NORTHERN IRELAND ELECTRICITY plc

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

NIE's response to NIAER's Consultation Paper

15 June 2005.

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Introduction

1. NIAER's consultation paper seeks views on whether the Authority's proposals for the regulation of Phoenix Natural Gas Limited, as contained in the agreement that was reached between the two parties in August 2004, should be reconsidered in light of the proposed acquisition of East Surrey Holdings plc by Kellen Acquisitions Limited.

2. The paper explains that the August 2004 agreement comprised the following components:

   - extension of the period for the recovery of capital costs from 20 years to 40 years;
   - a reduction in the Regulatory Asset Base from £351m to £306m;
   - a reduction in the regulated rate of return on the transmission RAB from 8.5% to 7.5% with immediate effect and a commitment to mutualise the Belfast transmission pipeline at no premium;
   - a continuation of the regulated rate of return on the distribution RAB of 8.5%, but with a move to an 'agreed return on equity' (although the paper gives no detail of this).

3. NIAER states that it is minded to reconsider the August 2004 agreement.

Re-opening a price control

4. A regulator's decision to re-open an agreed price control is one that would normally be taken only after careful consideration of the impact it may have on investors' perception of the stability of the regulatory framework. Whilst the paper states that the agreement has yet to be formalised through licence modifications, NIAER's August 2004 press release appears to convey a very clear message that a new price

control deal had been agreed. Our reading of the consultation paper indicates that the Authority is properly sensitive to the importance of the issue of whether the price control has been in fact agreed as indicated by the paper's elaboration of considerations relevant to this question. If a price control that had been agreed were re-opened, it is likely that investors generally would perceive such a reopening negatively, as indicating a form of regulation which was less predictable and so subjecting their investments to increased regulatory risk. This would almost inevitably result in a higher required rate of return in the future, which would be reflected in the long run in higher costs to customers. In NI the impact on investors' perceptions of NIAER re-opening the Phoenix price control could extend beyond the gas industry to electricity, and at some future date to water. This factor is not mentioned alongside the other factors that NIAER needs to balance in deciding how to respond to the proposed acquisition, but NIE believes that it merits being given significant weight.

Rate of return

5. NIAER is concerned that the rate of return allowed to Phoenix could now appear to be excessive given the premium to RAB reflected in Kellen's offer (as estimated by NIAER in its calculations).

6. Whilst NIE does not have access to the detail of the offer, we consider that the following considerations are relevant:-

- We note that the rate of return is only one element in the overall agreement and that another component involved a reduction in the value of the RAB – so there may well have been an interaction between these two elements. In other words, had the RAB remained intact the agreed rate of return may well have been lower.

- Recent Ofgem and Ofwat determinations of the allowed rate of return for electricity distribution and water (6.9% and 7.1% respectively on a pre-tax real basis), provide a benchmark against which Phoenix's rate of return may be assessed. Due account should be taken of Phoenix's immaturity relative to the more established electricity and water networks and the need to build its customer base from scratch by capturing customers from the incumbent suppliers of competing fuels. We understand that, under the regulatory model, a substantial under-recovery has built up in the initial stages. While the provision whereby accrued losses may be capitalised into the RAB may be seen as positive, these losses still have to be recouped within the lifetime of the price control. In practice, recovery is not guaranteed as it will depend on the relative competitiveness of other fuels over a long period.

- Regulatory precedent supports a small company premium. In its most recent determinations Ofwat allowed a premium depending on the size of the RAB. With a RAB of c£300m Phoenix would have qualified for a 0.3% premium under Ofwat's approach.

- An 8.5% rate of return is not unknown in GB regulation where new assets are involved. We understand that CAA's March 2002 determination in respect of new assets at Heathrow used that figure.

- Part of the agreed purchase price would be attributable to the need for East Surrey Holdings to recover its transaction costs which are likely to be substantial.

- The premium paid may not be out of line with previous transactions in the utility sector.

7. Most importantly, there is nothing to say that the price offered by Kellen will turn out to be an accurate reflection of the actual return that the acquired business will deliver nor to what extent it may reflect some element of strategic view on pricing on the part of the acquiror. Prospective purchasers' views on value will differ widely depending on their own particular circumstances and their future outlook. The price paid is the price that is judged right by the prospective purchaser and is not necessarily the 'right price' in absolute terms, or a price which another purchaser would be willing to pay.

Ring fencing

8. The paper notes that precedents have been established for licence modifications following transactions involving the sale and purchase of regulated infrastructure assets. The suggestion that NIAER needs to consider such modifications to Phoenix's licence to ensure that it has sufficient managerial and financial resources to carry out its regulated functions and is appropriately ring-fenced from the rest of the Kellen Group would appear to be in line with established practice.

Supply revenue

9. NIAER seeks views on whether there are any other matters to which it should have regard. In the context of full electricity market opening in 2007, NIE Supply is keen to introduce dual fuel (electricity & gas) products, as this is one of the few areas where there may be scope to make attractive offers to domestic customers. Although it is not directly related to the proposed acquisition it would be helpful to have an assurance that no element of the distribution revenue entitlement is associated with the recovery of Phoenix's supply costs (billing etc).

Conclusion

10. NIE believes that there would be potentially serious implications for investor perceptions from regulatory interventions that seek to re-open price control agreements and this should be avoided in all but the most extreme circumstances.