

The Acquisition of Viridian Group PLC by ElectricInvest Acquisitions Limited

A position paper by the

**Northern Ireland Authority for Utility
Regulation**

11 April 2007



Introduction

1. On 6 October 2006, ElectricInvest, an acquisition vehicle for Arcapita, announced its offer to acquire Viridian Group PLC, a company whose activities are at the heart of the Northern Ireland energy sector, particularly through its ownership of Northern Ireland Electricity Plc (NIE). The Scheme of Arrangement to implement the change in ownership was approved by the Courts on 5 December 2006, after a majority of Shareholders agreed to the takeover at a Court Meeting and Extraordinary General Meeting on 20 November 2006.
2. The Northern Ireland Authority for Energy Regulation (now the Northern Ireland Authority for Utility Regulation or the Utility Regulator) issued a consultation paper on 01 December 2006, focusing on how changed circumstances might make it appropriate to change the regulatory arrangements applying to NIE and asked for responses on six separate questions :
 - a. Are the current ring fencing and cash lock-up provisions sufficient to ensure that the financial position of the licensed undertaker does not reflect financial risks taken by other group entities? If not, what additional ring fencing provisions might be appropriate and what might be the costs and benefits of these?
 - b. Are existing obligations to provide ultimate-controller undertakings appropriate? Should any additional undertakings also be required?
 - c. Should the Utility Regulator require NIE to provide information on the same basis as a listed company in addition to NIE's annual regulatory accounts and Viridian's accounts? Would other transparency obligations be appropriate?

- d. Should the Utility Regulator impose licence obligations relating to corporate governance and management, for instance requiring the majority of NIE's board to be independent non-executives?
 - e. Do respondents agree with the Utility Regulator's position that the introduction of a special administrator regime for energy networks in Northern Ireland would significantly strengthen security of supply?
 - f. Do respondents believe the creation of a legal basis for appointment of a supplier of last resort in the event of supplier insolvency is appropriate?
3. We received responses from Viridian group, ESB International, The Consumer Council, Disability Action and Professor John FitzGerald of the Economic and Social Research Institute, who was a member of the NIAER board until October 2006. We also took note of comment in the media. Additionally we received confidential responses from a number of financial institutions.
4. The Utility Regulator's aim is to establish a regulatory regime which is invariant to changes in ownership. However, this should not be creating disproportionate rules covering all possible contingencies. Our proposed response to the change in NIE's ownership, set out below, is designed to ensure that, regardless of ownership, it will continue to have sufficient financial and managerial resources to perform its functions, and that it will operate with the interests of its customers uppermost. However the fitness for purpose of this regime may be reviewed in the future, notably if ownership of NIE changed again.

Ring-fencing

5. Respondents to our consultation were all supportive of the ring fencing proposals already consulted on as part of the T&D price review. The

general opinion was that the proposals are all necessary and desirable features that, for a well run company, should not pose an undue burden, whilst helping prevent assets being inappropriately used or encumbered.

6. John FitzGerald noted that the cash lock-up provisions only come into place after the company has lost, or is likely to lose its investment grade rating, which could be seen as locking the stable door after the horses have bolted. A requirement to maintain a rating above investment grade could, in principle, mitigate this problem.
7. An investment grade rating is a clear and generally recognised designation, and the requirement to maintain at least an investment grade is in line with the approach taken by regulators in GB. Rating agencies largely base their determinations on the capital structure of companies. Therefore, if the Utility Regulator were to impose a requirement to maintain a credit rating above investment grade, we would implicitly determine how the licensee financed its operations. Were the Utility Regulator not to utilise the professional judgement of credit rating agencies, we would inevitably have to make explicit judgements as to the appropriate methods for the licensee to finance its operations.
8. Credit ratings are complementary to information made publicly available by the company or provided directly to the regulator. Given sufficient information, creditors and other stakeholders will be in a position to determine their own view as to the position of the company, and this applies equally to the regulator should we have any particular concerns.
9. The Utility Regulator is therefore of the opinion that maintaining the financial ring-fencing proposals as originally proposed in the T&D price review is the appropriate course.

Corporate Governance

10. It is Arcapita's intention, as explained to the Utility Regulator during discussions, to maintain the current management of Viridian and NIE. However, it is not the case that NIE's (and its customers') interests and those of the wider Viridian Group are necessarily aligned. Changes in electricity market arrangements – notably the introduction of a single electricity market on the island of Ireland and full retail competition in Northern Ireland – make it particularly important that NIE's interests are seen as separate from those of the rest of Viridian Group.
11. Other GB regulators, notably Ofwat, have imposed licence conditions requiring the licensee to maintain a set number of independent directors. In considering independence Ofwat refer to the Higgs report on the role and effectiveness of non-executive directors, which was incorporated into the Combined Code on Corporate Governance in July 2003.
12. Higgs argued that although all directors have a legal duty to put the best interests of the company first, it has long been recognised that this is insufficient to assure that potential conflicts will not impair decision making. Independent directors on the other hand bring a dispassionate objectivity, and for this reason he recommended that at least half the members of the board (excluding the chairman) should be independent.¹
13. Following Higgs, the Combined Code on Corporate Governance calls for a balance of executive and non-executive directors, and, except for smaller companies, a majority independent board². NIE is a sufficiently large company that, were it independently listed, would be expected to have a majority independent board.

¹ Derek Higgs (2003) *Review of the role and effectiveness of non-executive directors* DTI, p.35

² A smaller company is defined as one outside the FTSE 350 throughout the year immediately prior to the reporting year.

14. Except for Viridian, who felt that existing legal obligations on NIE directors to put the best interests of NIE first was sufficient, other respondents felt that either a condition to have a set number of independent directors, or a majority independent board was appropriate. Currently there are no independent members on the NIE board.
15. The Utility Regulator feels that it is appropriate to impose a licence condition obliging at least half of NIE's board to be independent non-executives. However, we are not proposing that the Chairman be independent on appointment, as is preferred under the Combined Code. The requirement to maintain a majority independent board will have to be fulfilled within one year of the condition becoming effective. The proposed licence modification which gives effect to this intention is at Annex A. The changes will also have the effect of giving the Authority a formal confirmation role to ensure that the board is continuously comprised of a majority of independent non executive directors, regardless of future personnel changes at director level.
16. Imposing a condition to maintain a majority independent non executive board goes beyond what has been required by other UK regulators so far. However the Utility Regulator's decision on this point recognises the fact that best practice in corporate governance has been evolving rapidly in recent years.
17. The reason for these changes is to help protect customers by securing the ability of the regulated business to act independently of the wider Viridian Group.

Information issues

18. In the 01 December 2006 consultation paper the Utility Regulator expressed its desire to ensure the appropriately high degree of transparency for all stakeholders in NIE. For this reason we asked for

responses to proposals that we follow the approach taken by Ofwat, requiring non-listed companies to publish information on the same basis as a listed company

19. Viridian considers there is no need to increase the disclosure requirements in respect of NIE over those which currently exist on the basis that it would increase costs unnecessarily. Viridian also pointed out that under the current licence document, the Utility Regulator has the right to request NIE to provide additional financial information where it deems it necessary.

20. We received a number of submissions which indicated support for these proposals. The Consumer Council commented that the fundamental principle should be transparency in relation to the operations of the regulated company.

21. While there are clear benefits to imposing an obligation of this sort, we have not, as yet, sufficiently established the likely costs, nor on whom they would be expected to fall. Therefore, we intend to investigate the costs and ensure they are proportionate to the likely use that would be made of the information. In the meantime, the Utility Regulator expects that Viridian Group, whether as a result of obligations following from its issuance of listed debt or otherwise, will continue to make information on NIE available as was the case when Viridian Group was a listed company.

Ultimate Owner Undertakings

22. As current provisions are in line with common GB practice, respondents were asked to describe clearly why additional undertakings would be appropriate in the NI situation. In its response Viridian states that it cannot see any reason to move beyond common GB practice. The Consumer Council stated that “the legally enforceable undertaking to refrain from any action that could cause the regulated business to breach its license is

adequate”. The Utility Regulator does not propose to make any change in the undertakings required. Arcapita has already provided the requisite undertakings to the Utility Regulator. After taking ownership of Viridian Group PLC, Arcapita provided the undertaking required under Part IIB Condition 3A of the NIE Licence.

23. The Utility Regulator wishes to clarify that, in line with GB precedent, undertakings can be required from more than one entity, depending on the suitability of the requirement to the structure of the ownership chain in question.

24. It is also proposed that certain changes are made to Part IIB Condition 6, which is concerned with the provision of information to the Utility Regulator. The effect of these changes would be to require an undertaking from the ‘ultimate controller’ rather than from the ‘holding company’, to require a new undertaking to be given on a change of control, and to require NIE to enforce the undertaking where directed to do so. The reason for these changes is to align Condition 6 with the other conditions that refer to ultimate ownership (in keeping with best regulatory practice to promote uniform use of terms) and to increase the extent to which members of the Viridian Group can be required to co-operate with NIE in relation to information requests. The revised text is at Annex B.

Supplier of Last Resort and Special Administrator

25. Respondents were supportive of the establishment of Special Administrator and Supplier of last Resort Regimes in Northern Ireland. Both of these issues lie within the remit of the Department of Enterprise Trade and Investment (DETI).

26. The Utility Regulator has commenced discussions with DETI and NIE as to how a Supplier of Last Resort regime will operate as it is likely that PES will take on this role initially. We are also working closely with CER in the

Republic of Ireland as to how this scheme will function in the new SEM wholesale electricity trading arrangements.

27. The Utility Regulator welcomes the support expressed by respondents for the establishment of a Special Administrator regime. We have been in discussions with DETI on this matter, and made clear our belief that this would be a useful change. Establishing provisions for a Special Administrator will require legislative change. The Utility Regulator will endeavour to ensure this is given a sufficiently high priority.

Licence Modification Process

28. This paper also constitutes a notice by the Northern Ireland Authority for Utility Regulation (the “**Authority**”) pursuant to Article 14 of the Electricity (Northern Ireland) Order 1992 (the “**Order**”).

29. Having obtained the consent of NIE, the Authority hereby gives notice that it proposes to make modifications to the conditions applicable to the public electricity supply licence and transmission licence held by NIE.

30. The Authority proposes to make the modifications as set out in Annex A, having regard to the reasons for, and the effects of, such modifications as outlined in paragraphs 15-17 of this position paper.

31. The Authority proposes to make the modifications as set out in Annex B, having regard to the reasons and effects outlined in paragraph 24 of this position paper.

32. The Authority would now like to welcome representations and objections (to the extent there are any) from all interested parties as to both sets of proposed modifications. The Authority accepts that most contributors’ comments will have already been made in response to the initial consultation of 1st December 2006 which preceded this position paper.

33. Should anyone wish to contribute, please note that we shall receive responses from the date of this position paper, up to and including Wednesday 11 May 2007. Responses should be sent to:

Tadhg O'Briain

The Utility Regulator

Queens House

14 Queen Street

Belfast

BT1 6ER

tadhg.obriain@ofregni.gov.uk

Unless specifically requested by respondents otherwise, responses may be published on our website. Respondents should clearly mark any part of their response (or, if appropriate, the whole response) if they wish it to remain confidential, along with the reasons as to why this is the case.

34. In accordance with Articles 14(3) and (4) of the Order, notice of the proposed modifications (as contained in this position paper) has been sent to NIE and DETI.

Annex A

Modification notice of board independence licence condition

Part IIG

Condition 21: Board Independence

1. Within one year from the date upon which this Condition becomes effective, and at all times thereafter, the licensee shall:
 - (a) ensure that its board of directors comprises a majority of independent non-executive directors who are persons of standing who individually possess either:
 - (i) relevant experience and knowledge of the energy industry; or
 - (ii) relevant experience and knowledge of any other regulated industry,provided that at least one independent non-executive director must possess the required energy industry experience and knowledge; and
 - (b) demonstrate to the satisfaction of the Authority, prior to any appointment from time to time of a board director, that the said appointment will not cause the licensee to enter into any breach of the requirements contained in sub-paragraph (a).
2. If at any time the licensee, by virtue of any person being appointed as, or ceasing to be, a director of the licensee (for the purposes of this Condition, an “**Event**”), is unable to comply with the requirements of paragraph 1, the licensee shall take such steps as are necessary to ensure that compliance is achieved as soon as reasonably practicable after that Event and in any case within two months (or such longer period as may be agreed by the Authority) of that Event.
3. In this Condition:

“independent non-executive director”

means a person who has not been employed by the licensee, its ultimate controllers or any affiliate or related undertaking of the licensee within the last five years; and who does not have a material business relationship with the licensee, its ultimate controllers or any affiliate or related undertaking of the licensee.

“ultimate controller”

shall have the same meaning as that ascribed to it in Part IIB, Condition 3A.

Annex B

Proposed form of licence modification to harmonise the requirements upon 'ultimate controllers'

Part II B

Condition 6: Provision of information to the Authority

1. Subject to paragraphs 6 and 7, the licensee shall, in relation to each licence granted by this Licence Document, furnish to the Authority, in such manner and at such times as the Authority may require, such information and shall procure and furnish to it such reports, as the Authority may consider necessary in the light of the Conditions or any Schedule applicable to that licence or as it may require for the purpose of performing:
 - (a) the functions assigned to it by or under the Order or the Energy Order; and
 - (b) any functions transferred to it under the Order or the Energy Order.
2. The licensee shall, within 7 days after the date when these modifications become effective or after the person in question becomes an ultimate controller (as the case may be), procure from each person which the licensee knows (or reasonably should know) is at any time an ultimate controller of the licensee a legally enforceable undertaking in favour of the licensee in a form specified by the Authority, which shall provide that that ultimate controller will give to the licensee, and will procure that each subsidiary of that ultimate controller (other than the licensee and its subsidiaries) will give to the licensee, all such information as may be necessary to enable the licensee to comply fully with paragraph 1 of this condition. Such undertaking shall remain in force for as long as the licensee remains the holder of this licence and the giver of the undertaking remains an ultimate controller of the licensee.
3. The licensee shall:
 - (a) deliver to the Authority evidence (including a copy of each such undertaking) that the licensee has complied with the obligation to procure any undertakings pursuant to paragraph 2;
 - (b) inform the Authority immediately in writing if the directors of the licensee become aware that any such undertaking has ceased to be legally enforceable or that its terms have been breached; and
 - (c) comply with any direction from the Authority to enforce any such undertaking.

4. The licensee shall not, save with the consent in writing of the Authority, enter (directly or indirectly) into any contract or arrangement with an ultimate controller of the licensee or any of the subsidiaries of that ultimate controller (other than the subsidiaries of the licensee) at a time when:
 - (a) an undertaking complying with paragraph 2 is not in place in respect of that ultimate controller; or
 - (b) there is an unremedied breach of such an undertaking; or
 - (c) the licensee is in breach of the terms of any direction issued by the Authority under paragraph 3 in respect of such an undertaking.
5. Without prejudice to the generality of paragraph 1, the Authority may call for the furnishing of accounting information which is more extensive than or differs from that required to be prepared and supplied to the Authority under Condition 3.
6. The licensee may not be required by the Authority to furnish it under this Condition with information for the purpose of the exercise of its functions under Article 7 of the Energy Order.
7. The licensee may not be required by the Authority to furnish it under this Condition with any information in relation to an enforcement matter which the licensee could not be compelled to produce or give in evidence in civil proceedings in the High Court.
8. The power of the Authority to call for information under paragraph 1 is in addition to the power of the Authority to call for information under or pursuant to any other Condition or any Schedule.
9. The licensee shall, if so requested by the Authority, give reasoned comments on the accuracy and text of any information and advice (so far as relating to the Supply Business) which the Authority proposes to publish pursuant to Article 7 of the Energy Order.
10. In this Condition:

“information” shall include any documents, accounts, estimates, returns or reports (whether or not prepared specifically at the request of the Authority) of any description specified by the Authority; and

“ultimate controller” means:

- (a) any person which is a holding company of the licensee, and which is not itself a subsidiary of another company; and/or
- (b) any person who (whether alone or with a person or persons connected with him) is in a position to control, or to exercise significant influence over,

the policy of the licensee, or any holding company of the licensee, by virtue of:

- (i) rights under contractual arrangements to which he is a party or of which he is a beneficiary;
- (ii) rights of ownership (including rights attached to or deriving from securities or rights under a trust) which are held by him or of which he is a beneficiary,

but shall exclude any director or employee of a corporate body in his capacity as such and any minister, ministry, department, agency, authority, official or statutory person;

and a person shall be considered to be connected with another person if he is party to any arrangement regarding the exercise of any such rights as are described in paragraph (b) above.