NORTHERN IRELAND ELECTRICITY plc

RESPONSE TO NIAER'S JULY 2005 CONSULTATION

THE PROPOSED COMPANY STRUCTURE OF NORTHERN IRELAND ENERGY HOLDINGS LIMITED

In response to the earlier consultation on 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 (the October 2004 Response), we argued that important public interest issues were raised by those proposals. We argued that 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. We noted that these have prompted UK regulators, DTI, parliamentary committees and expert commentators to examine the issues; and that 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. These concerns remain and would not appear to have been further substantively addressed in the instant consultation paper. Furthermore, at the time of the former consultation, we argued that it would be imprudent strategically to accept Team NI's suggestion for the formation of Northern Ireland Energy Holdings to hold both Moyle and SNIP assets: this is what is now proposed.

The mutual model represented by the arrangements surrounding Moyle Holdings Limited and Northern Ireland Energy Holdings Limited is one under which risk is transferred to customers. The consumer undertakes this additional risk on the basis of a reduction in the cost of capital which is assumed to lead to a reduction in overall costs of the assets to consumers at large. We have accepted that this may be the case with discrete infrastructure assets with relatively simple business models, well-defined maintenance regimes and limited capital expenditure programmes, but, even in this context, the model remains relatively unproven.

The rationale for the concentration of these mutualised assets within one corporate structure is not rigorously tested in the consultation paper. It is argued that there will be significant operational efficiency gains through cost savings in relation to the sharing of management and administrative functions, as well as cost savings in relation to joint outsourcing such as the procurement of maintenance and other service contracts; furthermore the creation of a much more robust structure for the management of the two mutualised energy companies owning and operating similar infrastructure assets which are financed and regulated in similar ways. This, it is argued, would facilitate the provision of mutual support and contingency cover.

Neither of these anticipated benefits is substantiated or quantified. Arguably they are at variance with other features of the mutualised assets including the ring-fencing obligations contained in the licence conditions and with the assertion contained in the paper that the day-to-day management of the Moyle Interconnector and SNIP would remain in the hands of the existing professional managers and does not entail the creation of a single operations unit to run both energy assets. These constraints which are emphasised in the consultation paper, and which are prudent, must necessarily limit the anticipated benefits.

In relation to financial ring-fencing, it was understood that any surplus generated in a mutualised asset would be returned to customers and we are concerned that the expression of this in the consultation paper "…all financial surpluses generated, if any, will be retained for the benefit of its operating companies and, ultimately, energy customers." expresses a different intent: viz. that they may be retained for the purpose of funding the acquisition of other assets.

The corporate governance and other costs which are incurred in order to provide comfort around the operation of these structures, whether individually or in combination, are likely to be considerable in the context of the businesses to which they relate. In order to give a considered view on the prospective economic benefits of the combined structure it would be necessary to have visibility of the promised savings.

Other than the tax benefit of the combination of the SNIP and Moyle, the other supposed benefits for energy customers in Northern Ireland adverted to in the consultation relate to the capacity of NIEH to acquire other energy assets in Northern Ireland and to have sufficient influence and capability to act in the long-term interests of consumers, for example in any future all-island energy market negotiations.

Firstly, the element of risk that the consumer bears in relation to such structures is well recognised. The development of this model to a further stage should certainly wait until the structures have been proven over a long period of time.

Secondly, it can be implied from the paper that the Authority is a proponent of the model of mutualisation of assets represented by the NIEH structures. Yet this is far from being accepted public policy and we would question whether the future mutualisation of further energy assets is an appropriate objective for the Authority to adopt. Public policy in this sphere is a matter in which the Department of Enterprise Trade and Investment have a clear interest and, if this is a public policy imperative, reference to it might be expected to have been contained in the Department's energy strategy.

Mutualisation is a model which other regulators eschew or of which they are at least properly wary. There may also be a concern whether in Northern Ireland, where there is a significant enterprise deficit, it is appropriate to encourage the appropriation of assets, which can otherwise be owned and managed efficiently in the private sector, by semi-public structures. A principal objective of public policy should be to encourage private enterprise and entrepreneurship.

Thirdly, as the other supposed advantages of the current proposal are not quantified or transparent, it may appear that the promotion of a structure with the ultimate objective that it holds a multiplicity of infrastructure assets is the primary motivation. It is certainly questionable how NIEH could have significant influence in any future all-island energy market negotiations in the manner suggested unless it is intended that it will own substantially more and different assets than it currently has.

Turning to the specific risks identified by the paper:

Lack of Transparency and Accountability

This remains a matter of concern. It is suggested that the membership structure will ensure that the Board's activities are transparent. The Board is to be relied upon to scrutinise the various management boards and the membership in turn to scrutinise the Board. In the October 2004 Response we raised various concerns about corporate governance within the PTL model; it is arguable that the fundamental flaw in these structures is the absence of any real economic interest by the members in the performance of the company. Without this there is no real guarantee that the structures will work in a rigorous and effective manner as there is no financial consequence for the members in the event that they fail in the role of supervision and calling management to account. In stark contrast, the members of a public company lose value in their investment if the company does not perform.

It remains unclear from paper what is the role of the Board. On the one hand, it is described as non-executive and appears to be supervisory in nature. On the other hand, the paper ascribes to NIEH, a company ostensibly without executives other than at operating subsidiary level, various objectives which are executive in nature (for example co-ordinating future asset acquisitions; participating in all-island energy market negotiations, etc.). It will be necessary, to ensure confidence in these structures, that there is transparency, accountability and that no ambiguity remains around the role and function of the various organs. These are not tried and tested structures for assets of key public importance. To ensure the longevity of such structures, and that they endure, they must contain appropriate checks and balances. They must be robust enough to prevent undue personal influence being exerted by those who may, over the potentially long period of the existence of these structures, come to be involved and who may not share their originators' objectives (in this regard please note the concerns expressed under "Conflicts of Interest").

Conflicts of Interest

There are significant conflicts of interest inherent in these structures which are not recognised in the paper. In particular, the structures have significant cross-overs which may prevent them operating effectively. For example the Board has a significant input into the composition of the membership from its representation on the Membership Selections Committee and the members have significant input into the board from its role in choosing the directors. Similarly the Authority has a significant role in selecting the members, is seen to be a proponent of the mutualisation structures and yet will be the Company's regulator. Notwithstanding these and other conflicts recognised in the paper, the paper states as fact that the corporate governance structures that will be in place will prevent any conflicts of interest arising.

Potential for Systemic Energy Industry Failure

The paper argues that this risk is mitigated by the fact that the Moyle and SNIP group of companies will continue to function as separate entities. It is difficult to take a view on this point as the paper provides no visibility of the detail of the operational management at the level of the individual companies and any cross-overs. However, the potential for systemic energy industry failure is a serious issue and it is clear that, if the structures represented by NIEH fail in any respect, then any such failure is likely to affect both assets and any others that may be brought under NIEH's control in the future. Ofwat have recognised these highly geared structures as potentially "unsustainably brittle" and the impact of failure is all the greater where there is a concentration of assets within them.

August 2005