



Mr John O'Connor
Chairman
EirGrid PLC
The Oval,
160 Shelbourne Road,
Ballsbridge,
Dublin 4,

*Advice for your attention
ref: 14/0012/PER*

*Done
(orig with Min. for info)*

21 March 2014



Dear John,

The Minister for Public Expenditure and Reform and I have given consideration to the way in which Government objectives for EirGrid PLC (“EirGrid” or the “company”) are formulated and shared with EirGrid, 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 have decided to initiate a more structured approach to confirming Government’s objectives for EirGrid over the short and medium term with a view to assisting the company in its operations and in complying with its obligations under the prevailing governance framework.

This letter is intended to provide guidance to EirGrid and its Board of Directors (the “Board”) with respect to Government’s current objectives for EirGrid 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 European Communities (Internal Market in Electricity) Regulations 2000 and the Electricity Regulation (Amendment) (EirGrid) Act 2008 (collectively the “Governing Legislation”), under the company’s Memorandum and Articles of Association and the Code of Practice for the Governance of State Bodies (the “Code”). We believe that this letter will be helpful to the company 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 EirGrid, namely that:

- EirGrid should continue to operate a safe, secure and reliable transmission power system in Ireland and Northern Ireland;
- EirGrid should continue to operate a transparent, stable and reliable Single Electricity Market (“SEM”);
- EirGrid should remain a profitable company with a capital structure which maintains a level of headroom to have sufficient liquidity and financial flexibility to protect loan covenant requirements;
- EirGrid should continue to work with relevant Government departments, regulatory authorities and industry to implement the EU Target Model for electricity on the island; and

- EirGrid should continue to develop and implement grid roll-out and upgrade, in line with GRID25 and with the July 2012 Government Policy Statement on the Strategic Importance of Transmission and Other Energy Infrastructure.

1. Dividends

Moreover, as you will be aware the 2013 Budget figures include an additional €100m in dividends, to come from across all the commercial semi-State companies. In that regard I welcome payment of the additional dividend of approximately €4 million, which was very much appreciated.

Aside from the special dividends referred to above, the Government requests that EirGrid would now develop a formal dividend policy which would reflect the following principles:

- (A) an appropriate balance should be struck between payment of dividends and re-investment in the business; in this regard it is an important Government objective that a robust medium term framework for the calculation of dividends be put in place which will reflect the imperative that EirGrid remain strong financially and in a position to invest commercially whilst also delivering an appropriate return to its shareholders; and
- (B) the proposed policy should also be related to an agreed proportion of a cash flow as well as net profit after tax (NPAT).

The objective of formulating a new dividend policy is to 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 or appropriate for special dividends to be paid from time to time (e.g. in event of sales of assets, windfall gains etc). To the extent that any special dividend is paid, it is our expectation that the likely impact of such payment on the policy would be reviewed at the time.

We ask that you engage actively with both Departments and NewERA with a view to developing an appropriate new dividend policy.

2. Shareholder Returns

We propose to augment our monitoring and measurement of EirGrid 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 EirGrid delivers shareholder returns over the relevant period that are in excess of its equity 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 EirGrid procure an independent third party to carry out a formal commercial equity valuation of EirGrid with a valuation date as at 30 September 2013, to be submitted to my Department by no later than 27 June 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 my Department, in consultation with the Department of Public Expenditure and Reform, 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 three years.

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

3. Energy Policy Objectives

In addition to the overall policy objectives and the specific policy objectives listed above, I wish to ensure that EirGrid, along with all of the other State energy companies, 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 includes delivering on its commitment to work in close co-operation with ESB to develop and implement grid roll-out and upgrade, in line with GRID25 and 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 EirGrid 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 EirGrid's obligations in this regard under the Governing Legislation and its Articles of Association. We also expect EirGrid to continue with the quarterly meetings that are held with NewERA and our Departments, and we are very appreciative of the co-operation that EirGrid 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 will continue to review its own operation and performance and that of its committees and individual members with the Board continuing to undertake 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 EirGrid 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 when such an evaluation has been completed.

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 this 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 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 flow from operating activities less capex
Return on Equity	Adjusted net profit after tax / Average Equity

Profitability / Efficiency

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

Leverage / Solvency

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
FFO Interest Coverage	Funds from Operations plus Interest Paid / Interest Paid
FFO / Debt	Funds from Operations / Gross Debt
Retained Cash Flow (RCF) / Capex	Funds from Operations less Dividends / 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 2 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.
Funds from Operations	Net cashflow from operating activities (post interest and tax paid and pre-working capital changes)
Gross Debt	Interest bearing debt such as loans, bonds and commercial paper plus interest bearing finance leases
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 I: Financial Performance Measures

Shareholder Return

Measure	Calculation
Total Shareholder Return (TSR)	(Commercial equity value(end) <i>less</i> Commercial equity value (beg) <i>plus</i> Dividends <i>less</i> 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 flow from operating activities less capex
Return on Equity	Adjusted net profit after tax / Average Equity

Profitability / Efficiency

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

Leverage / Solvency

Measure	Calculation
Gearing Ratio (net)	(i) Net debt / net debt <i>plus</i> equity (ii) Net debt / Net debt <i>plus</i> pension liabilities <i>plus</i> employee related liabilities <i>plus</i> equity
Interest Cover	Adjusted EBITDA / Interest paid
FFO Interest Coverage	Funds from Operations <i>plus</i> Interest Paid / Interest Paid
FFO / Debt	Funds from Operations / Gross Debt
Retained Cash Flow (RCF) / Capex	Funds from Operations <i>less</i> Dividends / 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 <i>plus</i> equity <i>plus</i> pension liabilities <i>plus</i> employee related liabilities
Capital Employed	Net debt <i>plus</i> equity
Commercial Value	See Section 2 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.
Funds from Operations	Net cashflow from operating activities (post interest and tax paid and pre-working capital changes)
Gross Debt	Interest bearing debt such as loans, bonds and commercial paper <i>plus</i> interest bearing finance leases
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 <i>plus</i> interest bearing finance leases <i>less</i> cash

