

**Consultation on SONI  
Divestment and  
Proposed Modifications to the  
System Operator and Market  
Operator Licences**

**SEM/08/021**

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## **Executive Summary**

On 3rd July 2007 (SEM Go-Active) the licences for the System Operator and Market Operator were granted to SONI Ltd. These licences did not come into full effect in their current form until 1<sup>st</sup> November 2007 (SEM Go-Live). This consultation proposes licence modifications the effect of which will be to include new conditions in both the system operator and market operator licences. Subject to the results of the consultation, it is proposed that these modifications will be made, with the consent of the Department of Enterprise, Trade and Investment (DETI), pursuant to the Authority's powers under Article 3 of the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007.

The authority's powers under Article 3 will remain in force until June 2009 and this is an indicator that post Go-Live licence changes deemed to be necessary or expedient for the proper implementation of SEM were envisaged in the period before Go-Active when the SEM order in council was passed. It was expected that the period to June 2009 would be a transition period in which any outstanding SEM issues, including SONI divestment and changes required to licences to accompany divestment, would be dealt with. SONI's role as transmission system operator (TSO) in Northern Ireland is of vital importance to the safe, secure and economic operation of the transmission system upon which generators, suppliers and customers depend. Furthermore SONI's responsibilities have recently been extended with the addition of an all-island dimension and it now provides a range of services that are critical to the success of the Single Electricity Market (SEM).

It is in this context that NIAUR (in discussions with CER) (jointly the Regulatory Authorities) has formed the view that two extra licence conditions may be required in both the "Licence to Participate in the Transmission of Electricity" (System Operator) and the Licence to Act as SEM Operator (Market Operator) licences. It is the purpose of this consultation to invite views from interested parties as to the form and content of the two proposed new conditions and the appropriateness of their inclusion. The proposal is that the first new condition should impose on SONI a requirement to maintain an investment grade credit rating and/or a minimum gearing ratio and the second should impose a requirement that the board of the company has some degree of independence in the form of non-executive independent members.

## **Background**

The introduction of the SEM in Northern Ireland was effected principally through the exercise of powers conferred on the Department and the Authority by the Electricity (Single Wholesale Market) (Northern Ireland) Order 2007 (the “SEM Order”) with similar legislation also being introduced to facilitate the introduction of the SEM in the Republic of Ireland. In Northern Ireland, the introduction of the SEM was also accompanied by changes to further implement the IEM Directive facilitated through powers conferred on the Department and the Authority by the Electricity Regulations (Northern Ireland) 2007.

In Northern Ireland, the introduction of the SEM included not just the establishment of the single wholesale trading arrangements enshrined within the Trading and Settlement Code, but also a number of broader changes to licences and industry codes as well as structural changes within the Industry in Northern Ireland. In particular, the December 2006 Memorandum of Understanding between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Ireland (the “MOU”) states that:

“In the interests of promoting competition, it is intended that the SEM arrangements will include an appropriately defined set of transmission system operator activities in each jurisdiction (including appropriate contractual arrangements in relation to the conduct thereof), such activities and the activities of the SEM Operator to be carried out by one or more organisations that neither carry out the activity of generation or supply in Northern Ireland or Ireland nor, from such time as may be considered appropriate, have any affiliates that carry out the activity of generation or supply in Northern Ireland or Ireland.”

The MOU goes on to say that:

“To that end, the SEM arrangements in Northern Ireland will include the transfer of such transmission system operator activities into a company which, at the time of transfer, conducts no electricity-related activities other than activities of transmission system operator and SEM Operator.”

The initial transfer of the transmission system operator activities to a separately licensed SONI took place as part of the initial introduction of the SEM in November 2007. However the second stage of the introduction of the SEM in Northern Ireland remains to be introduced. This second stage includes arrangements such that the activities of the SEM Operator and defined set of system operator activities are carried out by one or more organisations that neither carry out the activity of generation or supply in Northern Ireland or Ireland nor, from such time as may be considered appropriate, have any affiliates that carry out the activity of generation or supply in Northern Ireland or Ireland.

NIAUR has indicated on a number of occasions that it expects that such arrangements will be introduced no later than 12 months after the initial introduction of the SEM, i.e. by no later than November 2008. In discussions with the Department of Enterprise Trade and Investment (DETI) and NIE, it has been agreed that in order to give effect to such arrangements, SONI will be divested by NIE and that initially, the divestment process would be carried out on a voluntary basis by NIE.

NIAUR and DETI are continuing to monitor progress on such matters and understand that NIE has made progress on such matters over the past few months and is on track for a divestment by or before November 2008. As a consequence NIAUR and DETI accept that it is appropriate for the voluntary divestment process to continue to be progressed for the time being.

Nonetheless, in light of the pending divestment of SONI by NIE, the Regulatory Authorities (RAs) have reviewed the licence conditions applying to SONI under its SEM Operator licence and licence to participate in transmission and are of the view that it is appropriate to make further amendments to SONI's licence conditions to make explicit a number of matters which are implicit under the current structure (either because the arrangements have been adopted as part of price control arrangements or are implicit as a consequence of NIE's licence to participate in transmission).

This consultation document sets out those proposed licence changes. It should be noted that the RAs will continue to keep under review the arrangements for SONI divestment and that depending upon the nature of the business of the person or persons to whom SONI is divested, it may become necessary to consider further licence changes to accompany the divestment process.

## **Proposed New Conditions For SO and MO Licences.**

This section sets out the rationale for the proposal that both a "credit rating" and a "Board Independence" condition be included in both the SO (system operator) and MO (market operator) licences.

### **Financial Gearing and Credit Rating**

As a starting point the Utility Regulator wishes to invite views on whether it would be appropriate to include a condition in each SONI licence which requires either:

- (i) both a minimum investment grade credit rating and a maximum gearing ratio or
- (ii) either an investment grade rating or a maximum ratio.

We also invite views as to the feasibility of a company of SONI's size being capable of achieving an investment grade rating. An investment grade rating is a clear and generally recognised designation, and the requirement to

maintain one is in line with existing requirements of the NIE licence and the approach taken by regulators in Great Britain. A company's rating is directly linked to its capital structure and levels of indebtedness. Hence imposing such a condition greatly reduces the likelihood of the regulated business being unable to finance its activities without otherwise unjustified price increases.

It is an implicit condition on SONI today that it maintains an investment grade rating as the company is a wholly owned subsidiary of NIE plc which itself must maintain investment grade rating. This is a requirement of condition 9A of Northern Ireland Electricity plc Participate in Transmission (TO) Licence. Condition 9A also refers to gearing but states only "*The licensee shall, within 14 days of this condition 9A taking effect and thereafter by 30 June each year, submit to the Authority a certificate, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution, showing the Financial Gearing as at the end of the preceding Financial Year. The Licensee shall provide the Authority with such information to support that certificate as the Authority may request*".

There is therefore no specific requirement on NIE to maintain a certain gearing in its licence conditions. There is however an assumption that it has a maximum gearing as part of its price controls. The RAs are of the view that if a requirement concerning gearing was to be included in SONI's licence it should be done through a direction from the Authority pursuant to the licence condition and not as part of the SO or MO price controls. This however should not in any way be onerous for SONI. Indeed in recent price control negotiations SONI indicated to the regulator that its gearing ratio is lower than that assumed for NIE plc in the NIE price control. As stated the RAs are of the view that one or other of these requirements should be included in SONI's licence (or possibly both) to control the capital structure of SONI and limit the potential for the company becoming financially distressed at some future stage. The reasons for this are twofold. Firstly control over the financial status of the System Operator is implicitly afforded to the RAs today via the NIE plc licence. Secondly it is the assertion of the RAs that for the safe secure operation of the market it is essential that the system operator, which has a pivotal and essential role in the all-island market, carry out its licence obligations on a secure financial basis and post divestment from NIE plc be in no weaker a financial position that it is currently. It could be argued that a laissez faire approach could be adopted. However in the absence of "special administration" arrangements for the transfer of the licence of the regulated activity, large scale disruption would likely be caused by an insolvency of the SONI business. Hence a preventative measure seems appropriate.

This proposed condition would also compliment the operational ring fencing that the current licence ensures. The licensee for instance can have no affiliates who are engaged in generation or supply in Ireland or give or receive any cross subsidies from any other business of the licensee or of any affiliate or related undertaking of the licensee. Furthermore the licence creates a bar on SONI committing to borrowings or charges that are not for a permitted purpose or on an arm's length basis or on normal commercial terms. This in effect is a prohibition on setting up intra-group financial arrangements which

could disadvantage SONI as either the MO or SO. For example it cannot borrow from any holding company it may have with an interest rate above what it would pay on the open market. This ensures no predation of the regulated business by an unregulated holding company. Finally the licensee must procure from each person that the Licensee knows (or reasonably should know) is at any time an ultimate controller, a legally enforceable undertaking in favour of the licensee in a form approved by the Authority, to the effect that the ultimate controller will refrain from any action, and will procure that every subsidiary of the ultimate controller (other than the Licensee and its subsidiaries) will refrain from any action, which would be likely to cause the Licensee to breach any of its obligations under the Order, the Energy Order, the SEM Order or its licence.

These arrangements have been designed to reduce the risk of financial distress by constraining the conduct of the company, ensuring its resources are not diverted and that it is not exposed to undue risk. Their presence helps to reassure that the MO and the SO remain in a position to finance their activities and consumers' interests are not adversely affected by the company's capital structure. The only condition that is potentially required and would give extra confidence that the licence conditions would, as a package, achieve the desired level of security for consumers is in the view of the RAs the credit rating/gearing condition being proposed. As stated before it is implicit today and it would appear to be reasonable and sensible to make it explicit in the two SONI licences to ensure that any potential purchaser of the business is fully aware that the condition will apply post divestment and to afford consumers the appropriate protection. A draft of this condition for the SO licence is included in the appendix. The MO condition will include the same wording.

Two options for such licence condition are put forward for comment. The first is that SONI would be required (under both licences) to maintain both an investment grade credit rating *and* a maximum gearing, and the second that SONI would be required (under both licences) to maintain either an investment grade credit rating or a maximum gearing.

The second of these two approaches would clearly offer SONI more flexibility and might be considered appropriate if it were accepted that companies of SONI's size/business type might find it onerous to secure an investment grade credit rating. It is clear however that the introduction of such flexibility would be accompanied by a slight degradation of the safeguards afforded by the first of the two options. Respondents' views are specifically invited on these alternative options and/or derivations of them.

## Board Independence

Condition 3A of the Northern Ireland Electricity plc licence to Participate in Transmission requires that the licensee must ensure that its board of directors comprises a majority of independent non-executive members with relevant experience of the energy industry or another regulated industry or private sector experience gained at board level in an organisation of similar size. At least one of these non-executive members must have relevant experience and knowledge of the energy industry.

These independence requirements were imposed on NIE plc following its acquisition by Arcapita. Other GB regulators, notably OFWAT, have imposed licence conditions requiring a set number of independent directors. In considering independence OFWAT refer to the Higgs report on the role and effectiveness of non-executive directors, which was incorporated into the Financial Reporting Council's Combined Report on Corporate Governance of July 2003.

Higgs argued that although all directors have a legal duty to put the best interests of the company first, it has long been recognised that this is insufficient to assure that potential conflicts will not impair decision making. Independent directors on the other hand bring a dispassionate objectivity, and for this reason he recommended that at least half the members of the board (excluding the chairman) should be independent.

Following Higgs the Combined Report went further and called for a majority independent board except for smaller companies which are defined as those outside the FTSE 350. It is widely accepted that following Higgs, having at least some independence on a company board is best practice. The RAs ask for responses relating to the appropriateness of a licence condition for the SONI board to have a set number of independent directors and invites views as to whether or not the condition should be included in both the SO and MO licences. Views are also invited on the level of independence i.e. the proportion of the board that should be made up of independent members. The initial proposal from the RAs which is reflected in the draft of this condition is included in the appendix.

## Next Steps

The Regulatory Authorities request comments from interested parties in relation to this consultation. In particular we invite views as to the appropriateness of the proposed two new conditions and/or any amendments to the conditions as proposed. However, views pertaining to any part of this consultation paper and associated matters are welcome.

Comments should be forwarded, preferably in electronic form, to [michael.campbell@niaur.gov.uk](mailto:michael.campbell@niaur.gov.uk) or posted to:

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Belfast BT1 6ER

## **Appendix – Draft Licence Conditions**

### **Condition -- Financial Gearing and Credit Rating**

The Licensee shall, within 14 days of this Condition - taking effect and thereafter by 30 June of each year, submit to the Authority a certificate, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution, showing the Financial Gearing as at the end of the preceding Financial Year. The Licensee shall provide the Authority with such information to support that certificate as the Authority may request. In the event of any change to the Financial Gearing of the Licensee, the Licensee shall notify the Authority with details of such change of the Financial Gearing and shall provide the Authority with such details of the change of Financial Gearing as the Authority shall direct.

For the purposes of paragraph 1:

**“Financial Gearing”** means Net Debt as a percentage of the Transmission Operator regulatory asset base of the Licensee ( such regulatory asset base having been agreed with the Authority) .

**“Net Debt”** means the Licensee’s total borrowings (including bank loans, debt securities, finance leases, hire purchase contracts and non-equity shares) less the Licensee’s cash and cash equivalents.

The following paragraphs of this condition shall only apply where the Authority has issued a direction stating that they are to apply, and shall cease to apply on the expiry of any period specified for such purpose in that direction or on the Authority directing that they are no longer to apply.

The Licensee shall take all appropriate steps to ensure that the Licensee obtains and thereafter maintains an investment grade credit rating or Financial Gearing amounting to no more than Net Debt of 57.5% of the regulatory asset base of the Licensee.

In this condition, an “investment grade credit rating” means:

unless sub-paragraph (b) below applies:

an issuer rating of not less than BBB- by Standard & Poor’s Ratings Group or any of its subsidiaries;

an issuer rating of not less than Baa3 by Moody’s Investors Service Inc. or

any of its subsidiaries;

an issuer senior unsecured debt rating of not less than BBB- by Fitch Ratings Ltd or any of its subsidiaries; or

an equivalent rating from any other reputable credit rating agency which, in the opinion of the Authority, notified in writing to the Licensee, has comparable standing in both the United Kingdom and the United States of America; or

such higher rating as may be specified by those agencies from time to time as the lowest investment grade credit rating.

Paragraph 7 shall apply if at any time which is not less than 4 months after the Authority has issued the direction referred to in paragraph 3:

the Licensee does not hold an investment grade credit rating;

where the Licensee has a rating with more than one of the rating agencies referred to in paragraph 5, one or more of the ratings held is below those referred to in paragraph 5;

the Licensee has one of the ratings referred to in paragraph 5 and:

is on review for possible downgrade; or

the rating outlook of the Licensee as specified by one or more of the credit rating agencies referred to in paragraph 5 has been changed from stable or positive to negative; or

(d) the Financial Gearing of the Licensee increases beyond 57.5% net debt (regulatory asset base of the Licensee).

Where paragraph 6 applies, the Licensee may not without the prior written consent of the Authority (following disclosure of all material facts) transfer, lease, license or lend any sum or sums, asset, right or benefit to any affiliate or related undertaking of the Licensee otherwise than by way of:

payment properly due for any goods, services or assets in relation to commitments entered into prior to the date on which the circumstances described in paragraph 6 arise, and which are provided on an arm's length basis and on normal commercial terms;

a transfer, lease, licence or loan of any sum or sums, asset, right or benefit on an

arm's length basis, on normal commercial terms and where the value of the consideration due in respect of the transaction in question is payable wholly in cash and is paid in full when the transaction is entered into;

repayment of, or payment of interest on, a loan not prohibited by Condition 10 and which was contracted prior to the date on which the circumstances in paragraph 6 hereof arise, provided that such payment is not made earlier than the original due date for payment in accordance with its terms; and

payments for group corporation tax relief or for the surrender of Advance Corporation Tax calculated on a basis not exceeding the value of the benefit received, provided that the payments are not made before the date on which the amounts of tax thereby relieved would otherwise have been due.

**Board Independence**

1. The licensee shall at all times from the date of this licence condition becoming effective:
  - a) ensure that at least 1/3 of its board of directors comprises independent non-executive directors who are persons of standing who individually possess:
    - i relevant experience and knowledge of the energy industry (preferably in relation to transmission system operation or market operation) or other regulated industry; or
    - ii. substantial private sector commercial or financial experience gained at board level (or equivalent) in another organisation comparable (in relative terms of roles and responsibilities) to the licensee, and
  - b) demonstrate to the satisfaction of the Authority, prior to any appointment from time to time of a board director, that the said appointment will not cause the licensee to enter into any breach of the requirements contained in sub-paragraph (a).
2. If at any time the licensee, by virtue of any person being appointed as, or ceasing to be, a director of the licensee (for the purposes of this Condition, an "Event"), is unable to comply with the requirements of paragraph 1(a), the licensee shall take such steps as are necessary to ensure that compliance is achieved as soon as reasonably practicable after that Event and in any case within two months (or such longer period as may be agreed by the Authority) of that Event.
3. In this Condition:

<b>"independent non-executive director"</b>	means a person who has not been employed by the licensee, its ultimate controllers or any affiliate or related undertaking of the licensee within the last five years; and who does not have a material business relationship with the licensee, its ultimate controllers or any affiliate or related undertaking of the licensee.
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