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ar son na hAeráide & Comhshaoil**
Department of Communications,
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Strictly Private and Confidential
Mr John O'Connor
Chairman
EirGrid PLC
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160 Shelbourne Road
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02nd August 2017

Updated Shareholders' Expectations for EirGrid PLC

Dear John,

You will recall the letter to you dated 24 March 2014 (on the Minister's own behalf and on behalf of the Minister for Public Expenditure and Reform) for the purpose of providing guidance to EirGrid PLC ("EirGrid" or the "Company") 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 EirGrid's governing legislation, including the European Communities (Internal Market in Electricity) Regulations 2000 and the Electricity Regulation (Amendment) (EirGrid) Act 2008 (in each case as amended from time to time and collectively the "Governing Legislation"), under the Company's Constitution and the Code of Practice for the Governance of State Bodies (the "Code"). This letter should be helpful to the Board particularly in its corporate and strategic planning processes.

The Government's overall current policy objectives for EirGrid are unchanged from the previous letter:

- 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, and contribute as appropriate to the redesign of this market into the Integrated Single Electricity Market (I-SEM);
- EirGrid should continue to implement the DS3 Programme (Delivering a Secure, Sustainable Electricity System) to assist Ireland meet its renewable electricity targets by 2020 (and beyond);

Fáiltítear roimh comhfhreagras i nGaeilge

- EirGrid should continue to work with relevant Government departments, regulatory authorities and industry to implement the EU Target Model for electricity on the island of Ireland;
- EirGrid should continue to develop and implement grid roll-out and upgrade, appropriate in scale and scope to Ireland's infrastructure needs, in line with its grid development strategy *"Ireland's Grid Development Strategy - Your Grid, Your Tomorrow"*, the July 2012 *"Government Policy Statement on the Strategic Importance of Transmission and Other Energy Infrastructure"* and the Energy White Paper *"Ireland's Transition to a Low Carbon Energy Future 2015-2030"*; and
- 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.

Additional overall policy objectives of Government are that EirGrid should focus on long term value generation and should aim to perform better than any operating and financial targets set down in regulatory determinations for EirGrid.

EirGrid should ensure that it recognises the importance of engagement with people and communities directly impacted by the development and operation of its infrastructure.

The specific objectives set out hereunder should be considered in the context of these overall policy objectives.

1. Specific Energy Policy Objectives

It is important that EirGrid continue to support general energy policy being the safeguarding of energy security, development of a sustainable energy future and ensuring competitive, efficient and properly-regulated energy markets. This will continue to require an appropriate level of ongoing investment by EirGrid.

In relation to the general energy policy objective to develop a sustainable energy future, Eirgrid should also have regard to the Government's overall climate policy objectives underpinned by the Climate Action and Low Carbon Development Act 2015 and set out in the National Mitigation Plan as well as the forthcoming National Adaptation Framework and any relevant statutory sectoral adaptation plans arising from it.

In developing and implementing a market-specific, dynamic and progressive corporate strategy focussed on regional growth, against the backdrop of both national and European energy policy, care must be taken by EirGrid to prioritise core areas of activity. 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 *"Ireland's Grid Development Strategy - Your Grid, Your Tomorrow"* and the July 2012 *"Government Policy Statement on the Strategic Importance of Transmission and Other Energy Infrastructure"*.

EirGrid should pay particular attention to:

- the implementation of EU and Government energy policy initiatives, including those advocated under the Internal Energy Market and the Integrated Single Electricity Market; and
- compliance with EU and national regulatory requirements and decisions including the five-year network reviews overseen by the Commission for Energy Regulation and relevant Single Electricity Market Committee decisions.

EirGrid should continue to ensure that it is operating a first class transmission power system and through the employment of appropriate scenario planning exercises to 2020, 2030 and 2050, should make a strong contribution to achieving sustainable development goals.

EirGrid is also requested to consider the potential for any further opportunities to facilitate the deployment of high speed broadband through its infrastructure.

2. Financial Targets

Appendix I sets out a number of financial performance measures, the New Economy and Recovery Authority (“NewERA”) will monitor these financial performance measures and provide advice to the Minister for Public Expenditure and Reform and I as necessary.

Following discussions with NewERA, we now wish targets to be set for the following:

- (i) a capital structure target¹ (gearing or debt/equity ratio); and
- (ii) a profitability target² (e.g. underlying profit before tax); and
- (iii) a dividend target³.

We consider that relevant financial targets should be developed having regard to the objectives of balancing value creation and maintenance of financial risks at a reasonable level, without incentivising increased business risk. The aim should be to formulate high-quality targets that are ambitious while remaining realistic, and that are well defined and clear and thus capable of being monitored on an ongoing basis.

In this context, and also to assist in assessing financial performance⁴, EirGrid should develop appropriate financial targets⁵ for the measures set out above, in the context of EirGrid’s five year

¹ To be discussed and agreed with EirGrid as to what might be the most appropriate target

² To be discussed and agreed with EirGrid as to what might be the most appropriate target

³ The period to which the current dividend framework relates ended on 30 September 2016

⁴ Pursuant to Section 21 of the Act, NewERA shall “... in respect of each designated body, assess its financial performance and prepare, at least annually, a report on its financial performance”, with EirGrid being one of the designated bodies.

⁵ The targets do not necessarily mean a single number of X% but could include a tight range of X% to Y%

strategic plan submitted under the Code. These targets should be agreed with the Minister for Public Expenditure and Reform and I, with the support of NewERA, by the end of September 2017. My Department, the Department of Public Expenditure and Reform (together, the “Departments”) and NewERA should be kept informed of progress in the formulation of these targets with NewERA carrying out any detailed financial analysis it requires in order to provide its advice to the Minister for Public Expenditure and Reform and I in relation to the targets.

As part of the evaluation and monitoring of the financial targets, we expect that both Departments, together with NewERA, would meet with EirGrid at least once annually to discuss these targets, their outcome and relevance, EirGrid’s work to achieve the targets, and whether any changes need to be made to the targets.

3. Shareholder Returns

As set out in the March Letter, and in order to assist in measuring value creation, which is a separate matter to the financial targets set out above, we will continue to review total shareholder return (“TSR”) over the five-year period from 1 January 2014, 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 the factors driving changes in EirGrid’s value are clearly understood.

As regards measuring TSR and value creation, Appendix I sets out financial performance measures developed by NewERA in consultation with the Departments in respect of shareholder return which we propose to apply. As you will see, certain of those measures for calculating shareholder return necessitate the use of a commercial equity value of the entity (“Commercial Equity Value”). We ask that EirGrid carry out an equity valuation of EirGrid with a valuation date as at 30 September 2016, to be submitted to my Department by no later than the end of September 2017. The equity valuation should be undertaken on a basis that is consistent with the equity valuations in respect of EirGrid carried out previously. This valuation will be reviewed by NewERA and my Department, in consultation with the Department of Public Expenditure and Reform. We expect that a similar valuation exercise will be carried out on an annual basis with a valuation to be carried out by an independent party at least once every three years. When you appoint a third party to carry out the valuation the terms of reference for the valuation should be agreed in advance with the Departments, who will be supported and advised by NewERA.

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

4. Governance Arrangements:

4.1. Corporate Plan

With respect to EirGrid’s rolling five-year corporate plan, as required pursuant to the Code, my Department, together with NewERA, will continue to engage with you in this process in order for us to provide feedback to you on the plan.

4.2. Reporting

As you know, the Code sets out reporting obligations, which supplement EirGrid's reporting obligations under the Governing Legislation and its Constitution, which EirGrid should continue to comply with. We also expect EirGrid to continue with the quarterly meetings co-ordinated by NewERA, 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.

4.3. Board evaluation

As required under the Code we expect that the Board continually reviews its own operation and performance and that of its committees and individual members, undertakes an annual evaluation of its performance and that the Board considers having such an evaluation facilitated by an independent assessment every three years. We understand that in EirGrid such a review and evaluation process is led by the Chairman and it is expected that this process 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 report be provided to the Departments (copied to NewERA) which provides feedback on overall Board performance⁶, and the key focus areas for continuing development, together with an assurance that the review process has been properly implemented. The feedback report should be sent to us as soon as practicable after the evaluation has been completed by the Chairman for the financial year ending 30 September 2017.

5. Wind and Hydro Capacity Reporting

The timely publication of generation capacities and in particular renewable capacities is essential for the calculation, tracking and early estimation of our renewable electricity target under the Renewable Directive (2009/28/EC) (the "Directive Target").

The Directive Target is calculated with reference to the normalisation of wind and hydro electricity production by reference to their installed capacity. Therefore, it is essential that installed capacity of generation is published in a timely fashion. Currently, installed capacity is recorded for most, but not all, transmission connected generation units but not for distribution connected units.

We would like to see regular publication of installed capacity and maximum export capacity (MEC) of all generation units together with a summary table for the main generation sources. Publication of monthly updates on installed capacity would facilitate early profiling of the progression towards the Directive Target. The figures for installed capacity should relate to capacity connected – that is, it should include units that may not have been operational during the month but are still commissioned.

⁶ Note that performance relates to the performance of the Board as a collective and the feedback report should not contain comments on the performance of individual board members

Generation capacity, by source, is also required under the EU Energy Statistics Regulation (1099/2008).

Therefore, we request that EirGrid report the above data monthly on a M-1 basis (at the end of a month for the end of the previous month). Details of who the relevant contacts in my Department who should receive such monthly reports will be provided in further discussions.

6. Engagement

Our expectation is that you will engage with both Departments, along with NewERA, shortly after receiving this letter to discuss in more detail the matters raised. This process will enable EirGrid to set out its perspectives in relation to the proposed approach, and I would be grateful if you would make the appropriate arrangements for such discussions with NewERA and the Departments.

Yours sincerely

A handwritten signature in black ink, reading "Denis Naughten", is written over a solid horizontal line.

Denis Naughten T.D.
Minister for Communications, Climate Action and Environment

c.c. Paschal Donohoe T.D
Minister for Public Expenditure and Reform

c.c. Eileen Fitzpatrick
Director, NewERA

Appendix I: Financial Performance Measures

Shareholder Return

Measure	Calculation
Total Shareholder Return (TSR)	(Commercial Equity Value (end) <i>less</i> Commercial Equity Value (beginning) <i>plus</i> Dividends <i>less</i> Equity injected) / Commercial Equity Value (beginning)
Dividend Yield	Dividends Paid / Commercial Equity Value (average)
Dividend Payout	Dividends Paid / Adjusted net profit after tax for dividend purposes (prior year)
Return on Equity	Adjusted Net Profit after Tax / Equity (average)
Earnings Growth	Compound annual growth rate in Adjusted Net Profit after Tax

Profitability / Efficiency

Measure	Calculation
Operating margin	Adjusted EBIT/Revenue
Return on Capital Employed (ROCE)*	(i) Adjusted EBIT / Capital Employed (average) (ii) Adjusted EBIT / Adjusted Capital Employed (average)
Return on Invested Capital (ROIC)*	Adjusted NOPAT / Invested Capital (average)

Liquidity

Measure	Calculation
Current Ratio	Current Assets/Current Liabilities
Acid Test Ratio	Current Assets excluding inventory/Current Liabilities

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 NOPAT	Adjusted EBIT adjusted for tax
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
Adjusted Invested Capital	Equity <i>plus</i> gross debt <i>plus</i> pension liabilities <i>plus</i> finance leases <i>plus</i>

	capitalised operating leases plus provisions plus deferred tax
Capital Employed	Fixed assets plus working capital
Commercial Equity 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.
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 plus interest bearing finance leases <i>less</i> cash