

Response to:

The Office for the Regulation of Electricity and Gas

on

**The Proposed Acquisition of East Surrey Holdings plc
by Kellen Acquisitions Ltd
- Implications for Phoenix Natural Gas Limited**

by

The Consumer Council

June 2005



1. Introduction

I. The General Consumer Council for Northern Ireland welcomes the opportunity to comment on the Northern Ireland Authority for Energy Regulation's consultation document on the proposed acquisition of East Surrey Holdings plc by Kellen Acquisitions Ltd and the implications for the supply of natural gas.

1.1. In principle, the Consumer Council welcomes any arrangements which provide consumers in Northern Ireland with a reduction in their energy bills, improved customer service and adequate security of supply. Whilst the acquisition of East Surrey Holdings could potentially be beneficial for Northern Ireland gas customers there are outstanding questions regarding some of the implications. Indeed shortly after the proposed acquisition was announced, the Consumer Council wrote to the Authority setting out our questions to ensure that the consumer interest was examined. In our response to this consultation we have elaborated on these concerns in addition to responding to the specific questions that the Authority has posed. A copy of our letter to the Authority is attached.

2. The Consumer context

2.1. The arrival of natural gas in 1996 into the Northern Ireland energy market provided another choice of fuel for consumers. Phoenix Natural Gas (Phoenix) was awarded the licence to provide a gas pipeline system in accordance with the Gas (Northern Ireland) Order 1996, throughout what is referred to as the gas licence area. The 1996 Order also gave the General Consumer Council new responsibilities to represent and protect the interests of consumers of natural gas.

2.2. Since 1996, the Consumer Council has been working on behalf of gas consumers in order to represent their interests as set out in its statutory responsibilities of representing and protecting the interests of consumers of natural gas and investigating and seeking to resolve consumer complaints against gas suppliers. This area of responsibility was enhanced with the Energy (NI) Order 2003 which gave responsibility for the interests of electricity consumers to the Council. This enabled the development of a specialist support team on energy matters whose aim is to champion the consumer cause in respect of the cost and quality of energy supplies and services

2.3. The significance of the arrival of natural gas in Northern Ireland went beyond the addition of a new fuel. It injected much needed competition into the home heating and cooking markets and provided opportunities for business and industrial concerns to reduce their annual energy bills. Moreover, in a region with 1 in 3 homes suffering from the effects of fuel poverty, natural gas brought with it the possibility of transforming the domestic energy landscape by enabling consumers in Northern Ireland to avail of the benefits of what promised to be a relatively low-cost fuel.

2.4. When Phoenix proposed a 20 per cent increase in gas prices in April 2004, the Consumer Council was extremely active and vocal in its opposition and led the debate to have the proposed increase removed. The Council considered that the 20 per cent price increase, which followed a 10.8 per cent rise in October 2003, was unjustified, would damage the gas industry and would be detrimental to existing customers. After months of campaigning and working closely with the Northern Ireland Authority for Energy Regulation (the Authority), the Department of Enterprise, Trade and Investment (DETI), Phoenix Natural Gas, local political parties and other interested groups the 20 per cent increase was removed.

2.5. The price review in October 2004 related to the long-term sustainability of the gas industry. It followed a period of negotiation between OFREG and

Phoenix that resulted in an agreement in August 2004, the key elements of which were:

- (i) the extension of the cost recovery period;
- (ii) reduction in the Regulatory Asset Base from £351m to £306m;
- (iii) the mutualisation of the Bulk Transmission Pipeline (BTP);
- (iv) the reduction in the rate of return for transmission assets to 7.5 per cent; and a movement to equity based returns.

2.6. Following a detailed examination at the time, the Consumer Council concluded that the agreement provided a framework to protect the interests of consumers, the gas industry and the Northern Ireland economy. In particular, the Council believed that it would provide consumers with the best option for price stability and security of supply in the longer term. For these reasons, the Council supported both OFREG and Phoenix in taking forward this proposal, based on the information available at that time. This is evidenced by the welcoming press release that the Council issued on the 25 August.

3. Proposed Licence Modifications

3.1. The Consumer Council is impressed by the extent of cooperation and advance consultation between OFWAT and Kellen to date, as indicated by the OFWAT consultation issued in May 2005.

3.2. The Authority has suggested in its paper that this may be an appropriate time to review the existing Phoenix licence and to ensure that provisions are in line with best practice established by other utility regulators. This is entirely normal and in line with standard practice elsewhere. The Consumer Council takes the view that Northern Ireland consumers deserve to have the highest level of licence protection available and therefore welcomes this proposal.

3.3. As the Kellen acquisition of East Surrey Holdings includes not only the acquisition of Phoenix Natural Gas but also Sutton and East Surrey (SES) Water plc, OFWAT, the Office of the Water Service in GB, has issued a consultation paper to investigate the potential impact of the acquisition on SES. OFWAT is proposing a number of licence modifications in order to gain assurance that the company is in a position to finance all its functions. These would:

- Require SES to operate as if it were a separate company, to act solely in the interests of the water company and for its Board to act independently of the parent company;
- Strengthen the ring fence, ensuring no cross subsidy between SES and its associated companies;
- Require SES to ensure that its dividend policy rewards efficiency and the management of economic risk, and would not impair the company's ability to finance its functions as a water undertaker;
- Require it to have sufficient financial and managerial resources to carry out its activities;
- Ensure that its financial affairs could be assessed and reported on separately from other businesses and activities of its group;
- Require SES to maintain an investment grade corporate credit rating;
- Prohibit (without Ofwat's consent) cross defaults, whereby its financial liabilities are increased or accelerated because of a default of any other companies in the group; and
- Require it to publish its results as if it were listed on the Stock Exchange.

3.4. Most of these modifications, to which Kellen have already indicated that they have no objections¹, are similar to those proposed by the Authority in its consultation paper. The Consumer Council fully supports the

¹ The proposed acquisition of East Surrey Holdings Plc by Kellen Acquisitions Limited and its impact on Sutton and East Surrey Water plc – A consultation paper by Ofwat, paragraphs 5.8 and 5.9.

Authority's proposed licence modifications, particularly:

- (i) That Phoenix's payment of dividends should not have any adverse effect on its ability to carry out its licensed activities;
- (ii) That Phoenix should provide any information that the Authority requires in performing its statutory duties;
- (iii) That Phoenix should avoid taking any action that may interfere with its ability to meet its licence obligations; and
- (iv) That the parent company of Phoenix should consult and seek the approval of the Authority to any material changes to the financial structure of any associated companies.

4. Issues raised by the proposed acquisition

4.1. The Consumer Council expects consumers to receive fair treatment from their utility supplier. Generally consumers are less concerned with ownership of the company and more interested in seeking assurance that any changes will not negatively impact on the price, security of supply and the service they receive. It is in this context that the Consumer Council is responding to this consultation.

4.2. As stated above, the Consumer Council supported both OFREG and Phoenix in the proposed agreement in August 2004. The Consumer Council is not in a position at this stage to judge whether a better agreement should or can be reached than that which was arrived at in August 2004. However, in light of the new information, the Council believes it prudent of the Authority to consider the proposed agreement in the round and taking into account all relevant (including new) information.

4.3. The Consumer Council's understanding from this consultation paper is that while the new rate of return from the transmission assets has been in place from January 2004 and the extension of the cost recovery period has been agreed, little progress has been made in moving to the

mutualisation of the BTP or establishing more detailed proposals for an agreed return on equity. Both these aspects of the agreement are of particular benefit to consumers. This therefore appears to represent limited progress in contrast to movement with other aspects of the August agreement which are at a more advanced stage.

4.4. The Consumer Council would seek assurances that, irrespective of the outcome of the acquisition process, the mutualisation will be implemented or if this is not practicably possible that safeguards are put in place to ensure it is implemented as soon as possible thereafter. Whilst there is no indication that Kellen will not put into operation all the terms of the agreement, we believe such safeguards are necessary. Without these assurances, the Consumer Council would have reason to question the overall benefits of the agreement arrived at in August 2004. We would therefore support the Authority in seeking these assurances.

4.5. The consultation paper also states that, despite the fact that East Surrey Holdings acquired Phoenix for £250m in January 2003, the Authority agreed to a Regulatory Asset Base of £306m in August 2004, 18 months later. This would suggest that, at the time of negotiations in summer 2004, the Authority agreed to a Regulatory Asset Base (RAB) over and above the actual investment. The Council considers it a matter of legitimate public interest that the Authority should review this aspect of negotiations to examine if the amount of £306m – on which the August 2004 agreement is based – continues to be a sound basis for proceeding.

4.6. The consultation paper indicates that Phoenix may now be deemed more valuable than previously estimated. If this is the case the Consumer Council would want to see this reflected in lower prices and better services for consumers.

5. Conclusions

- 5.1. The proposed acquisition of Phoenix Natural Gas by Kellen Acquisitions Ltd may be of benefit to Northern Ireland consumers. However, the Council considers that it is only by a public and transparent consideration of the facts that assurance will be forthcoming on the extent to which the proposed acquisition is good for consumers as well as shareholders.
- 5.2. The August 2004 agreement between Phoenix and the Regulator provided a framework to protect the interests of consumers, the gas industry and the Northern Ireland economy. It is vital that any new owners continue this commitment – and the Regulator will rightly consider whether the regulatory agreement needs to be reviewed in light of the new circumstances
- 5.3. The Council seeks assurance that the proposed acquisition will not have a detrimental impact on the ability of the gas industry in Northern Ireland to be sustained into the foreseeable future on the basis of fair and affordable prices and a high standard of customer service.
- 5.4. The Council agrees with the Authority that this is an appropriate time to examine the terms of the August 2004 agreement in its totality and to take forward their proposed licence modifications, where necessary, to provide further safeguards for consumers. Specifically, the Consumer Council would like to see safeguards in place to protect consumers in the event that Terra Firma, if successful in the acquisition, should in the future decide to sell Phoenix Natural Gas.
- 5.5. As a general principal the Council considers that any proposed change to the financial basis of the utility company should be a matter for consultation and agreement with the Regulator. The Council would therefore support a licence modification that would give effect to this requirement.

5.6. In a region with high energy prices and a third of homes in fuel poverty, it is entirely proper that the Authority has initiated this process by which the impacts on consumers can be fully identified and addressed. The Council, in its statutory role as the energy consumer representative organisation, looks forward to engaging in further discussion with all interested stakeholders on this issue.

5.7. If Terra Firma is successful in its acquisition of Phoenix Natural Gas, the Consumer Council will expect to see improved services, and stable and competitive prices. The natural gas industry in Northern Ireland is no longer a fledging industry and must be required to compete as the mature industry it now is. In any event it would be unacceptable if the outcome for consumers is higher prices and lower standards of service.

5.8. The Consumer Council considers that the time is now right to ensure that the principal objective of DETI and the Authority should be identical for both electricity and gas industries. At present the principal legislative objective in relation to gas is to promote the gas industry whilst in electricity the principal objective is to protect the interests of consumers. This move would be in keeping with other UK regulatory regimes and would reflect the maturity of the NI gas industry.