

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

A Consultation Paper issued by the Northern Ireland
Authority for Energy Regulation
May 2005

**Response by
Northern Ireland Energy Holdings Limited**

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Introduction

Development of the natural gas industry in Northern Ireland is now well established, with gas having become the fuel of choice for electricity generation, and having largely displaced heavy fuel oil in the industrial/commercial sector, both mainly due to environmental considerations. In addition, LPG and coal have been displaced on a cost and convenience basis. Therefore a great deal of the risk associated with development of the gas industry is now in the past.

As the industry continues to mature, regulation of the industry in Northern Ireland must focus on the efficiency with which gas can be transported and supplied to end-consumers, principally by driving down operating costs and return on capital to the owners of the infrastructure. Gas prices have risen, but not as much as those for light distillate, its main remaining competitor.

This situation is likely to continue for some time and represents a significant opportunity for further penetration of gas in the energy market. NIEH's view is that gas transportation can be achieved at significantly lower cost than has historically been the case.

Northern Ireland Energy Holdings Limited ("**NIEH**") is responding to the Consultation Paper in its capacity as a potential acquirer of the Belfast Transmission Pipeline ("**BTP**"), the principal asset of the gas transmission business of Phoenix Natural Gas Limited ("**PNGT**") from East Surrey Holdings plc ("**ESH**") or Kellen Acquisitions Limited ("**Kellen**"), as the case may be.

NIEH is also responding on behalf of its subsidiary Premier Transmission Limited ("**PTL**"), in the latter's capacity as provider of gas transportation services to Phoenix Natural Gas Limited ("**PNG**"), as a shipper of gas through the PTL-owned Scotland to Northern Ireland Pipeline ("**SNIP**").

NIEH addresses below each of the questions posed by the Authority in Section 6 of the Consultation Paper.

If it is not possible for Phoenix to complete the steps envisaged under the proposed regulatory agreement prior to the acquisition of ESH by Kellen, are there any assurances that should be sought by the Authority in relation to them?

The Consultation Paper makes it clear that mutualisation of PNGT is one of the key parts of the regulatory agreement reached between the Authority and ESH in August 2004 (the "**2004 Agreement**"). For the reasons outlined below, NIEH believes that mutualisation of PNGT is a desirable outcome for the Authority, and that it is appropriate for the Authority to require assurances from Kellen that the 2004 Agreement will be honoured in this regard.

In furtherance of this outcome, NIEH believes that the Authority should require the parties to enter into an agreement evidencing heads of terms in respect of the mutualisation of PNGT, prior to completion of the Kellen acquisition of ESH. NIEH recommends that the heads of terms should include, *inter alia*:

- headline agreement to mutualise PNGT;
- outline of the legal steps required to separate transmission from the balance of PNG's business;
- agreed purchase price, or formula for determining a purchase price;
- objective conditions to completion of the mutualisation; and
- process and timetable.

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This would ensure a clear path to delivering this important element of the measures taken by the Authority to protect the interests of Northern Ireland gas consumers.

Are those steps still an appropriate means of protecting the interests of gas consumers in Northern Ireland?

NIEH believes that the mutualisation of PNGT is fundamental to protecting the interests of gas consumers in Northern Ireland. The mutualisation model is under no pressure to generate surpluses either to enhance returns nor to achieve an attractive exit price. The mutual model, unlike the equity model, is designed specifically to be there for the long term.

The Moyle Interconnector and PTL transactions have established mutualisation of regulated transmission assets – and the associated 100% long-term debt financing – as a proven vehicle for delivering significant financial savings to energy consumers in Northern Ireland. In aggregate, the Moyle and PTL acquisitions generate savings of over £50 million on an NPV basis, measured against the agreed cost of capital existing under previous ownership. In addition, it is confidently expected that operating cost savings will also be deliverable, as described further below.

NIEH understands that, as part of the 2004 Agreement, a valuation of PNGT for the purposes of mutualisation of approximately £105 million (as at 1st January 2004, in December 2003 prices) was provisionally agreed between the Authority and ESH. On this basis, NIEH's initial analysis indicates consumer savings of approximately £5 million could be generated in the first year after mutualisation, and aggregate savings of over £30 million on an NPV basis, again measured against the agreed cost of capital. It is difficult to conceive of an equity-based ownership model being capable of delivering a comparable reduction in the weighted average cost of capital.

NIEH was established with the express object, *inter alia*, of owning other energy assets including, explicitly, other transmission assets, having regard to the interests of energy consumers in Northern Ireland. NIEH has assembled a highly experienced executive and operational management team, which has proved itself capable of managing an expanding asset portfolio.

The intention to merge the Moyle Interconnector group of companies into NIEH, and to establish a joint services company (“**JSC**”) to provide administrative, accounting and other services to both PTL and Moyle, has been agreed in principle with the Authority, subject to appropriate consultation in due course, once significant progress has been made towards establishing the full membership of NIEH.

The Moyle and PTL transactions have also demonstrated the deliverability of an efficient, competitive, low-coupon, long-term (to match the life of the underlying asset) financing solution, carefully tailored to precisely meet the objectives of the Authority, in terms of cost profile to consumers.

NIEH believes that the common ownership of gas transmission assets is a logical extension of the main objectives of Postalisation, which was introduced on 1st October 2004, namely the establishment of a common tariff structure and the elimination of competition in gas transmission.

The NIEH corporate structure is already in place to facilitate the seamless acquisition of PNGT, with appropriate ring-fencing of assets, security, operations and funding, to ensure no cross-collateralisation, cross-subsidisation or cross-default in respect of other NIEH-

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owned assets. As part of the establishment of this structure, the Authority and NIEH agreed a number of corporate governance measures, which ensure that the widest possible range of interests are represented both in the membership and on the Board of NIEH.

Common ownership and management, and the creation of the JSC, will enable SNIP and BTP to be operated effectively as a single pipeline. This is expected to facilitate efficient management of operations, security of supply, safety and compliance (licence, regulatory reporting, financing, etc.).

When BTP was constructed, it was always envisaged that BTP and SNIP would be operated effectively as a single pipeline, and hence there is no volumetric control or custody transfer at Ballylumford. It is proposed that physical and commercial operation of a combined SNIP and BTP would continue to be outsourced to reputable third party service providers via competitive tender.

NIEH notes that the preliminary cost savings analysis undertaken to date evaluates cost of capital/financing benefits only. NIEH expects it will be able to demonstrate that the operational synergies achievable through common ownership and management will deliver real cost savings, above and beyond savings against cost of capital. This will include simplifying the complex contractual arrangements that have been put in place to manage the interface between BTP and SNIP, in particular to give effect to Postalisation.

Against this backdrop, the NIEH board is committed to moving forward with a proposal to acquire PNGT. NIEH has already initiated discussions, both with its advisers and potential funders, regarding the feasibility of raising debt to fund the acquisition of PNGT on an accelerated timetable. NIEH believes this can be achieved within a 2-3 month timeframe, including adequate time for regulatory and government consultation/approval processes. NIEH is highly confident of being able to raise both long-term debt financing, and (if required) bank bridge financing, to facilitate a timely closing.

Should the proposed regulatory agreement with Phoenix, when taken as a whole, be reconsidered in the light of the recent developments? If so, are there any particular considerations to which the Authority should have regard, or any particular changes or provisions that are necessary to strike the right balance of interests in the light of its general duties?

With the exception of the proposed mutualisation of PNGT, NIEH does not propose to comment in detail on the wider implications of the 2004 Agreement.

Are the proposals under the heading 'Review of the Licence Conditions' appropriate to ensure that the Phoenix business is safeguarded and its compliance with licence conditions ensured? Are there any other proposals that the Authority should be considering at this stage?

NIEH does not question Kellen's ability to satisfy the Department of Enterprise, Trade and Investment ("DETI"), in respect of its possession of the requisite technical, financial and managerial capability to own PNG, including PNGT.

NIEH endorses the Authority's intention to conduct a review of certain of the licence conditions applicable to PNGT, to the extent that the Authority should ensure they are consistent in all material respects with what was agreed for PTL.

Are there any other matters or information to which the Authority should have regard in the context of the proposed acquisition of ESH?

NIEH understands that there were certain issues to be resolved prior to implementing the mutualisation of PNGT (including potential chargeable gains for corporation tax purposes). However, NIEH believes that these issues are capable of resolution and do not represent an impediment to concluding the mutualisation. NIEH would be happy to work with the Authority, PNG and its parent company, in order to resolve these issues.

Conclusion

NIEH has put forward above the indisputable benefits of a mutualisation – rather than an equity – ownership model, as the best vehicle for delivering efficient long-term ownership and management of the gas transmission network, combined with the lowest achievable cost of capital. In conclusion, the following points are worth reiterating:

- The perceived risks inherent in a growing market environment are now diminishing, as the gas market in Northern Ireland matures. As the risk profile diminishes, the gas industry in Northern Ireland – and particularly transmission – no longer warrants high return equity funding.
- While implementation of the key terms of the 2004 Agreement has not been possible, for a variety of reasons, it is incumbent on the Authority to press for implementation of, and/or changes to, the key provisions of the 2004 Agreement, in the interests of the ongoing development of the energy industry and for the direct benefit of consumers.
- The Moyle and PTL transactions have demonstrated that mutualisation is an extremely viable, effective, and, in NIEH's view, unrivalled, model for delivering cost savings for the direct benefit of consumers. NIEH considers that the Authority should recognise the mutualisation of PNGT to be a key part of a wider package of measures, to deliver value to, and safeguard the interests of, energy consumers.
- The NIEH corporate and management structure has been specifically designed to accommodate further acquisitions in Northern Ireland energy infrastructure, including specifically gas transmission.
- NIEH has already undertaken preliminary work, and is highly confident of being able to complete the acquisition, and secure competitive funding, to deliver significant sustainable benefits to consumers.

The Board of Directors
Northern Ireland Energy Holdings Limited
15 June 2005