

Single Electricity Market

Acquisition of NIE plc, NIE Powerteam and allied businesses by ESBNI Ltd

Decision Paper & Consultation on Licence Modifications

19 January 2011

SEM-12-003

Introduction

1. In July 2010, Electricity Supply Board and ESBNI Limited (**ESB**) entered into a sale and purchase agreement with Viridian Capital Limited and Viridian Group Limited (**Viridian**) for the sale and purchase of Northern Ireland Electricity plc (**NIE**); NIE Powerteam Limited and Powerteam Electrical Services (UK) Limited (PES) and Capital Pensions Management Limited, (**the Purchase**). As ESB completed the Purchase in December 2010, ESB now own NIE.
2. The SEM Committee (**the SEMC**)¹ considered the regulatory functions that might be exercised in relation to the Purchase, and determined that the impact of the Purchase had or was likely to have a material effect on the Single Electricity Market (**SEM**). Therefore it was necessary to review the transmission licences of NIE and ESB and documents generated under those transmission licences (**Licences**) in light of the Purchase, as it was a SEM matter.
3. In March 2011 the SEMC published a consultation paper (SEM-11-011) (**Consultation Paper**) setting out the proposed areas of change to the NIE T&D Licence following the Acquisition of NIE by ESB.

The proposed changes were to the following conditions:

- Condition 3: Availability of procurement and other issues
 - Con 3A: Board Independence
 - Con 4: Restrictions on Dividends/Licence tidy up
 - Con 10: Restriction on Use of Certain Information
 - Con 12: Independence of the Transmission and Distribution Business
4. This decision paper (**Decision Paper**) sets out the proposed wording changes that the SEMC considers are required to the Licences or to other documents or information required under those Licences (the **Licence Changes**). As detailed in the Consultation Paper, the proposed changes were required only to the NIE Licence, This was largely because NIE as the subsidiary of ESB was much more likely to require closer scrutiny around areas likely to be of concern to market participants.
 5. The Consultation Paper elicited 6 responses and these were from:
 - Airtricity
 - EirGrid (although the contents of what EirGrid said are not referred to throughout as EirGrid requested their response be kept confidential).

¹ There is a single all island electricity trading market (the Single Electricity Market or SEM for short). The SEMC decides on matters where the exercise of a relevant function by a regulatory authority in either Northern Ireland or Ireland (being the Northern Ireland Authority for Utility Regulation in Northern Ireland and the Commission for Electricity Regulation in Ireland) relates to a SEM matter. The legislation setting this out is The Electricity (Single Wholesale Market) (Northern Ireland) Order 2007, Article 6 and The Electricity Regulation Act 1999, Section 8.

- Electricity Supply Board
- Endesa Ireland
- Northern Ireland Electricity
- The Consumer Council of Northern Ireland

All responses where a specific point was made in relation to a suggested Licence Change, where not marked confidential, are referred to with this Decision Paper.

6. Following the closure of the consultation period, the Northern Ireland Authority for Utility Regulation (**Utility Regulator**), on behalf of the SEMC, met both NIE and ESB on a number of occasions to discuss the concerns they raised in their respective responses to the consultation.
7. This is the Decision Paper that follows on from the Consultation Paper. This Decision Paper is designed to be read in conjunction with the Consultation Paper.
8. Subsequent to the issue of the Consultation Paper, SEMC decided that it would commission an assessment of how ESB interacted and was likely to interact with its new subsidiary, NIE. The reason for this was that given the SEMC's rationale for suggesting Licence Changes was based around transparency of operation, market confidence and the impact of a trade buyer owning NIE, it made sense for SEMC to look at this interaction to give a higher degree of assurance around transparency, market confidence and the impact of a trade buyer owning NIE T&D. That report has been done by Cambridge Economic Policy Associates Ltd and is attached as **Annex A** to this Decision Paper (**CEPA Report**). The CEPA Report has helped inform the Licence Changes required and not required, as set out in this Decision Paper and should also be reviewed by interested parties alongside what was described as the Commercial Measures in the Consultation Paper.
9. The SEMC are thankful for the well considered conclusions as set out in the CEPA Report. However, it is important to emphasise that the CEPA Report is an independent report and it does not necessarily reflect the views of the SEMC. That said, the CEPA Report has made some recommendations which were not considered in the Consultation Paper. To the extent the SEMC consider it is appropriate to adopt some of the CEPA Report recommendations, this Decision Paper is the opportunity to set out those recommendations.
10. **Annex B** sets out the suggested Licence Changes that would be required to the NIE licence should this Decision Paper be implemented in full. For ease of use, the entire licence has been set out to give a better context to the changes.

The proposed Licence Changes

Condition 3: Availability of Resources and Undertaking of Ultimate Controller/Compliance Plan

Information sitting behind statement on resources

11. SEMC were recommending in the Consultation Paper that the factors behind the certificate given by NIE on having sufficient financial resources include an Annex of information of the key pieces of information that made up this certificate also being sent to the Utility Regulator.
12. Endesa and NIE did not consider this to be necessary and felt existing protections were adequate.

13. The Consumer Council suggested that licence modifications should, amongst other issues, improve transparency in the electricity market and that the focus of SEMC should remain on customer protection. Airtricity welcomed the Consultation Paper and thought the proposed approach was correct and that the suggested modifications were prudent and balanced.
14. ESB emphasised that this needed to be limited to key material information and also made the point that this information should not be made public.
15. SEMC broadly agree with the ESB view and the proposed licence modifications reflect this materiality threshold, as anything else would be disproportionate to the aim of the regulation. In relation to confidentiality, although that will be a matter of discretion for the Utility Regulator we understand the Utility Regulator is sympathetic to testing what can and cannot be disclosed to the public with this annex of information. SEMC are also of the view that this change is required. It will not add a regulatory burden on NIE and will give the opportunity for the market to see that the Utility Regulator is gaining access to very specific information on resources and that there is a higher degree of transparency than was previously the case.

Testing the sufficient resources licence condition

16. SEMC were recommending in the Consultation Paper that the Compliance Plan (broadly speaking a document prepared by NIE setting out how it remains independent and dealing with other regulatory issues not set out in the NIE Licence) set out how NIE complied with the licence condition to ensure it had sufficient resources to operate as a stand alone entity (as the annual statement only addressed financial issues). Endesa considered this to be unnecessary. ESB thought the principle was fine so long as confidentiality was maintained and they were also of the view that no licence change would be required. NIE had a similar view. The Consumer Council emphasised the necessity of customer protection.
17. However, the CEPA report suggested a fresh approach. CEPA have recommended that the resource test should both be a financial test and "other resources" test. SEMC think this is helpful and as this would require a licence change would be more transparent to the market than something that was dealt with in the Compliance Plan. SEMC have therefore decided to accept CEPA's suggestion and have a licence change which addresses both financial and other resources in the statement sent to the Utility Regulator each year.

Clarification of licence condition

18. SEMC were recommending that the licence condition on resources available be brought into line with the equivalent National Grid licence condition to make it clearer to everyone involved what was meant by "resources".
19. The only specific response to this was from NIE who had no objection to this change.
20. SEMC are therefore of the same view as they were when the Consultation Paper was published, that this will be a helpful signal to the market if adopted and have decided to make the relevant change.

Undertaking of ultimate controller

21. SEMC were recommending in the Consultation Paper that the ultimate controller undertaking to be given included saying that nothing should be done to prejudice the interests of consumers in Northern Ireland. This was designed to mirror the assurances given (described as Commercial Measures in the Consultation Paper) and to reflect the ESB Directors Code of Conduct, which we understood had changed to reflect this concept. The SEMC aim was to

reinforce explicitly that the ultimate controller, when exercising control, had in mind the primary focus of regulation in Northern Ireland, namely the protection of consumers.

22. ESB were of the view that this was not necessary. Without prejudice to this position they did, however, suggest a form of wording that was closer aligned to the ESB Code of Conduct than that consulted on by SEMC. The only other comment that had a direct link to this was from Airtricity who considered the proposed changes to be prudent and balanced.
23. SEMC reflected further on this since the Consultation Paper. SEMC consider this is a useful regulatory tool, but this should be weighed against the Commercial Measures already in place, how this provision would be enforced in practice, the other suggested changes and also only making new licence conditions were necessary. On balance, SEMC have decided not to ask for this language in the ultimate controller undertaking.

Condition 3A Board Independence

24. SEMC were recommending in the Consultation Paper that at least one executive director should be independent from the ultimate controller. Both NIE and ESB felt this was unnecessary and without precedent in the Irish or GB regulated market space. None of the other consultees had a specific comment on this, other than the Airtricity view stated above.
25. SEMC have considered NIE and ESB's position on this. It is correct to say that ESB's role in the energy market on the Island will and has increased as a consequence of it purchasing NIE. Specifically, ESB or an affiliate of ESB will have a role in just about every part of the electricity market, including supply, generation and network ownership. We consider this is without precedent in the Irish or GB regulated energy market space and thus, there are a unique set of circumstances to hand. The consequence of this is that there has to be market confidence that NIE does and will continue to act independently and that there is clear and transparent evidence in the licence to reinforce this. The choice facing SEMC is therefore to test the existing licence conditions and if they are found to be wanting, to suggest a raft of changes to the NIE licence that deal with discrete potential issues that are related to this unique ESB position or to have one provision which is intended to assure SEMC and the wider market that when critical board decisions are taken by NIE, those decisions are as independent as possible, within the context of good corporate governance.
26. Having one independent executive director not connected in any way to ESB allows the NIE Board (and specifically the non executive directors) to have a high degree of assurance that information presented to the NIE Board will remain totally focused on NIE's interests. This in turn gives SEMC and the wider energy market on the Island a high degree of assurance that the NIE Board not only has the requisite numbers on the Board to make independent decisions but the facts those decisions are grounded in papers and facts that no one could reasonably say is unduly influenced by a parent company. SEMC have an assurance that information presented to the whole Board is partially presented by someone with no link to ESB. It is a very practical way of demonstrating to the market that within the context of good corporate governance, NIE will continue to act independently. This measure will also assist any executive director who is connected to ESB when matters arise that can be Group wide matters (such as financing) as that individual could choose to let the unconnected director lead the relevant discussion.
27. However, the SEMC note that ESB as parent and NIE as the licensee have voluntarily agreed to have a second executive director on the NIE Board who is not connected to ESB. The SEMC further note that there is already a majority of independent non executive directors on the NIE Board. SEMC are also mindful of the protection gained by the other proposed licence changes in this Decision Paper (see paragraphs on Associated Business).

28. SEMC are therefore of the view that the existing high level of protection afforded by a majority non executive board and noting the voluntary action set out in paragraph 27 should be sufficient for present purposes should all the other suggested licence changes be implemented. SEMC have therefore decided that a licence change is not necessary. This will allow NIE and ESB the requisite freedom to constitute their board the right way and SEMC can always return to this issue if evidence comes to light that there is an actual issue or perceived credible market issue with this structure.

Condition 3B Economic Procurement of Assets and Services

29. SEMC were recommending in the Consultation Paper that the issue of procurement was given more focus in the NIE Licence and that a specific procurement licence obligation should be inserted, with this in turn re-assuring market entrants that procurement happened in the right way.
30. NIE had no strong objections to this proposal, with no other consultee expressing a strong view.
31. Since the Consultation Paper was done, the CEPA Report examined this issue. The CEPA report is very helpful and that led to further dialogue between CEPA, the Utility Regulator and CER on behalf of the SEMC with NIE and ESB on how it was intended that NIE would procure goods and services in the future. So, for example, it has become clear that ESB would like NIE to use ESB for a range of group services. SEMC has no opinion on this so long as there are clear and transparent mechanisms in place to demonstrate this is both transparent to the wider energy market and that it also delivers the most economically advantageous answer. As ESB have been providing group services to ESB group companies for some time, this is already dealt with to the satisfaction of CER. However, given the range of potential services that could be accessed by NIE, the NIE Licence will need to alter to reflect this issue.
32. This has led to SEMC considering that it would be appropriate for NIE (both for group services and more generally) to use open tender for procurement, unless a set of circumstances is fulfilled in the Compliance Plan. So, for example, de minimis levels could be set out in the Compliance Plan so that small procurements did not need to be openly tendered as this would be disproportionate to the aim. In other words, the onus would be on NIE to show in a considered and transparent way the circumstances under which open procurement was not appropriate, most obviously under a certain economic threshold but perhaps in other areas. This will give reassurance to both the SEMC and the wider energy market that there is a default principle of open procurement with a defined set of circumstances where it is not employed. We do not consider that general procurement law is sufficient to wholly address this issue as general procurement law is not designed to deal with the unique circumstances faced in the energy market in Ireland and equally just using price controls does not give (in the Utility Regulator's case) sufficient transparency or evidence as to why a course of action has been taken and why this is the most appropriate action. The SEMC recommend the de minimis level is set at £50'000 per contract or series of related contracts as a starting point for when procurements should be openly procured. How procurements are done under £50'000 should also be set out in the Compliance Plan to the Utility Regulator's satisfaction (for example, taking tenders from three credible suppliers over a certain economic level). The SEMC further have decided that this level of £50'000 should be reviewed from time to time.
33. There will also be certain circumstances where it makes sense for NIE and ESB to jointly procure goods or services. SEMC endorse this approach where it leads to overall reduction in cost to consumers on the Island. However, again, SEMC believe it is important that these joint procurements are done through a clear and transparent mechanism and that these joint procurements deliver the most economically advantages answer for all **consumers** on the

island of Ireland. SEMC also consider that given the relative disparity in economic purchasing power and the subsidiary and parent relationship between NIE and ESB, this requires focus is in the NIE licence, as opposed to the ESB licence. Therefore, the SEMC has decided to request that joint procurements are only done with the express consent of the relevant Regulator and that these joint procurements can be subject to such conditions as the relevant Regulator sets out from time to time.

Condition 4: Restrictions on Dividends/Licence tidy up

34. The Consultation Paper talked about consolidating conditions in the NIE Licence. NIE themselves agree with this aspiration. However, the SEMC are mindful that the NIE Licence is likely to change a lot over the next year months anyway, with the split of transmission and distribution licensing, for example. The SEMC therefore think it is more efficient to consider these sorts of tidying up issues in that forum as opposed to making structural changes now and then perhaps making further such changes in the later split transmission and distribution licences.
35. The only exception to this is changing references of Northern Ireland Electricity plc to Northern Ireland Electricity ltd. There seems little point in persisting with something subsequent to the purchase by ESB of NIE that is now factually wrong.

Condition 8 and definition of ultimate controller (also condition 3 and analogous definition in Condition 12)

36. This is a consequential change required because of the ownership of NIE by a body ultimately controlled by the Irish State. To remove any ambiguity, SEMC have decided that it should be made clear that the body who is in actual control of NIE is ESB (not the Irish State). It is also public knowledge that the Irish State intends to sell a minority interest in ESB, so SEMC have further decided that the definition of "control" is made specific that whilst ESB is majority state owned, the definitions set out should still be appropriate. SEMC view this as a technical change and will liaise with ESB as to what the appropriate language should be (not included in Annex B).

Condition 10: Restriction on Use of Certain Information

37. SEMC were recommending in the Consultation Paper that the only types of information that would be made available between NIE and ESB would be types pre agreed with the relevant Regulator. These types of information would be set out in the Compliance Plan.
38. Both ESB and NIE, for different reasons, queried if this was appropriate or workable in practice.
39. SEMC are of the view that this is both appropriate and workable in practice. SEMC consider it should be straightforward for NIE to list the types of information that was flowing between NIE and ESB. So, for example, this might be information on how to deal with storms or more general network issues and think it is within NIE's understanding to ascertain with ESB the broad categories of information which is shared and which should be shared between the two networks. This is not asking for reams of detail, simply giving interested parties a sense of the framework of types of information exchange happening. This can only help to build confidence amongst market participants. It would be of concern to SEMC if NIE did not think they could categorise and articulate the categories of information flow.
40. SEMC remain of the view this is appropriate and important. Setting out these types of information or categories will assist transparency (especially for new entrants) on how the two

networks on the Island interact with each other. SEMC consider it reasonable that the onus should be on NIE to set out what those categories are. SEMC consider this will assist market confidence. The alternative of allowing all classes of information to flow with no structure or safeguards around that would create an uncertainty at the heart of regulation on what was appropriate and what was not. SEMC also consider that this information flow should be allowed and that, for the purposes of permitted information flow, ESB would not be treated as an Associated Business (see later) so long as Condition 10 and the Compliance Plan are complied with.

41. Should the Utility Regulator and CER discover, over time, that the information flows between the two businesses remains wholly appropriate and the ring fences in place remain adequate, we would expect each sectoral regulator to address this issue again and to consider relaxing this requirement further.
42. A point not discussed in the Consultation Paper relates to overall corporate governance of NIE by ESB. The SEMC acknowledge and accept a legitimate corporate governance role for ESB over NIE. This is part and parcel of a normal corporate relationship. However, what is unique is the role that ESB has in the overall electricity market. Given that certain officers of ESB could well be observers/participants in NIE board meetings (quite correctly) and do so with other ESB group companies, this could lead to a confidentiality issue.
43. SEMC therefore recommend that ESB develop a protocol that sets out clearly how officers of ESB (directors, company secretary or others) and it's group will deal with situations where they are privy to confidential information gained from an NIE board meeting when such information would be useful to an ESB group company. SEMC are not currently recommending that this is set out in the NIE Licence (contrary to the CEPA recommendation) and will monitor ESB's response to this recommendation over time and revisit if required.

Condition 12: Independence of the Transmission and Distribution Business

Corporate governance role and caveats to that

44. The existing NIE licence says that when NIE is making decisions around the development of the total system, those decisions must be taken independent of influence. The only caveat to that is the legitimate corporate governance role of a parent. This corporate governance role is caveated itself such that the corporate governance exercise shall not distort competition in electricity supply or generation.
45. SEMC were recommending in the Consultation Paper that this caveat on corporate governance is extended so that corporate governance cannot be an reason to make a decision which does not have due regard to the interests of consumers in Northern Ireland. This is similar to the issues set out in paragraph 21 and following of this Decision Paper.
46. ESB were the only consultee with strong views on this, which were that this was unnecessary.
47. SEMC have for reasons similar to those set out in paragraph 21 and following of this Decision Paper not to request a licence change to reflect the interests of consumers issue.

Relevant holding company

48. SEMC were recommending in the Consultation Paper that who gives the undertaking mentioned was altered to become a party who was agreed as between NIE and the Utility Regulator from time to time.

49. Consultees who responded on this broadly agreed with this approach.
50. Until this is resolved, Condition 12 states that NIE cannot enter into any agreement or arrangement with ESB.
51. SEMC are therefore minded to make the suggested change and to allow ESB to be the relevant party to allow the undertaking to be given. SEMC further recommend this is conditional on ESB retaining ownership as it is prudent for the Utility Regulator or SEMC to review this fresh upon any sale. However, SEMC are only minded to do this as part of a wider package of changes, as set out in this paper. It is important that the issues set out in this Decision Paper are dealt with in one place as it allows consultees to look at the issues presented in the round.

Associated Business

52. SEMC were recommending in the Consultation Paper that the definition of Associated Business (which in effect says that NIE must remain fully independent from a managerial and operational perspective from an Associated Business) be altered to include ESB. The rationale for this was that the very essence of this Condition was to ensure that whatever the ownership structure, NIE maintain managerial and operational independence.
53. Both ESB and NIE did not think this was appropriate and would, in effect, prefer if the full managerial and operational independence test was removed for ESB Networks. NIE cited information flows between the two regulated networks as an example of where the two networks should work together.
54. SEMC agree on information flows and that is the purpose of allowing the licence changes to Condition 10 above. SEMC are also of the view that there will be synergies between the two businesses over time in relation to assets and resources and should these be ones that both bring benefit to consumers whilst at the same time maintaining independence, these are likely to be welcomed.
55. However, this is different from allowing NIE's managerial and operational independence to be eroded over time with the Utility Regulator having no specific licence remedy to review and manage this, which would be the effect of allowing ESB (and therefore ESB Networks) to be excluded from the independence test.
56. SEMC are therefore minded to make ESB an Associated Business but to make clear that any synergies that are agreed in advance with the relevant Regulator are allowed, despite where this condition starts. No viable alternatives have been presented to this model by consultees.
57. A good example of a likely synergy is the Retail Market Harmonisation Project.
58. The Retail Market Harmonisation Project, considered what pragmatic changes could be implemented within both jurisdictions to achieve greater harmonisation of messages and processes. It also considered any opportunities for greater alignment of technical solutions (the technical infrastructure that supports and enables the flow of market messages). The Enduring Solution project selected an infrastructure for suppliers (both north and south) to face/interact with Central market systems. The project is working off a single interface model where suppliers would have a single portal through which they submit market messages. The market messages will then be directed to the appropriate jurisdiction through a single 'market hub'. It is proposed that the hub be located in Northern Ireland, with links to the NIE and ESB Systems.

59. The SEMC acknowledge the potential synergies of this type of project but require the detail to be approved by the appropriate regulator. For example, in the above example, regulatory approval would be based on the following being in place:

- Details on the risk mitigation strategy if 'market hub' fails
- Details of the contract and Service Level Agreements (SLAs) in place between NIE and ESBN in order for ESBN to access the 'message hub'
- Details on the payments from ESBN to NIE for access and usage of the 'Message hub'. It is assumed that payments would be based on usage, in order to ensure full cost reflectivity and avoid any cross subsidies between NIE & ESB.

60. This is a good example of how this will operate in practice. We also believe this regulatory oversight will give market participants the comfort they need that the correct type of regulatory oversight is occurring.

How to Respond

61. The SEMC welcome representations and views from all interested parties as to the proposed Licence Changes (see Annex B), as to other potential Licence changes or any other relevant points. Responses should be received by **17 February 2012**. The SEMC have asked Kevin O'Neill of the Utility Regulator to act as the point of contact and recipients of any representations made. The contact details are set out in paragraph 64 below.

62. It should be noted that any licence modifications to NIE's licence can only be made by the Utility Regulator in accordance with the modification procedures set out in legislation.²

63. Unless otherwise advised by respondents, responses may be made publicly available, via the AIP website. Respondents should clearly mark any part of their response they wish to remain confidential. The SEMC will do its best (under law and good practice) to honour this, but respondents need to be aware that the SEMC when responding to the consultation may have to give details of representations made to properly consult. It should be noted also that information provided in response to this consultation, may be subject to publication or disclosure in accordance with the Freedom of Information legislative regimes applicable to each regulator.

64. Contact Details for responses are:

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² See Article 14(1) Electricity (NI) Order 1992 (as amended)