed structure and the regulatory model were genuinely in the best interest of customers. Ultimately the performance of this structure will have to be robustly compared to what would have been the outturn under the conventional model. Even then, any analysis of the performance of the model would be relevant

only to a limited set of discrete assets with a simple business model of the type represented by the Moyle and SNIP assets.

17. The paper contends that 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 and goes on to describe structures and incentives which are designed to be proxies for those which would apply in the conventional model. It is strongly arguable that the disciplines and incentives can never be as effective as they are in a more conventional equity-owned company where the disciplines and incentives have been developed and created incrementally over a very long period of time through practice as modified by law and regulation. The risks in this regard only become acceptable where a single relatively simple asset is involved as in this case and in the case of Moyle.

18. The paper identifies that Licence conditions are necessary to ensure proper corporate governance and highlights three layers of potential safeguards:

Appointment of the Members and the Board of Directors

19. Unlike a conventional equity-owned company the members are not subject to the range of disciplines which derive from having a direct financial interest in the company; neither is the ability to become a member entirely open. These are inherent weaknesses in the CLG structure which raise issues of accountability and transparency which cannot be wholly answered. In relation to the Moyle Interconnector CLG, the Authority has a consultative role in the appointment of members by the Appointments Board. In the absence of evidence that a clearly better model is available, and recognising that control of appointments is effectively in the hands of Team NI, it would not seem appropriate to adopt a different model for SNIP.

20. Maintaining a separation between the Membership and Board Directors of Moyle and SNIP (as opposed to allowing an overlap as explored in the paper) would help to facilitate a degree of benchmarking as to the relative effectiveness of the corporate governance arrangements within the two entities.

Motivation of Directors to monitor management

21. The concept of the non-executive director as the custodian of members' interests tasked to monitor management is familiar and can work well in the conventional corporate arena. In the proposed structure the main concerns will be to ensure that directors do not represent narrow sectional interests and to guard against conflicts of interest. These issues may be particularly acute where the directors are drawn from a small body of members. It is noted that the licence conditions designed to ensure that good corporate governance, in this area including robust, transparent reporting requirements in an Annual Report and Accounts; and compliance with the UKLA Principles of Good Governance and Code of Best Practice, rely on features which apply to conventional equity-owned companies. However, it should be noted that these mechanisms rely for their force on accountability to a wide body of shareholders (the securities of a listed company being freely transferable) which will not be the case in respect of the CLG.

Management and Company Incentives

22. It is clear that management must be incentivised in a manner which links pay with performance. Remuneration is the subject of intense shareholder scrutiny in the corporate world.
23. The paper variously describes the CLG as a not for profit company and as a not for dividend company which should seek to maximise its surplus for the benefit of consumers. Although it is not entirely clear from the paper how surpluses can arise in the first instance (given the

way that regulated revenue entitlement is dealt with under the postalisation arrangements), subject to these inconsistencies, the paper suggests that the Company should be incentivised to maximise its surplus which it could partly invest in further projects. If the purpose of the proposed structure is to reduce the long-term cost of the gas interconnector, the concept of encouraging it to maximise its surplus with a view to making 'other' investments appears to be at variance with this. It is not clear that the appointment and governance structure of the CLG would provide people who would make decisions on 'other' investments that would be superior to simply returning any surplus to customers. We would be surprised if customers themselves had a different view. Given the lack of track record, it seems inappropriate to encourage any more complex scheme. Instead, it may be more appropriate for the entirety of any surplus to be distributed directly to customers via reduced regulated revenue entitlement under the postalisation arrangements. The arrangements for accessing any surplus should be devised so as to minimise any leakage of value eg due to tax costs.

24. In this regard Ofreg should consider whether there are any aspects of the experience to-date with the Moyle structure which give any cause for concern as to the effectiveness of the regulatory control which it can exercise and the degree to which the Authority can hold the licensee to account.

Support by electricity customers

25. The paper sets out the arguments as to why electricity customers should support the refinancing of SNIP through a levy that would provide further credit enhancement. Ofreg has said that the arrangement should be structured in a manner to keep NIE neutral and NIE is currently working with Ofreg and others to develop such an arrangement.

Conclusion

26. The 100% debt model for the financing of regulated utility assets remains unproven and is recognised as being inherently more risky for customers. Any addition to the Northern Ireland basket of strategically important infrastructure assets that are financed in this way needs to proceed with extreme caution and a clear understanding of the risks and benefits for customers. The SNIP proposal involves a transfer of risk to customers as regards cost efficiency, cost shocks, concessions on security rights and (depending on the term of the financing) the stranding of the asset. It is difficult to value this risk transfer in order to compare it against the quantum of the estimated customer savings (in which there is some ambiguity). It is arguable that the disciplines and incentives within a CLG structure can never be as effective as within a conventional equity-owned company. However, the risks are a good deal lower where a discrete, relatively simple asset is involved. We have made a number of suggestions to be included in the arrangements for regulatory control and corporate governance including:

- Maintain a separation of the Membership and Board Directors as between Moyle and SNIP.
- Not to establish Northern Ireland Energy Holdings as a holding company for the combined assets of SNIP and Moyle.
- Require the licence holder to participate in regular reviews by the Authority of costs against relevant benchmarks and publish the results.
- Maintain the financing term coincident with the term of the Coolkeeragh ESB 'ship or pay' commitment.
- Ensure the Authority has the final say in determining how any financial surplus is to be applied.