

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

**A Statement by the Northern Ireland
Authority for Energy Regulation
June 2005**

1. Introduction

On 8 April 2005, Kellen Acquisitions Limited (**Kellen**), an acquisition vehicle for the private equity house Terra Firma, announced its offer to acquire the shares in East Surrey Holdings plc (**ESH**).

The principal assets of ESH are East Surrey Water plc, a water company in southern England, and Phoenix Natural Gas Limited (**Phoenix**). Phoenix holds licences which authorise (mainly on an exclusive basis) it to convey and supply natural gas within the Greater Belfast area. It currently supplies gas to over 80,000 consumers.

Although Kellen's offer to acquire ESH does not require the consent of the Northern Ireland Authority for Energy Regulation (**the Authority**), it does reveal new information and give rise to a number of questions about issues related to the ongoing regulation of Phoenix. The Authority therefore issued a consultation paper on 25 May 2005 in order to seek the views of all interested parties on whether its extant proposals in relation to the regulation of Phoenix were adequate or should be reconsidered in the light of the acquisition. The closing date for responses was 16 June 2005.

The Authority is grateful to all of those who responded to its consultation paper. In total it received some 21 responses by the closing date. One of these was marked as confidential, but the remaining 20 have been published on the Authority's website (<http://ofreg.nics.gov.uk>) and the names of those respondents are listed in the Annex to this regulatory statement.

The Authority has paid close attention to all of these responses. While it is too soon to form any definitive conclusions about the situation, the Authority has reached some preliminary views as to the way forward, and the purpose of this statement is, for the benefit of interested parties, to indicate its thinking as to the appropriate next steps.

Following the publication of this statement the Authority will seek to initiate further discussions with those parties who are directly affected or interested by the matters covered in the consultation. It will consult further with all interested parties in due course.

2. Consultation Issues

The Views of Respondents

Respondents to the consultation paper made a number of comments and observations. However, there were three broad areas of comment which were particularly relevant to the issues that were consulted on. These were –

- Widespread agreement by all respondents that the Authority’s proposals to consider introducing further licence conditions which would ensure the financial security and ring-fencing of the Phoenix business were sensible and appropriate. Respondents generally commented that licence conditions in Northern Ireland should be brought into line with best practice as it has developed in the rest of the UK, and both Kellen and Phoenix were in agreement in principle with the proposals.
- Concerns by a number of respondents that any attempt to reconsider an ‘agreement’ reached between Phoenix and the Authority during 2004 would be inappropriate because it would increase the perception of regulatory risk in the market and therefore the long term cost of capital. Phoenix specifically commented that there was an agreement which “was implemented in September 2004 and is binding on Phoenix and the Authority”.
- Concerns by a number of other respondents that the proposed regulatory agreement arrived at in August 2004 did not represent an appropriate agreement for consumers or for the future development of the gas industry in Northern Ireland, and that its terms should be reconsidered by the Authority in the light of its general duties and having regard to the information disclosed by recent developments.

Initial Response of the Authority

As explained in the consultation paper, the general duties of the Authority require it to act in the manner that is best calculated to further a principal objective, which is “the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland”. In doing so, the Authority is also required to have regard to a number of factors, including in particular the need to protect the interests of consumers of gas and the need to secure that licence holders can finance the activities which they are obliged to undertake.

These duties require the Authority to use its discretion in balancing a number of different factors. In the exercise of that discretion it must take into account all of the information available to it, and give due weight to all relevant observations received from interested parties during the course of consultation.

The Authority has considered carefully the responses received to the consultation paper, and its initial views are as follows –

- The Authority has always taken seriously the potential for any market perceptions of regulatory risk associated with the regulation of licence holders, not least since one of its priorities has been to seek ways of reducing the cost of capital for utility infrastructure where that is consistent with its principal objective.

Examples of the Authority’s commitment to minimising the cost of capital include the regulatory frameworks created to facilitate the mutualisation of both the Moyle electricity interconnector and the gas interconnector with Scotland. In both cases, low cost financing mechanisms were put in place which met the requirements of the financial markets and provided lower tariffs for customers.

A consideration of the market perception of regulatory risk will continue to be a factor to which the Authority will have all due regard in deciding on the appropriate course of action in relation to the proposed regulatory agreement.

Further, the Authority in exercising its duties, is mindful of the balance that needs to be struck between the various stakeholders including potential investors.

As noted in the consultation paper, the discussions with Phoenix concerning the proposed regulatory agreement were predicated (at least in part) by concerns expressed by Phoenix that the 20 year rate of recovery period agreed in 1996 might be insufficient to enable it to recover its initial investment by 2016, and uncertainty as to how the balance of the investment would be recovered.

Against this background, the Authority entered into discussions with Phoenix with a view to reaching a revised agreement that struck an appropriate balance between the interests of Phoenix, its investors, consumers and other stakeholders. The 'in principle' agreement of August 2004 on changes to the asset base and the rate of return on distribution assets, together with a move to a forty year capital recovery period, represented a substantial transfer of value to shareholders. However, part of the aim of the proposals was to ensure that investors could secure a reasonable rate of return on their investment, allaying Phoenix's concerns over the ability to recover that investment under the 1996 arrangements.

At the time, the arrangement was perceived by the Authority as appropriate in view of the information then available to it and the proposed changes affecting Phoenix's rate of return on transmission, the principle of an agreed return on equity and mutualisation of the transmission pipeline. The discussions leading to the proposed regulatory agreement themselves evidence the Authority's willingness to seek solutions that represent the correct balance between all stakeholders including investors, where consistent with its general duties.

However, a number of consultation responses, including that of Phoenix, do appear to contain misapprehensions as to the status of the proposed regulatory agreement arrived at in August 2004. The proposed agreement was not implemented in the immediately following month, as Phoenix should

appreciate since discussions as to its more detailed terms and implementation continued during the autumn of 2004 and into spring 2005. Indeed that proposed agreement, even in a detailed form that was suitable for implementation, could not have been implemented without first being subject to the Authority's duty of public consultation under the terms of the Gas (Northern Ireland) Order 1996.

The fact that the proposed agreement had not been the subject of public consultation prior to announcement of the offer for ESH was due to the fact that it was not sufficiently developed. Limited progress had been made with Phoenix in developing the two components of the agreement which might have benefited customers, but at the cost of reducing shareholder value (mutualisation and the concept of an agreed return on equity). Indeed, the Authority wrote to Phoenix on 4 March 2005 (before the Terra Firma offer was made) suggesting proposals aimed at avoiding any further delay caused by Phoenix's concerns over the impact of mutualisation.

The offer advanced the timing of the consultation both because it provided new information to the Authority and because it raised issues which the Authority believed it was appropriate to consult on at this juncture.

Therefore for the Authority to consider whether that proposed agreement continues to be appropriate, in the light of current circumstances and responses that are received during the course of consultation, is merely to follow a process and have regard to matters that the Authority would always, in due course, have been obliged to follow and consider.

Since the legally-required consultation process is well-known to Phoenix and to all those who participate in or invest in the market, the Authority believes that some respondents may have misconstrued the status and effect of its consultation paper.

- The Authority notes the concerns of a number of respondents that the proposed regulatory agreement may no longer reflect an appropriate balance of interests, and these are concerns which, as was clear from the consultation paper, it shares. In particular, the Authority is concerned to ensure that any

arrangements with Phoenix deliver the appropriate result for the development of the gas industry in Northern Ireland and meet the Authority's statutory objectives, bearing in mind the responses received to the consultation.

The Authority will explore appropriate arrangements with Phoenix and with other interested parties for its future regulation that meet the Authority's principal duty, adequately protect the interests of customers and strike the right balance between the various interests. The Authority will seek to progress this work as soon as possible.

- The Authority welcomes the broad support for new and amended licence conditions to ensure the financial security and ring-fencing of the Phoenix business. It is therefore prepared, following the publication of this statement, to enter into discussions with Phoenix with a view to agreeing the terms of licence conditions to be proposed as modifications to the Phoenix licence in due course. When these conditions have been drafted, and on the assumption that they can be agreed, they will be subject to public consultation in accordance with the procedure set out in the Gas (Northern Ireland) Order 1996.

3. Next Steps

The Authority remains committed to producing a regulatory framework for Phoenix which provides investors with a rate of return on their investment which is appropriate to the business and the risks and challenges which it faces whilst meeting the Authority's principle objective. Such a framework must instill public confidence in the future of the industry and its commitment to working in the interest of customers. The matters mentioned above in this statement and reflected more fully in the consultation paper and in the responses received to it will be the subject of further exploration and discussion by the Authority with Phoenix and other interested parties as soon as possible following the issue of this statement.

The Authority remains willing to consider any further information that should be drawn to its attention.