Roinn Cumarsáide, Fuinnimh agus Acmhainní Nádúrtha
Department of Communications, Energy and Natural Resources

Oifig an Aire
Office of the Minister

29-31 Bóthair Adelaide
Baile Átha Cliath

29-31 Adelaide Road
Dublin 2

1st August 2013

Adrian for your attention
Ref 13/0007/PER
Dan

Mr Lochlann Quinn
Chairperson
ESB
27 Lower Fitzwilliam Street
Dublin 2

Dear Lochlann

Introduction

The Minister for Public Expenditure and Reform and I have given consideration to the way in which Government objectives for ESB are formulated and shared with the Board, and our respective Departments have consulted with the NewERA unit of the National Treasury Management Agency ("**NewERA**") in this regard. Arising from that work we are proposing a more structured approach to confirming Government's objectives for ESB over the short and medium term with a view to assisting the Board in its operations and in complying with its obligations under the prevailing governance framework.

This letter is intended to provide guidance to the Board with respect to Government's current objectives for ESB and the primary considerations which will be taken account of by us (and other relevant Government Ministers) in respect of certain of the matters for which our consent is required under the Electricity Supply Acts 1927-2004 and the Code of Practice for the Governance of State Bodies (the "**Code**"). We believe that this letter will be helpful to the Board particularly in its corporate and strategic planning processes. It is our intention that we would issue henceforth a similar letter on an annual basis.

The specific objectives outlined in this letter should be considered in the context of the Government's overall current policy objectives for ESB, namely that

- ESB remains as a vertically integrated state-owned utility with a strong commitment to the all-island electricity market;
- ESB should continue delivering on its corporate strategy including investment in critical network infrastructure in Ireland and preparing for the integration of European regional energy markets (UK/Ireland initially); and
- ESB should maintain a capital structure and financial policies consistent with an investment grade credit rating of no less than BBB+ / Baa1.

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1. Dividends

I wrote to you on 24th October 2012 indicating the wish of Government that, having regard to the State's current budgetary requirements, it would receive special dividends in 2013 and 2014 under a programme of disposal of State assets. The Board was asked to develop and deliver specific proposals for the sale of generation capacity with a view to enabling such dividends to be declared. I acknowledge the progress that is being made in that regard, and the level of support and commitment which the Company has brought to that process and look forward to continued progress being made to deliver the stated objectives.

Moreover, as you will be aware the 2013 Budget figures include an additional €100 million in dividends in the current year, to be remitted to the Exchequer from the commercial Semi-State sectors. As you are aware I have recently written to you (Letter dated 19th July 2013) requesting the Board to constructively consider payment of an additional dividend of €65 million in this context, this year.

In the letter of 19th July 2013, I also outlined the Government's objective that a new Dividend policy be defined for ESB over the medium to long term, with a view to giving greater certainty on dividend policy to enable informed decisions be made on financial management and investment and to provide clarity and assurance to financial markets. In that context, I am requesting that ESB would now develop a new formal dividend policy which would be consistent with the Government's overall policy objectives outlined above and would take into consideration the following principles:

(A) an appropriate balance should be struck between payment of dividends and re-investment in the business; in this context it is the strong objective that a robust medium term framework for the calculation of dividends be put in place which will reflect the imperative that ESB remain strong financially and in a position to invest commercially and fully operate as a VIU whilst also earning an appropriate return to the Shareholder.

(B) the policy and its implementation should ultimately be comparable with peer companies within a period of [5] years, taking into account structural, ownership, regional and other relevant differences ; and

(C) the proposed policy should also be related to an agreed proportion of cash flow as well as net profit after tax (NPAT).

In this regard it is proposed that the list of appropriate peer companies would be agreed between our respective Departments and the Board after consultation with NewERA. A suggested list of peer companies is set out in Appendix II. We ask that you engage actively with the Department and NewERA with a view to settling this list and developing an appropriate new dividend policy, with a target of having this finalised no later than the 31st October of this year.

The objective of formulating a new dividend policy is to also assist the Board by bringing clarity to the Government's objectives as regards future dividend payments over the medium term, thereby avoiding the uncertainty created by special dividends potentially being requested from time to time. It may still be necessary and appropriate for special dividends to be considered (e.g. in event of sales of assets, windfall gains etc) but to the extent that consideration of any such special dividend does arise, it is our expectation that the likely impact of such payment would be reviewed at the time in the context of the dividend policy and the overall policy objectives as outlined.

2. Shareholder Returns

We propose to augment our monitoring and measurement of ESB shareholder returns and in this regard we will be reviewing total shareholder return (TSR) over a [5] year period, assisted in this process by NewERA. We acknowledge that returns will vary from year to year, sometimes due to temporary or non-controllable factors but it is a key Government objective that ESB delivers shareholder returns over the relevant period that are in excess of its estimated equity cost of capital.

It may be helpful to the Board to have further guidance from us as to our views on the cost of capital. In this regard, we have asked NewERA to contact ESB with a view to progressing a review of ESB's cost of capital and the process by which the cost of capital is estimated, which review will inform our guidelines to the Board on cost of capital.

As regards measuring TSR, Appendix I sets out the financial performance measures in respect of profitability and shareholder return which we propose to apply. As you will see one of those measures necessitates the use of the commercial equity value of the entity. We ask that ESB procure an independent third party to carry out a formal commercial equity valuation of ESB with a valuation date as at 31 December 2013, to be submitted to my Department by no later than 30 April 2014. The terms of reference for the valuation should be agreed with my Department and NewERA in advance of appointing the third party. This valuation will be reviewed by NewERA and DCENR, in consultation with DPER, and your views in relation to any divergence will form part of the discussion. We expect that a similar valuation exercise will then be carried out on an annual basis with a valuation to be carried out by an independent party at least every two years.

This proposed approach to developing a perspective on shareholder return will be reviewed on an ongoing basis and may be adapted as necessary.

3. Energy Policy Objectives

In addition to the specific policy objectives listed above, I wish to ensure that ESB works actively to support general energy policy to safeguard security of energy supply, development of a sustainable energy future and competitive, efficient and properly regulated energy markets. This requires an appropriate level of ongoing investment by the Company.

In developing and implementing market specific, dynamic and progressive corporate strategies focussed on regional growth, against the backdrop of both national and European energy policy, care must be taken by ESB to prioritise core areas of activity. This includes delivering on its commitment to work in close co-operation with EirGrid to develop and implement grid roll –out and upgrade, in line with the July 2012 Government Policy Statement on the Strategic Importance of Transmission and Other Energy Infrastructure.

4. Governance Arrangements:

Corporate Plan

With respect to the rolling 5 year corporate plan which ESB is required to prepare and submit to us pursuant to the Code, NewERA will engage with you earlier in this process in order for us to provide feedback to you on the plan in a more timely fashion.

Reporting

As you know, the Code sets out current requirements in terms of reporting obligations, which supplement ESB's obligations in this regard under the Electricity Supply Acts 1929 - 2004and the regulations made pursuant to Section 6 of the Electricity Supply Act 1927. We also expect ESB to continue with the quarterly meetings that are held with NewERA and our Departments, and we are very appreciative of the co-operation that ESB have shown to date in this regard. We also anticipate a continuation of the existing policy of regular communication with both Departments and NewERA should any material matters arise.

Board evaluation

Consistent with the requirement in the Code we expect that the Board constantly reviews its own operation and performance and that of its committees and individual members and the Board undertakes an evaluation of its performance on an annual basis and that the Board considers having such an evaluation facilitated by an independent assessment every three years . We know that such a review and evaluation process in ESB is led by the Chairman and expect that it allows each Director to give honest and constructive feedback on performance, both individually and for the Board as a whole.

We request that a formal high-level feedback report be provided to us (copied to NewERA) on overall Board performance, key focus areas for continuing development and assurance that the process has been properly implemented.

5. Engagement

Our expectation is that you will engage with NewERA and our Departments in the near term to discuss the matters set out in this letter in more detail. This process will enable the Company to set out its perspectives in relation to the proposed approach, set out in the letter and appendices. I am, however, anxious that this process be concluded quickly and in this regard, I would be grateful if you would make appropriate arrangements for discussions with NewERA and the Departments.

Yours sincerely

Pat Rabbitte

Pat Rabbitte T.D.
Minister for Communications, Energy and Natural Resources

Cc Brendan Howlin T.D.
Minister for Public Expenditure and Reform

CC Eileen Fitzpatrick
Director, NewERA

Appendix I: Financial Performance Measures

Shareholder Return

Measure	Calculation
Total Shareholder Return (TSR)	(Commercial equity value(end) *less* Commercial equity Value (beg) plus Dividends *less* equity injected) / Commercial equity value (beg)
Dividend yield	Dividends paid / Average commercial equity value
Dividend payout	(i) Dividends paid / Adjusted net profit after tax (prior year) (ii) Dividends paid / net cash flow from operating activities (iii) Dividends paid / (net cash from operating activities less capex)
Return on Equity	Adjusted net profit after tax / Average Equity
Earnings Growth	Compound Annual Growth Rate in Adjusted net profit after tax

Profitability / Efficiency

Measure	Calculation
Return on Capital Employed (ROCE)	(i) Adjusted EBIT / Average Capital Employed (ii) Adjusted EBIT / Adjusted Average Capital Employed

Leverage / Solvency / Credit Metrics

Measure	Calculation
Gearing Ratio (net)	(i) Net debt / Net debt plus equity (ii) Net debt / Net debt plus pension liabilities plus employee related liabilities plus equity
Interest Cover	Adjusted EBITDA / Interest paid (PP Covenant Basis)
FFO Interest Coverage	S&P, Moody's & Fitch bases
FFO / Debt	S&P and Moody's basis
FFO Adjusted Net Leverage	Fitch Basis (equivalent to FFO / Debt metric)
RCF / Capex	Moody's Basis [(FFO – Dividends) / Capex] [Measures ability of cashflow generated to cover Capex]

Definitions of Key Terms used in calculations

Term	Definition
Adjusted EBIT	Earnings before interest and tax adjusted for exceptional items and IFRS fair value movements
Adjusted EBITDA	Earnings before interest, tax, depreciation and amortisation adjusted for exceptional items and IFRS fair value movements
Adjusted Net Profit after Tax	Net profit after tax adjusted for exceptional items and IFRS fair value movements
Adjusted Capital Employed	Net debt *plus* equity *plus* pension liabilities *plus* employee related liabilities
Capital Employed	Net debt *plus* equity
Commercial Value	See Section 3 of this letter
Dividends Paid	Dividends paid during the financial year per the cashflow statement (excl. special dividends)
Equity	Total shareholder(s) equity taken from the balance sheet

Fair value adjustments	Includes unrealised fair value gains / losses on derivatives or all fair value gains / losses on derivatives where the entity does not separately identify unrealised items.
Interest Paid	Interest paid for the financial year on interest-bearing debt per the company's cashflow statement.
Net cashflow from operating activities	Taken directly from the cashflow statement - ensure interest paid is included
Net Debt	Interest bearing debt such as loans, bonds and commercial paper plus interest bearing finance leases *less* cash

Appendix II: Peer Companies

[redacted]

[redacted]