NI 12 05
Response to NIAER Consultation on the Proposed Acquisition of Phoenix Natural Gas Ltd

1 CBI Northern Ireland welcomes the opportunity to comment on the consultation paper issued by the Northern Ireland Authority for Energy Regulation (NIAER) on the Proposed Acquisition of Phoenix Natural Gas Ltd by Kellen Acquisitions. The Regulator believes the proposed acquisition raises three broad issues for the Authority:

- an appropriate opportunity to take stock of the regulatory agreement, reached in principle (and currently being implemented) in August 2004
- the price offered causes the Authority to re-evaluate the rate of return shareholders are willing to accept, and the cost of capital and
- whether existing Licence provisions are adequate to ensure the sustained financial and operational stability of its business.

The NIAER has requested comments by 15 June.

2 The CBI is not in a position to comment in detail on the proposals set out but there are important matters of principle which do need to be addressed.

3 From an investment perspective it is critical that a stable and predictable regulatory environment is created – we believe this is also in the best interests of consumers. We understand that an agreement was reached between Phoenix and NIAER, after extensive discussions, in August 2004 (see Appendix 1) – this agreement underpins the tariff arrangements in place since October 2004. We understand that much of the agreement, which covered a wide range of issues is complete and being implemented while most outstanding components are in progress. The Press Release issued by NIAER at the time confirmed that an agreement had been reached. Unless the Regulator believes they have been given either false information, or there has been misrepresentation of facts, by Phoenix we believe an attempt to re-open or renegotiate a previous agreement is seriously worrying and will lead to a reduction in shareholder confidence of regulated utilities investment in Northern Ireland – this in itself could create a risk premium for future investments.

4 It is inevitable that changes in market expectations of risk and required rates of return could generate fluctuating valuations of Phoenix based on its earnings stream, which would differ from the net asset values. This should come as no surprise to anyone. The idea of the regulator reducing those income streams to bring the earnings based valuations back into line with the value of the asset base (and in effect to capture some of the value arising from the normal operation of the capital markets) could be construed

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as an attempt to "play the financial markets" rather than manage the cost effective delivery of a service.

5 A key principle underpinning good regulation is that those being regulated understand their obligations and know what to expect from the enforcing authorities. For those activities that are regulated, investment should flow from clear and predictable regulatory decisions about desired service outputs and controls on prices. A decision to re-open an agreement of this nature would create a precedent with significant negative consequences, particularly in terms of investor confidence, and the impact this will have on future investment. We believe Phoenix is implementing the agreement reached in August 2004 and there is a genuine attempt to resolve outstanding issues.

6 We do not believe that the proposed purchase of Phoenix by Kellen (or anyone else) is sufficient reason to review an existing regulatory agreement. The NIAER has assumed that the offer is indicative of a general market view. But there may be other reasons eg the acquirer may be keen to change the mix of risks in their own portfolio of investments and their current portfolio rather than Phoenix drive the premium. Different companies will clearly have a range of views on value depending on their own circumstances and risks they are prepared to take. The so called premium also depends on the original purchase price by East Surrey Holdings and the transaction costs incurred. As we have stated in Para 4 we do not believe the Regulator should try to "play the financial markets".

7 We do accept that the Licence Conditions may need to be reviewed in line with current provisions in the rest of the UK to ensure that the new shareholders are obliged to meet the requirements to ensure that the financial and managerial viability of Phoenix are not put at risk due to other group activities. We would expect the Regulator to ensure that the terms of the Licence are no more onerous in Northern Ireland than elsewhere in the UK and on that basis his actions and method of implementation should be consistent with that elsewhere in the UK.

8 We also accept that the proposed regulatory agreement needs to be completed in full – and it may be necessary for NIAER to secure assurances from Kellen that these will be completed as far as they are in the customers interest.

Appendix 1

Key elements of August 2004 Regulatory Agreement with Phoenix

- extension of the period for the recovery of capital costs from 20 years to 40 years
- a reduction in the Regulatory Asset Base (RAB) from £351m to £306m – with a reduction in the regulated rate of return on the transmission RAB from 8.5% to 7.5% with immediate effect to 2016 (with five year reviews thereafter)
- Rate of return on Distribution RAB of 8.5% to 2016 (reviewed at this stage) – with agreement that Phoenix is look at the possibility of a move to return on equity (with the intention of reducing cost of capital)
- a commitment to mutualise the Belfast transmission pipeline at no premium

CBI Northern Ireland
15 June 2005