

**Northern Ireland Energy Holdings
Corporate Governance Review**

Utility Regulator Consultation Paper

March 2009

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Executive Summary

The Utility Regulator has been committed to providing regulatory oversight of the Northern Ireland Energy Holdings (“NIEH”) group of companies to ensure that all aspects of the structure are performing satisfactorily. This has included initiating a review of the NIEH corporate governance and regulatory arrangements to ensure that they continue to meet best practice. The Utility Regulator has recently undertaken this review of NIEH – a company limited by guarantee formed to acquire and hold important energy infrastructure assets for the benefit of Northern Ireland energy consumers.

The purpose of the review is 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, Premier Transmission Ltd and Belfast Gas Transmission Ltd 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 this ongoing monitoring of NIEH and mutualisation.

Within a mutual company there is the concern that incentives for efficiency may be weaker than they would be were the owners motivated by maximising profits, and this has the potential to lead to higher operational expenditures. The benefits of the lower cost of capital achieved by a mutual company can however be substantial. For example the mutualisation of Moyle, SNIP and BGTL has 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.

As part of the review we procured Ernst & Young¹ to assess the appropriateness of the Combined Code on Corporate Governance 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 has also taken the opportunity to review the regulatory corporate governance arrangements in place for the three subsidiaries of NIEH.

Ernst & Young’s conclusions from the review have been very encouraging in that they have concluded that the Combined Code on Corporate Governance (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 have been made but only with the intention to enhance the existing processes, rather than to address any deviation from the Code. On governance, Ernst & Young have recommended:

¹ In carrying out their work, Ernst & Young have worked solely on the instructions of the Utility Regulator and for the Utility Regulator’s purposes. The review by Ernst & Young may not have considered issues relevant to any third parties, any use such third parties may choose to make of the review is entirely at their own risk and Ernst & Young shall have no responsibility in relation to any such use.

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.

Recommendations one and two have been accepted by the Utility Regulator and NIEH as reasonable. Indeed NIEH have already made the terms of reference available on their website and are in the process of implementing a Board Charter. Regarding acceptance of recommendation three, although NIEH have agreed to consider the options, assessment of their Members, who are not remunerated for their work, is questionable. Ernst & Young themselves were not aware of any comparisons used elsewhere and did not therefore suggest any detailed proposals for assessment of NIEH Members. It may be the case that the current process whereby Member attendance is recorded and NIEH assess their Members at re-appointment is the most appropriate option going forward.

On remuneration Ernst & Young have made three recommendations in terms of the performance related bonuses. Specifically:

1. the assessment of whether bonus targets set are appropriately stretching;
2. due consideration be paid to the "all or nothing" approach to bonus payments; and
3. the absence of a long term incentive plan to be taken into consideration when setting future bonus levels.

Both recommendation one and two have been accepted by the Utility Regulator as reasonable and we suggest that the NIEH Remuneration Committee consider them when setting future bonus structures and targets. NIEH have in fact already changed their bonus scheme away from an "all or nothing" approach.

With regards to the third recommendation, the unique structure of NIEH means that equity based reward is not possible. We therefore accept the recommendation that the NIEH Remuneration Committee should consider some form of long term incentive when designing future bonus structures.

In terms of the regulatory review, the Utility Regulator has 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 is 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 have 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.

Views Sought

The purpose of this paper is to inform interested parties of the corporate governance structure in place within NIEH. The paper sets 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.

The Utility Regulator seeks views on all aspects of this paper but in particular comments are sought on the recommendations made to NIEH and conclusions set out in each section.

Responses should be sent to Ian Davidson by Friday 17th April 2009 at ian.davidson@niaur.gov.uk or

Queens House,
14 Queen Street,
Belfast,
BT1 6ER.

Respondents may ask for their responses, in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.

1. Introduction

a. Purpose of Review

The Utility Regulator has been committed to providing regulatory oversight of the NIEH group of companies to ensure that all aspects of the structure are performing satisfactorily. This has included initiating a review of the corporate governance and regulatory arrangements of NIEH to ensure that they continue to meet best practice. It is crucial that this corporate governance structure and associated regulatory controls are aligned to consumers' interest thereby ensuring the benefits from the acquisitions are maintained and the potential savings are maximised with the aim of protecting the interests of Northern Ireland consumers.

The purpose of this review is to ensure NIEH has an appropriate corporate governance structure in place for a company of its size and nature, to ensure the appropriate regulatory controls are in place as well as to make any recommendations to NIEH. At the time of NIEH's acquisition of Moyle Limited (owner of Moyle Interconnector), Premier Transmission (owner of the Scotland to Northern Ireland Pipeline ("SNIP")) and Phoenix Natural Gas (owner of the Belfast Gas Transmission Pipeline ("BGTP")) the Utility Regulator set out the risks and benefits of moving from an equity and debt financed structure to a 100% debt financed structure. As part of this consultation process we stated how we would continue to monitor NIEH closely to ensure the risks are minimised and the benefits are maximised for Northern Ireland customers. This corporate governance review is an important part of our ongoing monitoring of NIEH and mutualisation.

Ernst & Young were procured by the Utility Regulator in 2008 to undertake a review of NIEH's internal corporate governance and remuneration structure. In conjunction with the Ernst & Young review the Utility Regulator has also taken the opportunity to review the regulatory arrangements in place for Moyle Interconnector Limited ("Moyle"), Premier Transmission Limited ("PTL") and Belfast Gas Transmission Limited ("BGTL"). Although BGTL was not explicitly part of the Ernst & Young review, it is structured in the same way as PTL with a licence which has only minor differences compared to the PTL licence. Therefore any recommendations made as part of the Ernst & Young review are directly applicable to BGTL also.

b. Structure of Paper

The remainder of this paper looks at:

- the background to NIEH;
- the importance of effective corporate governance;
- the scope of the review of NIEH's corporate governance arrangements;
- the findings of the corporate governance review including an assessment of the NIEH corporate governance structure and the structure/role of the NIEH Members as well as the consistency of NIEH's current corporate governance practices with the Code;
- the findings of the Ernst & Young remuneration review; and
- the regulatory review findings and conclusions.

At the end of each of the last three sections a summary of the recommendations and the Utility Regulator thoughts on the recommendations have been included.

2. Background

NIEH is a company limited by guarantee (“CLG”) which was formed in January 2005 to acquire and hold important energy infrastructure assets for the benefit of the energy consumers of Northern Ireland. NIEH owns the Moyle Interconnector which links the electricity systems of Northern Ireland and Scotland; the SNIP which runs from Twynholm in Scotland to Ballylumford Powerstation in Northern Ireland; and the BGTP which runs from Ballylumford Powerstation to Torytown in Belfast.

The acquisition of Moyle in 2003, PTL in 2005 and BGTL in 2008 have all been funded by long-term bond finance.

The mutual business model was introduced to the energy industry in Northern Ireland in 2003 when Moyle Interconnector Limited was re-financed and acquired from previous owners Viridian Group plc by Moyle Holdings Limited. NIEH was then formed in January 2005 in preparation for the purchase of Premier Transmission in March 2005. Moyle Holdings Limited then joined the Group in October 2005. BGTL was purchased from Phoenix Natural Gas Limited in March 2008 and became the third subsidiary of NIEH.

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 £41.5m². 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 years³.

NIEH has a unique governance model within the energy industry, with the CLG status meaning that NIEH does not have any shareholders. Members have been appointed to represent the stakeholders and fulfil many of the traditional roles of shareholders, although they do not have any financial interest in the company or receive any remuneration. The model allows for thirty Members, who are appointed by the Board on the recommendation of the Membership Selections Committee. Glas Cymru (Welsh Water) is another example of a utility with a mutual status although all other UK gas and electricity networks are owned by private sector companies.

NIEH is therefore relatively unusual in that it is an energy infrastructure company which has no shareholders. The assets are 100% financed by debt so the cost of capital is usually less than half that of a private sector or state owned company which is treated as if it were a private sector company. It is the role of the Board of NIEH to maximise customer value - minimising costs and ensuring that the company maintains the highest standards of cost control and operational efficiency. NIEH’s Members, representing energy users in Northern Ireland, are there to hold the NIEH Board to account for these responsibilities.

² Utility Regulator Press Release – 21 March 2005

³ Acquisition of Phoenix Transmission by Northern Ireland Energy Holdings – Outcome Paper, April 2008

3. Importance of Effective Governance

Given the absence of profit-motivated shareholders within a mutual company such as NIEH, there is the concern that incentives for efficiency may be weaker than they would be, were the owners motivated by maximising profits, and this has the potential to lead to higher operational expenditures. The Utility Regulator oversaw the implementation of robust corporate governance arrangements for NIEH in 2005 after public consultation⁴ and has ensured that the Moyle, PTL and BGTL licences contain adequate provisions to ensure appropriate corporate governance are in place.

Governance is a fundamental part of any organisation's effective performance, beginning with the tone at the top to evaluate the sponsorship of risk management and internal control. This tone at the top should recognize and reflect the overall strategies and objectives of the organisation and be aligned from a risk management and internal control perspective. These are then articulated into the internal control activities, including policies and procedures that provide guidance for consistent action throughout the organisation. The organisational structure formulates the bodies and individuals within the organisation that have a broader responsibility for risk, such as a formal risk committee or a dedicated risk function, as well as the way that responsibility for risk and controls are assigned throughout the organisation. Finally, compliance encompasses expectations for risk management and internal control efforts to create an organisation that is compliance risk aware and has established risk controls.

Based on their experience, Ernst & Young have created a simple governance maturity model to assess the effectiveness of a company's governance structure and to place key elements of governance in context. The model highlights the necessary checks and balances needed within an effective corporate governance structure. Using the model, all stakeholders in a business can better understand, plan and execute activities in response to challenges and risk arising from rapidly changing regulatory, market, financial and business pressures. The key premise used by Ernst & Young in development of the governance maturity model is that corporate governance:

- Is not about regulation and legislation, it is about doing what is right for the shareholders/ stakeholders;
- Is broader than Boards and Committees, it extends throughout the organisation, and includes element of internal controls, ethics, various risk functions, policies and procedures, internal and external audit; and
- Requires transparency of disclosure, effective communication, and proper measurement and accountability as essential elements for good governance.

⁴ "The Proposed Company Structure of Northern Ireland Energy Holdings: A Consultation Paper", July 2005.

4. Scope of Review

The terms of reference for Ernst & Young's review of the Corporate Governance and Remuneration arrangements within NIEH were as follows:

- a) To review the governance structure of NIEH;

In reviewing the governance structure within NIEH Ernst & Young have made reference to the Combined Code on Corporate Governance⁵ (the "Code") and also assessed the maturity of the current governance structures in comparison with indicative practices using their governance maturity model which runs on a continuum from basic to leading practices. Ernst & Young have determined where they feel NIEH sits on this model based on the level of maturity of governance processes in place whilst also taking into account the size and structure of the organisation. The conclusions can be seen in section 5.a. Linked to this is the role that the NIEH Members play which is analysed in section 5.b.

It should be noted that only those companies whose shares are listed on the London Stock Exchange are required to comply with the Code set out in the Listing Rules published by the UK Listing Authority. NIEH are however committed to be seen to be adopting best practice, by endeavouring to adhere to the Code where appropriate. In particular, the Code's key principles of accountability, transparency and effectiveness are key guiding principles for the corporate governance of NIEH.

- b) To assess the consistency of NIEH's governance structure with the Code;

Ernst & Young reviewed whether each of the required elements of the Code was in line with current practices within NIEH. The conclusions on this requirement are set out in section 5.c of this paper.

- c) To recommend appropriate deviations from the Code;

Ernst & Young have observed how the current governance structure is operating and whether any amendments are required. Any recommendations on deviations from the Code are listed in section 5.c.

- d) To benchmark the remuneration packages of senior management relative to industry standards;

Ernst & Young have benchmarked the current base salaries of selected NIEH Directors and employees (Managing Directors and group finance manager) including the reasonableness of potential bonuses and how the performance targets are set in relation to this. The review also considered the fees paid to the Non-Executive Directors of NIEH in comparison to current market rates. Section 6 of this paper looks at the remuneration packages within NIEH.

- e) To recommend improvements in line with industry best practice.

Based on the findings of the review a number of recommendations have been made to NIEH on potential improvements to the current corporate governance structure in place within NIEH. These

⁵ The Combined Code on Corporate Governance sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit and relations with shareholders. All companies incorporated in the UK and listed on the Main Market of the London Stock Exchange are required to report on how they have applied the Combined Code in their annual report and accounts.

recommendations have been made to enhance the existing processes, rather than to address any deviation from the Code and are summarised at the end of each section.

In addition to the Ernst & Young review, we have undertaken to examine the Regulatory and licensing arrangements in place for NIEH. Our review assesses whether the Moyle, PTL and BGTL licences contain adequate and robust corporate governance arrangements. Section 7 looks at the Regulatory arrangements in place and sets out our recommendations to NIEH.

5. Corporate Governance Review

This section looks at the findings from the Ernst & Young review of the NIEH corporate governance structure including how NIEH perform in comparison to Ernst & Young's own governance maturity model, the membership structure of NIEH and finally how consistent NIEH's governance structure is with the Code.

a. NIEH Corporate Governance Structure

The first part of the Ernst & Young review was to look at the high level corporate governance structure in place within NIEH. A number of criteria were analysed to determine how NIEH measured on Ernst & Young's governance maturity model, i.e. Indicative Basic Practice, Average Practice or Leading Practice. Ernst & Young have defined the maturity levels in relation to risk management and internal control activities and supporting examples are provided in the commentary under each of the component areas below.

"Leading practice" represents leading practices in design, consistent application, integrated, aligned and well coordinated activities across the organisation. The activities are viewed as leading practice both internally and externally by other organisations. "Average to leading practice" is indicative of activities that are advanced in design, relatively consistent in application and for the most part, well understood by management and relevant employees across the organisation. Limited opportunities for enhancement remain.

"Average practice" indicates risk management and internal control activities that are established in design, yet not consistently applied or fully understood by management and relevant employees in key functions/business areas and moderate opportunities for enhancement remain.

"Basic to average practice" represents activities that are evolving in design, but are inconsistently applied and well understood only by management and the relevant employees in limited business areas. Significant opportunities for enhancement remain. "Basic practice" indicates risk management and internal control activities that are basic in design and inconsistently applied across the organisation. Critical opportunities for enhancements remain.

The level of maturity in each of the component areas is dependent upon the control activities in place, as defined above. These activities will be influenced by the size and complexity of the organisation, where larger, more complex organisations will require and be able to support more sophisticated processes and technology.

The component areas of governance on which NIEH were assessed are as follows:

- Risk Strategy
- Governance
- Risk Management Processes
- Technology
- Risk Management Functions
- Culture and Capability

It should be noted that given the size and complexity of NIEH it was not our expectation that they would reach the higher end of the Leading Practice category for the above criteria, for example we would not

expect NIEH to have an in-house internal audit function or outsourced assurance provision. It is therefore encouraging to see that Ernst & Young have concluded that NIEH fall in the lower end of leading indicative practice for three of the above criteria and in the average to leading indicative practice for two of the above criteria - all of which are considered to be appropriate and the expected maturity for NIEH.

The detail of the Ernst & Young findings on the above criteria and how they measure on their maturity analysis is set out below:

i. Risk Strategy

The NIEH Audit Committee is responsible for ensuring that there is an appropriate framework in place to manage risk and that risk is managed across the organisation, although is reported to and owned by the Board as a whole. Ernst & Young concluded that there is an established framework in place to document risks and how they are being managed (see (iii) below), which is reviewed and updated quarterly by the Audit Committee on behalf of the Board.

They also found that the risks included in the current version of the risk register include linkage to stakeholder value; clear responsibility for managing the risk; and assessment of business implications.

The risk strategy in NIEH is well-established with clear accountability and ownership at all levels. Ernst & Young concluded that it is at the **lower end of “leading” indicative practice** in their maturity analysis, which is appropriate for an organisation similar in size and complexity to NIEH.

ii. Governance

The NIEH Board has a number of sub-committees which include Remuneration, Membership, Nominations and Audit Committees. Each committee has established terms of reference which defines the delegated authority granted by the Board.

Ernst & Young have noted that while not mandatory, emerging practice is for a Board Charter to be used to define membership and role of the Board; NIEH do not currently have this in place and Ernst & Young have included this as a recommendation.

The governance model of NIEH includes the appointment of Members to represent stakeholders. While the roles and responsibilities of Members are documented, Ernst & Young have noted that there is no formal measurement process in place for either individual Members or the overall output and efficiency of the membership process. These enhancements have contributed to Ernst & Young concluding that governance practices are operating in line with indicative **“average” practice**.

NIEH have now in fact implemented two of the three recommendations so it could be argued that they are now performing better than the conclusion of ‘average practice’ at the time of the review.

iii. Risk Management Processes

Ernst & Young concluded that there is an established risk register in place, which is reviewed and updated as appropriate at the quarterly meeting of the Audit Committee. In addition to defining the risk, the register defines the following:

- a) The impact and likelihood of the risk occurring; impact is measured in financial terms. These contribute to an overall risk rating;
- b) Risk owner;
- c) Potential business implications;
- d) Current arrangements for managing the risk;
- e) Any additional actions required to manage the risk.

Although 9 of the 14 risks identified are considered to have “super high” impact, none of the risks are considered to have a high likelihood of occurring. In addition, 11 risks are considered to have “good” control and three “satisfactory” control. The risk management process in NIEH is well-established with clear accountability and ownership at all levels. Ernst & Young concluded that it is at the **lower end of “leading” indicative practice**, which is appropriate for an organisation similar in size and complexity to NIEH.

iv. Technology

The level and sophistication of technology used to enable and manage the risk management process will be determined and influenced by the size and level of complexity of the organisation. Given the size of NIEH and the small number of people involved in the risk management process, Ernst & Young have stated that they would not have expected to see a fully integrated risk management system or any complex tools or databases.

Risks are captured in the risk register, which contains sufficient information to enable the NIEH Board and management to capture and manage risks. Ernst & Young came to the conclusion that NIEH is operating at an **“average” to “leading” indicative practice** which is both appropriate and sufficient for NIEH to carry out an effective risk management process.

v. Risk Management Functions

Given the size and complexity of NIEH, it is the opinion of Ernst & Young that many of the leading practices under risk management functions would not be appropriate, for example, an internal audit function. However, the Audit Committee operates under a terms of reference which includes consideration of the existing assurance provisions on an annual basis to ensure that an appropriate level of assurance is in place.

Risk management is currently overseen by the Audit Committee and managed on a day-to-day basis by the business, driven by the identified risks and controls to manage these. Ernst & Young found that the objectives in this process are clear and appropriate for NIEH.

“Leading” indicative practices would include, for example, internal audit functions or outsourced assurance provision, which would not be appropriate for NIEH. As a result, Ernst & Young concluded that NIEH is operating at **“average” to “leading” indicative practice**.

vi. Culture and Capability

It was concluded by Ernst & Young that risk management is embedded into the culture of NIEH through both a range of policies and procedures which have been established for key processes and also through the ownership of and responsibility for managing corporate risks. Performance measurement and ultimately bonuses are driven by individual targets, which include risk management.

By virtue of the size of NIEH, risk management is the responsibility of a small number of people, therefore a formal training programme or communications strategy, which would be included in indicative “leading” practice, are not appropriate. As a result, Ernst & Young have concluded that NIEH is operating at the **lower end of “leading” indicative practice.**

b. NIEH Membership Structure

As stated in section 2, NIEH does not have any shareholders, instead Members have been appointed to represent the stakeholders and fulfil many of the traditional roles of shareholders. The structure in place for Member selection, roles and performance is therefore an important part of NIEH’s overall corporate governance structure. The review by Ernst & Young has therefore looked at the role of these Members including how they are appointed, what their specific role is, how their performance is assessed and the role of the Utility Regulator in relation to the Members.

In summary Ernst & Young’s conclusion is that the membership selection and appointments processes are established, documented and operating as they would expect. They have not noted any issues with the operation of the current process or improvements which could be made to enhance the existing processes specifically in relation to selection and appointments. In terms of the Members’ role and performance the only recommendation falling out of the review is around the assessment of Member’s performance which is dealt with in more detail in section iii. With regards to the role of the Utility Regulator, Ernst & Young said that current arrangements are adequate while pointing out that the independence of the Regulator needs to be maintained.

This is an overall positive assessment by Ernst & Young in terms of the membership structure in place within NIEH.

The Ernst & Young conclusions on the specific areas are as follows:

i. Members Selection and Appointment

NIEH Members have been appointed to perform many of the roles of a shareholder although they do not have any financial interest in the company or indeed do not receive any remuneration. The model allows for thirty Members, who are appointed by the Board on the recommendation of the Membership Selections Committee.

Policies for the selection of Members are in place and supported by written procedures, which include the following:

- Role of Members

The role, terms of appointment and standards of conduct are documented in addition to the number of Members required. The role described sets out the various responsibilities and expectations of the Members once appointed, which form part of the governance arrangements for NIEH and include:

- Approving appointment, re-appointment and removal of Directors;

- Approving the annual report and accounts; and
- Approving certain changes to the Company's constitution.

In addition, the policy also sets out the standards of conduct which are expected of Members.

Given that the Members have a role in the overall governance arrangements for NIEH, selection of the Members is based upon criteria which would enable them to effectively discharge their duties, which include relevant skills, expertise, industry experience, capacity and ability to represent consumer interests.

The policy for membership selection provides that there should be no fewer than thirty Members and that the membership body should be broad enough to adequately represent all stakeholders. Members are appointed for an initial period of three years, subject to a maximum of three consecutive terms.

- Selection and appointment of Members

Members are selected by the Membership Selections Committee, which comprises two Non-Executive Directors, two Members who are not Directors and two independent persons, who are nominated by the Utility Regulator. There is an established terms of reference in place for the committee, which defines the responsibilities of the committee and quorum for decision making.

The appointment process includes a formal application, which is considered by the Membership Selections Committee in light of experience, skills and potential conflicts of interest, followed by an interview. All candidates put forward by the committee are approved by the Board before formal appointment.

- How Members may be sought

The policy requires that the membership includes representation from stakeholders and also that the Members should hold appropriate skills to enable them to discharge their duties effectively. Two methods of selecting Members are included in the policy, which are an open recruitment process and key stakeholders and consumer groups putting forward candidates. Both methods have been used by NIEH.

- Conflicts of Interest

Potential conflicts of interest on the part of the Members or potential Members are considered throughout the selections process, with existing roles considered in light of the impact on and conflict with the expected role as a Member for NIEH. In addition, all Members are required to declare any interests which may conflict their role.

On comparison with models for membership selection and appointment in other mutual organisations, Ernst & Young have concluded that the process which is followed by NIEH is broadly similar in structure. These comparisons do not offer any alternative processes or opportunities to improve the current processes in place within NIEH.

Ernst & Young's conclusion is that the membership selection and appointments processes are established, documented and operating as they would expect. They have not noted any issues with the operation of the current process or improvements which could be made to enhance the existing processes specifically in relation to selection and appointments.

Ernst & Young have made observations and recommendations around the assessment of Members' performance, which may indirectly impact on the selections process.

ii. Members Role

Members are responsible primarily for holding the Board to account for discharging their duties. The role is documented in full in the policies and procedures. Members have the opportunity to attend a Members Day and the AGM, in addition to informal contact with NIEH on an "as needs" basis.

In addition to receiving information at the AGM or Members Day, business developments are circulated to Members before they become public knowledge.

iii. Members Performance

Ernst & Young noted that attendance at the formal meetings is recorded and is currently the only measure of performance of Members. There is no formal assessment of Members' effectiveness either on an individual basis (review of objectives by Member) or on an overarching basis (review of process output against expectations).

There is no reason to doubt the effective performance of the NIEH Members both individually and collectively however it is Ernst & Young's view that without a formal assessment of whether the Members, both individually and as a body, have achieved their objectives as agreed in the role/responsibilities, it is not possible to conclude on the effectiveness of the membership structure and process or take action where it may be deemed necessary.

Ernst & Young have therefore made a recommendation that the NIEH Membership Selections Committee considers developing assessment criteria for Members' performance. Irrespective of the fact that there is no requirement within the Code itself to carry out such an assessment and that Members are equivalent to shareholders who themselves have no formal assessment; Ernst & Young feel that it may be appropriate in the context of a mutual organisation given the importance of the Members and the lack of financial incentive to have some formal assessment in place. Ernst & Young did not however suggest a detailed proposal for the implementation of member assessment and were not aware of any comparisons used elsewhere.

iv. Utility Regulator Role

The Utility Regulator is able to nominate two representatives for the Membership Selections Committee. These two representatives, with two Non-Executive Directors and two Members as described above, form the committee. The purpose of the representatives is to provide an independent view in the process. Although the Utility Regulator nominate the representatives, the Utility Regulator does not have any direct influence or final decision in either the selection or appointment of Members, which would conflict with the independent role of regulation.

Ernst & Young's opinion is that the Utility Regulator has an independent role in the process, which does not currently enable direct influence or decision making in membership selections. 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.

The Utility Regulator have also identified as part of this review the benefit of meeting with the NIEH Members on a regular basis and going forward have agreed to make themselves available to meet with NIEH Members. This will give both parties the opportunity to discuss a range of issues including their thoughts on their effectiveness as a group.

c. Consistency of NIEH's Governance Structure with Code

On conclusion of Ernst & Young's review of the high level corporate governance and membership structure within NIEH, they looked at each of the required elements of the Code in comparison to current practices within NIEH. These fell under four specific areas:

- Board Constitution and Responsibilities
- Board Remuneration
- Audit and Accountability
- Communication with Stakeholders

In summary Ernst & Young concluded that current practices are in line with the provisions of the Code. The recommendations made within this section have simply been made to enhance the existing processes, rather than to address any deviation from the Code.

The following conclusions were made by Ernst & Young about each of these corporate governance areas:

a) Board Constitution and Responsibilities

i. The Board

The Code requires that every company should be headed by an effective Board, which is collectively responsible for the success of the company.

While Ernst & Young recognise that the NIEH Board is guided by governance requirements as established in the Code, they note that emerging practice is for Boards to have a Charter in place to outline roles, responsibilities and terms under which they operate and recommend that NIEH should give consideration to implementing such a document.

In Ernst & Young's opinion in the absence of formally documented terms of reference, there is a risk that committees do not address all relevant responsibilities. Committees over time may adopt custom and practice, however should there be changes in the membership, there is a risk that roles and responsibilities are not understood or appropriately applied.

Detailed terms of reference are in place for each of the sub-committees of the Board (Audit Committee, Nominations Committee, Remuneration Committee, and Membership Selections Committee); however Ernst & Young noted that these are not published on the NIEH website or publicly available through other means. In order to maintain transparency and to provide full information on governance arrangements, Ernst & Young recommend that terms of reference are made available on the company website.

ii. Chairman and Chief Executive

Ernst & Young concluded as part of their review that as required of the Code there is a clear division of responsibilities at the head of the company between the running of the Board and the executive responsibility for the running of the company's business. No one individual within NIEH has unfettered powers of decision.

iii. Board Balance and Independence

The Board includes a balance of Executive and Non-Executive Directors (and in particular independent Non-Executive Directors) such that no individual or small group of individuals can dominate the Board's decision making which is in line with the requirements of the Code.

iv. Board Appointments

Ernst & Young completed their review in quarters one and two of 2008 during which there were no new appointments to the NIEH Board, which to a degree constrained the review of the NIEH Board appointment processes. Ernst & Young did however conclude that the procedures in place are formal and transparent, as per the Code and in line with industry practice, although noting that at the time of the review operating effectiveness could not be concluded on. It should be noted that NIEH has since appointed three new Board Members.

Ernst & Young found that conflicts of interest of Board Members are considered as part of the Board appointments process, through consideration of the other roles which potential Board Members hold and the potential impact on or conflict with the duties which are required in a Board role for NIEH.

In addition, Directors are required to declare annually any known conflicts of interest.

Ernst & Young have reviewed the documentation which supports the current appointments process and consider the approach to be appropriate to achieve the requirements of a "formal, rigorous and transparent procedure" as required by the Code.

v. Information and Professional Development

As required of the Code, the Board is supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All Directors receive induction on joining the Board and regularly update and refresh their skills and knowledge.

vi. Performance Evaluation

The Code requires that the Board undertakes a formal and rigorous annual evaluation of its own performance and that of its committees and individual Directors. Ernst & Young concluded that as per this requirement, evaluation of the NIEH Board is carried out annually. The objectives of this process have been documented, in addition to the required format for the review. The evaluation includes:

- Meeting of the Board without the Executive Directors to evaluate performance of, and information supplied by, the Executive Directors.
- Review of the Chairman, led by the Senior Non-Executive Director, against expected duties.
- Evaluation of the Non-Executive Directors, which is carried out by the Chairman in conjunction with a self-assessment carried out by each Director.
- Performance evaluation of the Board, which is considered by the Board as a whole.

Ernst & Young concluded that Board performance is carried out in line with Code requirements.

vii. Re-Election

As stated above, during the Ernst & Young review Directors had not been eligible for re-election. However, the Board have recently agreed and documented a succession plan, which has identified timeframes for refreshing Board membership over the next two to three years, taking into consideration requirements for retirement and re-election. Indeed since the review by Ernst & Young was completed three Board Members resigned and three new Members have been appointed, however given re-election of Board Members did not occur during the Ernst & Young review they were unable to test and confirm that the process for re-election of Directors is operating in an effective manner. However, the review of the succession plans and planned procedures would indicate that due consideration has been given to the constitution and refreshing of the Board over the medium to longer term.

b) **Board Remuneration**

i. Level and Make-Up of Remuneration

The Code requires that the levels of remuneration are sufficient to attract, retain and motivate Directors of the quality required to run the company successfully, but the company avoids paying more than is necessary for this purpose. A significant proportion of Executive Directors' remuneration is structured so as to link rewards to corporate and individual performance. Ernst & Young concluded that these requirements were in place and operating at the time of their review.

ii. Procedure

The Code also requires that there is a formal and transparent procedure for developing policy on Executive remuneration and for fixing the remuneration packages of individual Directors. No Director is involved in deciding his or her own remuneration. Ernst & Young concluded from their review that these requirements were in place.

c) **Audit and Accountability**

The following Code requirements regarding Audit and Accountability were considered and Ernst & Young concluded that these were in place and operating at the time of the review:

i. Financial Reporting

The Board presents a balanced and understandable assessment of the company's position and prospects.

ii. Internal Control

The Board maintains a sound system of internal control to safeguard shareholders' investment and the company's assets.

iii. Audit Committee and Auditors

The Board establishes formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

d) **Communication with Stakeholders**

i. Dialogue with Members

To satisfy this Code requirement, the Code requires that there should be a dialogue with Members based on the mutual understanding of objectives and the Board should be responsible for ensuring satisfactory dialogue with Members takes place. Ernst & Young concluded that this requirement is in place, however further actions could be taken in relation to the assessment of the members' effectiveness, which was referred to above, to reach Combined Code level of effectiveness.

ii. Constructive Use of AGM

The Board uses the AGM to communicate with members and to encourage their participation.

Corporate Governance Conclusions

In summary Ernst & Young encouragingly concluded that current practices within NIEH are in line with the provisions of the Code and there were no non-compliances with the Code noted. Their recommendations have therefore simply been made to enhance the existing processes, rather than to address any deviation from the Code.

In summary the following recommendations have been made by Ernst & Young:

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

NIEH have since published the documents referred to in recommendation three and they are also currently developing a Board Charter as proposed in recommendation two.

With regards to recommendation one, it is questionable whether this could be implemented within NIEH due to the fact that the Members are not remunerated for their participation in the business and they are equivalent to shareholders who themselves have no assessment requirement. Ernst & Young were also not aware of any comparisons used elsewhere for Member assessment and did not suggest a detailed proposal for the recommendation.

One possible option could be to appoint a regulatory nominee to be involved in Member events and communication as an observer. This could be implemented by agreement with NIEH and its Members or by including a licence condition to create a rotational regulatory nominee who reports back to the Utility Regulator on the activities of the members. The regulatory nominee could be written into NIEH's Membership Selections Policy and/or to the licence, but the nominee would not have any say or influence over the appointment of Members or their performance. Instead they would simply attend meetings/receive communication and observe.

An alternative option may be to put in place some form of self assessment whereby the Members assess their effectiveness as a group. This could be performed on an annual basis with the assessment being used as an indicator of Member attendance, input, performance etc.

Although these are possible options for assessing the performance of Members and their overall contribution, our initial view is that they are not appropriate for NIEH. The current process whereby Member attendance at formal meetings is recorded and NIEH assess their Members at re-appointment may in fact be the most appropriate option going forward given the difficulties outlined above.

6. Remuneration Review

As well as reviewing the corporate governance structure within NIEH, Ernst & Young were asked to review the remuneration process in place for the NIEH senior management (two Managing Directors and group finance manager). When undertaking the benchmarking of remuneration Ernst & Young typically took account of:

- The size of the organisation, by both market capitalisation and revenue;
- The type of organisation;
- The sector in which the business operates; and
- The level of responsibility of the post.

Ernst & Young took into account companies who NIEH consider to be comparators in addition to referencing market data for a range of appropriate comparators. Whilst Ernst & Young were able to compare against market data in terms of revenue, business sector and post responsibility, the unique structure of NIEH as a mutual company means that comparison was not possible by market capitalisation, whilst there is limited data on small listed utility companies. Therefore, comparison of company size was based on revenue only and company type was general.

In assessing the base salary of the two Managing Directors, Ernst & Young took account of:

- Base salaries in the bespoke comparator group;
- Market data on base salaries for holding the number one position as a subsidiary Director in companies of similar revenues to NIEH; and
- Market data on base salaries for a Director who sits on the main parent board.

The base salary of the group finance manager was benchmarked against market data on salaries for a senior head of function in companies of similar revenues to NIEH.

Ernst & Young noted that the market data that forms the basis for comparison is that for the UK, and whilst geographic location is not normally a significant factor outside of London, local market forces may impact salary levels. It should therefore be noted that although salary levels in the UK will be comparable, the lack of market data specifically for Northern Ireland means that direct geographic comparison cannot be made. In addition, Ernst & Young considered base salary levels in the comparator group to be unsuitable benchmarks due to the fact that revenues in the majority are substantially larger and not all the companies operate in the utilities sector; therefore, they have used market data on general companies of similar revenues to NIEH.

In summary, Ernst & Young found that remuneration levels and structures within NIEH are in line with current market rates. The conclusions of the remuneration review by Ernst & Young are summarised below:

i. Base Salaries of Managing Director and Group Finance Manager

The review and benchmarking analysis by Ernst & Young has shown that the base salaries of the Managing Directors and the group finance manager are aligned to current market rates. The Managing Director's base salaries are aligned to current market rates for a number one post as a

subsidiary Director i.e. the most senior position within each subsidiary and the group finance manager's base salary is aligned to current market rates for a position as a senior head of function.

ii. Non-Executive Director Fees

With regards to the Non-Executive Directors the review has found that the fees paid to them are currently aligned to the median of comparators companies. This includes the Chairman who is remunerated in line with the current market rates when considering the number of service days he currently commits to NIEH. Further, the additional fees received for chairing one or more committees are in the upper quartile of comparators.

iii. Performance Related Bonuses

Ernst & Young have noted that the current performance related bonus payments are based on a range of measures including cost, revenue and unavailability targets which is in line with the 'basket' approach. Although Ernst & Young did conclude that the level of potential bonus was in line with market rates they did state that payment of an "all or nothing" bonus⁶ is against market trend, instead bonuses are usually paid on an incremental basis, based on performance against each of the independently weighted targets.

Ernst & Young considered the quantum of payments, by comparing the reported bonus payments in the last two annual reports against maximum bonus opportunity and concluded that the actual bonus received is at or very near maximum level which may suggest that targets may not be sufficiently stretching. However it should be noted that the review by Ernst & Young did not look in any detail at the individual bonuses in relation to their targets achieved nor did Ernst & Young look at the commercial and financial performance of the business. Ernst & Young have however made a recommendation that performance targets are reviewed to assess whether bonus targets set are appropriately stretching and this is something for the NIEH Remuneration Committee to consider going forward. Ernst & Young also noted that the "all or nothing" approach to bonus payments is likely to account for maximum payment being made.

In addition, Ernst & Young recommended that due consideration be paid to the "all or nothing" approach to bonus payments, particularly as this is against market norm.

As part of the Ernst & Young analysis the issue also arose of an additional transaction based bonus payment made to one of the Managing Directors resulting from the completion of a recent transaction. As part of this bonus it was agreed that the Managing Director's salary be frozen to ensure that the total reward package received is not significantly out of sync with market rates. The overarching approval process is for bonus payments to be considered and approved by the Remuneration Committee, a process which is in place and which operated for the transaction bonuses referred to here.

iv. Long Term Incentives

⁶ The payment of 100% of potential bonus upon delivery of a given set of targets and 0% if even one target is missed.

Whilst equity-based long term incentives form a significant part of a typical Executive Director's reward package in listed comparators, the unique structure of NIEH means that a long term incentive which is equity based is not possible. Although a long term reward could be made in cash, this could be perceived as combative to the long term goal of maximising customer value and as such Ernst & Young feel the absence of a long term incentive should be taken into consideration by NIEH when setting future bonus levels.

In benchmarking the remuneration and bonuses for NIEH, these factors have been taken into consideration, therefore the conclusions stated in respect of both remuneration and bonus levels in this section have also factored in the structure and arrangements in place in NIEH.

Remuneration Conclusions

On remuneration, Ernst & Young have made three recommendations. Specifically:

1. Performance targets are reviewed to assess whether bonus targets set are appropriately stretching;
2. Due consideration be paid to the 'all or nothing' approach to bonus payments; and
3. The absence of a long term incentive plan be considered when setting future bonus levels.

Both recommendation one and two have been accepted by the Utility Regulator as reasonable and we suggest that the NIEH Remuneration Committee consider them when setting future bonus structures and targets. NIEH have in fact already changed their bonus scheme away from an "all or nothing" approach.

With regards to the third recommendation, the unique structure of NIEH means that equity based reward is not possible. We therefore accept the recommendation that the NIEH Remuneration Committee should consider some form of long term incentive when designing future bonus structures.

7. Regulatory Review

In conjunction with Ernst & Young's corporate governance and remuneration review the Utility Regulator has also taken the opportunity to consider whether the regulatory arrangements in place for the three NIEH subsidiaries are adequate. This has involved a review of the corporate governance conditions contained within the Moyle, PTL and BGTL licences and associated documents.

The Moyle, PTL and BGTL licences are in place to govern the operations and regulation of Moyle, PTL and BGTL and are an important element of governance for the Utility Regulator. The PTL and BGTL licences include specific conditions in relation to corporate governance. These provisions are not however included in the Moyle licence and our recommendation is therefore to bring the three licences up to the same harmonised standard by modifying the Moyle licence to include similar conditions to the PTL and BGTL corporate governance conditions. The inclusion of the licence conditions in the Moyle licence will be implemented through the established formal licence modification process.

The corporate governance conditions included in the PTL and BGTL licences but not in the Moyle licence are:

- compliance with the principles and guidance contained in the Code;
- requirements for the adherence to the Memorandum and Articles of Association;
- requirement to inform the Utility Regulator of the number of Directors and any changes in Directors;
- the provision of an undertaking from the holding company in favour of the Utility Regulator;
- the requirement to prepare and submit annual accounting statements;
- the obligation not to carry on any business or activity other than the licencee's business;
- the obligation not to own shares in any other company and/or investment; and
- the requirement not to undertake any indebtedness to other companies unless Utility Regulator consent is given.

In addition to the specific corporate governance conditions contained within the PTL and BGTL licences there is also a condition which allows monitoring of their controllable operating expenditure every three years in the form of a shadow price control. We are currently in the process of carrying out this monitoring exercise for both PTL and BGTL. It is our intention therefore to also introduce this licence requirement into the Moyle licence.

The Utility Regulator has also requested that following the completion of this corporate governance and regulatory review, NIEH initiate a review of its Membership Policy as per clause 1.3 of the Policy to ensure the document is up-to-date and that it reflects any changes that may arise as a result of this review and its recommendations.

Regulatory Review Conclusions

The regulatory review has concluded the following recommendations:

1. The inclusion of corporate governance conditions within the Moyle licence similar to those included in the PTL and BGTL gas conveyance licences;
2. The addition into the Moyle Licence of the licence condition which allows the Utility Regulator for monitoring purposes to undertake a three year review of Moyle's controllable operating expenditure; and
3. The review of the NIEH Membership Policy.

With regards to recommendation one it should be noted that apart from the provision of an undertaking from the holding company, Moyle already complies with all the proposed corporate governance conditions. The licence modification to include the corporate governance conditions will therefore not change the conditions under which Moyle operate and will merely formalise what is already happening.

The inclusion of the Shadow Price Control licence requirement as per recommendation two will mean the Utility Regulator will be able to monitor the operating expenditure of all three subsidiaries. Again, the Utility Regulator is currently able to monitor the operating expenditure of Moyle but it is recommended that we modify the Moyle licence to formalise the process for doing so.

All three of the recommendations have been accepted by NIEH as reasonable and it is intended to modify the Moyle licence to include the relevant corporate governance licence conditions. NIEH have also agreed to carry out a review of the NIEH Membership Policy once this corporate governance and remuneration review has been completed.

8. Conclusions

In summary the review by Ernst & Young has provided us with confidence that the corporate governance and remuneration structure in place within NIEH is operating adequately and is robust and fit for purpose for a company of NIEH's size and complexity.

The conclusion from Ernst & Young that the Code is an appropriate benchmark for NIEH to use and current practices in NIEH are in line with the provisions of the Code is reassuring and an encouraging conclusion from the review. A number of recommendations have been made but these are simply intended to enhance the existing processes, rather than to address any deviation from the Code. Indeed NIEH have already either accepted the recommendations and have agreed to consider them going forward or in some cases have already implemented them.