

Phoenix Natural Gas; Proposed Conveyance Licence Modifications

A Consultation Paper by the Northern Ireland Authority for Energy Regulation March 2006

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 were 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 90,000 consumers.

In May 2005 the Authority published a consultation document - *The Proposed acquisition of East Surrey Holdings plc by Kellen Acquisitions Limited – Implications for Phoenix Natural Gas Limited* - (<http://ofreg.nics.gov.uk/Consultation%20Papers%202005.htm>).

In this the Authority set out the elements of a proposed regulatory agreement of August 2004 and its concerns with aspects of this agreement in light of the Kellen offer. The proposed agreement had not been implemented at the time of the Kellen offer and the consultation document made this clear.

Terra Firma subsequently lodged a formal submission with the Panel on Takeovers and Mergers - the UK regulator of public acquisitions - to invoke certain conditions in relation to the offer by Kellen for ESH and sought to withdraw the offer on the basis of changes in regulatory circumstances.

On 17 October 2005 the Takeover Panel ruled against Terra Firma and Kellen was not allowed to withdraw its offer.

Kellen's acquisition of ESH went ahead on the 27th October 2005 and Kellen is now the sole owner of Phoenix.

Purpose of this consultation

The May 2005 consultation document referred to the duty of the Authority to evaluate the regulatory impact of the change of control of Phoenix, and to assess whether existing licence conditions adequately safeguard consumers' interests.

The Authority has to ensure it has adequate regulatory safeguards in place. The Authority saw the proposed takeover as representing an appropriate point at which to consider whether the conditions in the Phoenix licence currently reflect regulatory best practice and, if not, to consider what modifications should be sought.

Ring- Fencing

As was considered at pages 17 to 19 of the May 2005 consultation document, any activities of Kellen or its associates that could prejudice the financial and managerial viability of Phoenix would be of concern to the Authority.

In Great Britain, such concerns have been addressed by the inclusion of licence conditions to ensure that the regulated business is ring fenced from the other activities of the group of which it forms part. These reflect provisions which have become commonplace in utility licences in the UK, including electricity licences in Northern Ireland. The Authority is minded to propose licence modifications adopting similar provisions unless it is satisfied that there are good reasons why it should not do so.

Kellen responded to the May consultation document on the proposed ring-fencing conditions and noted that the proposed modifications are very similar in substance to licence provisions included by Ofwat in its water licences.

Kellen recognised the logic of the modifications included by Ofwat in the past; and understood why the Authority was considering these. Kellen stated its willingness in principle to all "Ofwat-style" modifications. Kellen also suggested draft conditions.

The response of Kellen echoed the views of many other respondents who also voiced broad support for the inclusion of such conditions. Those responses that were not marked as confidential were published by the Authority in June 2005 and can be viewed at <http://ofreg.nics.gov.uk/Press Releases 2005.htm>.

Following the 2005 consultation, the Authority has reviewed the licence conditions applying to other UK utilities and has drawn up a suite of conditions reflecting these. These are included at annexe 1 of this document.

Having consulted on, and received responses indicating broad consent to, the principles of ring fencing, the Authority is now seeking views on the detailed draft conditions attached at annexe 1. The Authority considers these conditions necessary and appropriate for the protection of consumers' interests and independent of implementation of any new regulatory agreement.

Once the Authority has received and considered the responses to this consultation document, it will finalise the drafts and formally propose the modifications to Phoenix. The Authority's preference would be to introduce these conditions as soon as possible with the agreement of Phoenix. In the event that there is no such agreement, the Authority may wish to refer the issue to the Competition Commission.

The Authority has, for the moment, concentrated on the conditions contained in the Phoenix licence, but the Authority will also be considering whether similar conditions should also be included in the licences of Northern Ireland's other gas pipeline operators. Whilst the ownership structures of Premier Transmission Limited, BGE (NI) Distribution Limited and BGE (UK) Limited distinguish them from Phoenix, the Authority will consider whether some of the same principles should apply.

Views Invited

The Authority invites views from interested parties on the proposed ring-fencing conditions included at annexe 1.

In particular:

- Are the proposed 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?
- Should any or all of the proposed conditions not be implemented and if so why not?
- Which of the proposed conditions are/are not appropriate for the other holders of gas conveyance licences, and why?

The Authority would welcome the views of interested parties by no later than 5pm on Friday 28th April 2006.

These should be sent in writing to:

Michael Lowry
Northern Ireland Authority for Energy Regulation
Queen's House
14 Queen Street
Belfast
BT1 6ER
+44 (0)28 90 316639

Responses in electronic form are acceptable and can be sent by e-mail to:

michael.lowry@ofregni.gov.uk

Unless specifically requested otherwise, responses may be published on our website. Respondents should clearly mark any part of their response (or, if appropriate, the whole response) they wish to remain confidential.

ANNEXE 1 Draft “Ring Fence” licence conditions

PART 1

New Definitions:

“Licensed Conveyance Business” means the activities connected with the conveyance of gas pursuant to the Licence, including the development, construction, operation and maintenance of the Network, the connection of premises to the Network, and the provision and maintenance of gas meters (but not meter reading);

“Licensed Supply Business” means the activities connected with the supply of gas pursuant to the Licence;

Condition 1.16: Corporate Governance

1.16.1 Conduct of business

The Licensee shall carry on its business as if (to the extent it is not):

- (a) the Licensed Conveyance Business and the Licensed Supply Business (taken together) was the Licensee's sole business; and
- (b) that sole business was a separate public limited company with no affiliates or related undertakings.

1.16.2 Compliance

Without prejudice (and, where necessary, subject) to Condition 1.16.1, the Licensee shall:

- (a) comply with the provisions of the Memorandum and Articles of Association;
- (b) not make any change to the Memorandum and Articles of Association without the prior written consent of the Authority; and
- (c) to the extent they are appropriate to the circumstances of the Licensee, comply with the principles and guidance for corporate governance from time to time annexed to (or otherwise recognised by) the listing rules of the UK Listing Authority.

1.16.3 Directors

The Licensee shall:

- (a) inform the Authority, without delay:
 - (i) on each occasion that a director is appointed to the board of the Licensee, of the director in question's name, of the responsibilities assigned to that director, and of any

directorships held by that director with any affiliate or related undertaking of the Licensee;

(ii) (whilst such person remains a director) of any changes in such responsibilities or directorships; and

(iii) of any person ceasing to be a director of the Licensee for any reason;

(b) have non-executive directors of appropriate standing with relevant experience who shall be greater in number than the executive directors;

(c) ensure that each of its directors discloses to the Authority any conflicts that do or may arise between that director's duties as a director of the Licensee and other duties that that director may have; and

(d) ensure that each director undertakes his duties in the best interests of the Licensed Conveyance Business and the Licensed Supply Business (taken together) and otherwise in conformity with the Licensee's obligation under Condition 1.16.1.

1.16.4 Prohibition of cross-subsidies

The Licensee shall procure that each of the Licensed Conveyance Business and the Licensed Supply Business shall not give any cross-subsidy to, or receive any cross-subsidy from, any other business of the Licensee or of an affiliate or related undertaking of the Licensee.

1.16.5 Publication of results

The Licensee shall, at such times and in such ways as would from time to time be required by the listing rules of the UK Listing Authority, publish such information about its annual final results as is by those rules required to be announced by a company whose ordinary shares are for the time being admitted to the official list of the UK Listing Authority.

1.16.6 Additional definitions

In this Condition 1.16, unless the context otherwise requires:

“Memorandum and Articles of Association” means the documents of those names established in respect of the Licensee in accordance with the Companies (Northern Ireland) Order 1986;

“UK Listing Authority” means the person from time to time exercising the functions of the competent authority under Part VI of the Financial Services and Markets Act 2000;

Condition 1.17: Indebtedness

1.17.1 General restriction

In addition to the requirements of Condition 1.13, the Licensee shall not, without the prior written consent of the Authority (following disclosure by the Licensee to the Authority of all material facts):

- (a) (subject to Conditions 1.17.1(b), (c), (d) and (e)) create or permit to remain in effect any mortgage, charge, pledge, lien or other form of security or encumbrance, undertake any indebtedness or other obligation to any other person, or enter into or permit to remain in effect any guarantee otherwise, in each case, than:
 - (i) on an arm's length basis;
 - (ii) on normal commercial terms; and
 - (iii) in the furtherance of the Licensed Conveyance Business and/or the Licensed Supply Business;
- (b) create or continue to permit to remain in effect any mortgage, charge, pledge, lien or other form of security or encumbrance in favour of, or otherwise for the benefit of, any affiliate or related undertaking of the Licensee;
- (c) transfer, lease, license or lend any sum, asset, good, right or benefit (or otherwise undertake any indebtedness or obligation) to any affiliate or related undertaking of the Licensee otherwise than by way of:
 - (i) a transfer, lease, licence or loan of any asset, good, right or benefit in compliance with the requirements of sub-conditions (i), (ii) and (iii) of Condition 1.17.1(a) and in compliance with the payment requirement set out in Condition 1.17.2;
 - (ii) a transfer (other than by way of loan) of any sum properly due under any payment obligation entered into in compliance with

the requirements of sub-conditions (i), (ii) and (iii) of Condition 1.17.1(a);

- (iii) a dividend or other distribution out of distributable reserves undertaken in accordance with Condition 1.18;
 - (iv) a repayment of capital; or
 - (v) payments for group corporation tax relief calculated on a basis not exceeding the value of the benefit received;
- (d) enter into an agreement or incur a commitment incorporating a cross-default obligation; or
- (e) continue, or permit to remain in effect, any agreement or commitment incorporating a cross-default obligation subsisting at the date this Condition 1.17 takes effect, save that the Licensee may permit any cross-default obligation in existence at that date to remain in effect for a period not exceeding twelve months from that date, provided that the cross-default obligation is solely referable to an instrument relating to the provision of a loan or other financial facilities granted prior to that date and the terms on which those facilities have been made available as subsisting on that date are not varied or otherwise made more onerous.

1.17.2 Payment requirement

The payment requirement referred to Condition 1.17.1(c) is that the consideration due in respect of the transfer, lease, licence or loan of the asset, good, right or benefit in question is paid in full prior to such transfer, licence or loan unless:

- (a) the counter-party to the transaction has, and maintains until payment is made in full, an investment grade issuer credit rating; or
- (b) the obligations of the counter-party to the transaction are fully and unconditionally guaranteed throughout the period during which any

part of the consideration remains outstanding by a guarantor which has and maintains an investment grade issuer credit rating.

1.17.3 Additional definitions

In this Condition 1.17, unless the context otherwise requires:

- “cross-default obligation” means a term of any agreement or arrangement whereby the Licensee’s liability to pay or repay any debt or other sum arises or is increased or accelerated or could reasonably be expected to be capable of arising, increasing or of being accelerated by reason of a default (howsoever such default may be described or defined) by any person other than the Licensee (including guarantees of third party obligations), unless:
- (i) that liability can arise only as a result of a default by a subsidiary of the Licensee;
 - (ii) the Licensee holds a majority of the voting rights in that subsidiary and has the right to appoint or remove a majority of its board of directors; and
 - (iii) that subsidiary carries on business solely for the purposes of the Licensed Conveyance Business and/or the Licensed Supply Business;
- “indebtedness” means all liabilities now or hereafter due, owing or incurred, whether actual or contingent, whether solely or jointly with any other person and whether as principal or surety, together with any interest accruing thereon and all costs, charges, penalties and expenses incurred in connection therewith;
- “investment grade issuer credit rating” means, in respect of any person, that that person has:
- (i) an issuer rating of not less than BBB- by Standard & Poor’s Ratings Group or any of its subsidiaries; or

- (ii) an issuer rating of not less than Baa3 by Moody's Investors Service Inc. or any of its subsidiaries; or
- (iii) an issuer senior unsecured debt rating of not less than BBB- by Fitch Ratings Ltd or any of its subsidiaries,

or such higher rating as may be specified by those agencies from time to time as the lowest investment grade credit rating.

Condition 1.18: Resources and Dividend Payment

1.18.1 Availability of resources

The Licensee shall act at all times in a manner calculated to ensure that it has available to it all such resources (including, without limitation, management and financial resources, personnel, fixed and moveable assets, rights, consents and facilities), on such terms, and with all such rights, as shall ensure that the Licensee is at all times able properly and efficiently to carry on each of the Licensed Conveyance Business and the Licensed Supply Business in compliance with the Order, the Energy Order and the Licence.

1.18.2 Annual certificate

The Licensee shall, by 31 July of each year, submit to the Authority a certificate, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution, in one of the following forms:

- (a) “After making enquiries, and having taken into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the Licensee, the directors of the Licensee have a reasonable expectation that the Licensee will have (i) sufficient financial resources and financial facilities available to itself, and (ii) sufficient rights under any agreements or arrangements with its affiliates or related undertakings, to (in each case) enable the Licensee to carry on each of the Licensed Conveyance Business and the Licensed Supply Business in compliance with the Order, the Energy Order and the Licence for a period of 12 months from the date of this certificate.”
- (b) “After making enquiries, and having taken into account in particular (but without limitation) any dividend or other distribution which might reasonably be expected to be declared or paid by the Licensee, the directors of the Licensee have a reasonable expectation, subject to what is explained below, that the Licensee will have (i) sufficient financial

resources and financial facilities available to itself, and (ii) sufficient rights under any agreements or arrangements with its affiliates or related undertakings, to (in each case) carry on each of the Licensed Conveyance Business and the Licensed Supply Business in compliance with the Order, the Energy Order and the Licence for a period of 12 months from the date of this certificate. However, they would like to draw attention to the following factors which may cast doubt on the ability of the Licensee to carry on those businesses.”

- (c) “In the opinion of the directors of the Licensee, the Licensee will not have both (i) sufficient financial resources and financial facilities available to itself, and (ii) sufficient rights under any agreements or arrangements with its affiliates or related undertakings, to (in each case) enable the Licensee to carry on each of the Licensed Conveyance Business and the Licensed Supply Business in compliance with the Order, the Energy Order and the Licence for a period of 12 months from the date of this certificate.”

1.18.3 Supporting information

The Licensee shall submit to the Authority, with each certificate provided pursuant to Condition 1.18.2, a statement of the main factors which the directors of the Licensee have taken into account in giving that certificate. Such statement must be approved by a resolution of the board of directors of the Licensee and must be signed by a director of the Licensee pursuant to that resolution.

1.18.4 Ongoing duty

The Licensee shall inform the Authority in writing immediately if the directors of the Licensee become aware of any circumstance that causes them no longer to have the reasonable expectation expressed in the most recent certificate given under Condition 1.18.2.

1.18.5 Auditors report

The Licensee shall require that each certificate provided in accordance with Condition 1.18.2 is accompanied by a report prepared by its auditors and addressed to the Authority stating whether or not the auditors are aware of any inconsistencies between:

- (a) that certificate and the statement submitted with it; and
- (b) any information which the auditors obtained in the course of preparing their reports for the purposes of Condition 1.2.

1.18.6 Dividend payment

The directors of the Licensee shall not declare or recommend a dividend, and the Licensee shall not make any other form of distribution within the meaning of Article 271 of the Companies (Northern Ireland) Order 1986, or redeem or repurchase any share capital of the Licensee, unless prior to the declaration, recommendation or making of the distribution (as the case may be) the Licensee has issued to the Authority a certificate in the following form:

“After making enquiries, the directors of the licensee are satisfied:

- (a) that the Licensee is in compliance in all material respects with all the obligations imposed on it by Conditions 1.16, 1.17, 1.18, 1.19 and 1.21 of the Licence; and
- (b) that the making of a distribution of [] on [] will not, either alone or when taken together with other circumstances reasonably foreseeable at the date of this certificate, cause the Licensee to be in breach to a material extent of any of those obligations in the future.”

1.18.7 Requirement for dividend certificate

The certificate given under Condition 1.18.6 must be signed by a director of the Licensee and must have been approved by a resolution of the board of directors of the Licensee passed not more than 14 days before the date on which the declaration, recommendation or payment in question will be made.

1.18.8 Dividends

Where the certificate given under Condition 1.18.6 has been issued in respect of the declaration or recommendation of a dividend, the Licensee shall be under no obligation to issue a further certificate prior to payment of that dividend, provided that such payment is made within six months of the issuing of that certificate.

Condition 1.19: Undertaking of Controller

1.19.1 Obligation to procure undertaking

The Licensee shall procure, from each person (if any) which is at any time an ultimate controller of the Licensee, a legally enforceable undertaking:

- (a) in favour of the Licensee;
- (b) in such form as is approved by the Authority;
- (c) within 7 days of the person in question becoming an ultimate controller of the Licensee;
- (d) that will remain in force until a further undertaking expressly stated to replace that undertaking is provided in accordance with this Condition 1.19;
- (e) that the person will give will give to the Licensee (and will procure that any company that is a subsidiary of, or controlled by, that person (other than the Licensee and its subsidiaries) will give to the Licensee) all such information as may be necessary to enable the Licensee to comply fully with the obligation imposed by Condition 1.5;
- (f) that the person in question will refrain from (and will procure that any company that is a subsidiary of, or controlled by, that person (other than the Licensee and its subsidiaries) will refrain from) any action that would then be likely to cause the Licensee to breach any of its obligations under the Order, the Energy Order or the Licence; and
- (g) that the person in question will secure that the Licensee has available to it all such resources (including, without limitation, financial resources, personnel, fixed and moveable assets, rights, consents and facilities), on such terms, and with all such rights, as shall ensure that the Licensee is at all times able properly and efficiently to carry on each of the Licensed Conveyance Business and the Licensed Supply Business in compliance with the Order, the Energy Order and the Licence.

1.19.2 Evidence

The Licensee shall:

- (a) deliver to the Authority evidence (including a copy of each such undertaking) that the Licensee has complied with its obligations to procure undertakings pursuant to Condition 1.19.1;
- (b) on becoming aware that any such undertaking is not in full force and effect or is not legally enforceable or has been breached, inform the Authority immediately in writing; and
- (c) comply with any direction from the Authority to enforce any such undertaking.

1.19.3 Arrangements with ultimate controller

The Licensee shall not, save with the consent in writing of the Authority, enter (directly or indirectly) into any agreement or arrangement with any ultimate controller of the Licensee or with any subsidiary of any such ultimate controller (other than the subsidiaries of the Licensee) at a time when:

- (a) an undertaking complying with Condition 1.19.1 is not in place in relation to that ultimate controller; or
- (b) there is an unremedied breach of such undertaking; or
- (c) the Licensee is in breach of the terms of any direction issued by the Authority under Condition 1.19.2(c).

1.19.4 Additional definitions

In this Condition 1.19, unless the context otherwise requires:

“ultimate controller”

means, in respect of the Licensee:

- (a) any holding company of the Licensee, which is not itself a subsidiary of another company; and/or

- (b) any person who (whether alone or with a person or persons connected with him) is in a position to control, or to exercise significant influence over, the policy of the Licensee, or any holding company of the Licensee, by virtue of:
 - (i) rights under contractual arrangements to which he is a party or of which he is a beneficiary;
 - (ii) rights of ownership (including rights attached to or deriving from securities or rights under a trust) which are held by him or of which he is a beneficiary,

but shall exclude any director or employee of a corporate body in his capacity as such and any minister, ministry, department, agency, authority, official or statutory person. A person shall be considered to be connected with another person if they are party to any arrangement regarding the exercise of any such rights as are described in (i) and/or (ii) above.

“holding company”

has the same meaning as given to it under Article 4 of the Companies (Northern Ireland) Order 1986;

Condition 1.20: Compliance Officer

1.20.1 Appointment of Compliance Manager

The Licensee shall, following consultation with the Authority, appoint a senior member of its personnel (to be known as the “**Compliance Officer**”) for the purpose of facilitating compliance by the Licensee with its obligations under Conditions 1.16, 1.17, 1.18, 1.19 and 1.21.

1.20.2 Access to resource

The Licensee shall ensure, in so far as is reasonably necessary, that the Compliance Officer has access to such staff, premises, systems, information, documentation, equipment, facilities and other resources as he might reasonably require to fulfil the duties and tasks assigned to him.

1.20.3 Duties and tasks

The duties and tasks assigned to the Compliance Officer shall include:

- (a) providing relevant advice and information to the Licensee for the purpose of ensuring its compliance with Conditions 1.16, 1.17, 1.18, 1.19 and 1.21;
- (b) monitoring the effectiveness of the practices, procedures and systems adopted by the Licensee in order to meet its obligations under Conditions 1.16, 1.17, 1.18, 1.19 and 1.21;
- (c) where requested to do so by the Authority in respect of any matter, and/or on receipt of any complaint or representation received by the Licensee from any person in respect of any matter, arising (in either case) under Condition 1.16, 1.17, 1.18, 1.19 and/or 1.21, investigating that matter;
- (d) recommending and advising the directors of the Licensee to and on the remedial action which any such investigation has demonstrated to be necessary or desirable; and

- (e) reporting, at such frequency as is determined in writing by the Authority, to the directors of the Licensee on his activities during the period covered by the report.

1.20.4 Report to the Authority

The Licensee shall, at such frequency as is determined in writing by the Authority, submit a report to the Authority detailing the activities of the Compliance Officer during the period covered by the report, including details of any matter recommended by the Compliance Officer.

Condition 1.21: Financial Gearing

1.21.1 Reporting on Financial Gearing

The Licensee shall, within 14 days of this Condition 1.21 taking effect and thereafter by 1 February of each year, submit to the Authority a certificate, approved by a resolution of the board of directors of the Licensee and signed by a director of the Licensee pursuant to that resolution, showing the Financial Gearing as at the end of the preceding Financial Year. The Licensee shall provide the Authority with such evidence to support that certificate as the Authority may request.

1.21.2 Prohibition on altering Financial Gearing

The Licensee shall not, without the Authority's prior written consent, allow the Financial Gearing to increase above 60% at any time.

1.21.3 Additional definitions

In this Condition 1.21, unless the context otherwise requires:

“Capital Employed” means, at any time, the fixed assets of the Licensed Business at that time, plus the current assets of the Licensed Business at that time, less the current liabilities of the Licensed Business at that time, each calculated in a manner consistent with their treatment in the most recent balance sheets produced under Condition 1.3 and in accordance with any policies applicable to the accounts produced under Condition 1.3;

“Financial Gearing” means, at any time, the Financial Indebtedness at that time as a percentage of the Capital Employed at that time;

“Financial Indebtedness” means, at any time, the value of the Licensee's Capital Employed at that time that is financed by sources other than equity shareholders (including all non-equity shares, all long-term borrowings, all creditors, short-term loans,

all finance leases and all hire purchase contracts);

“Financial Year” means the period referred to in Condition 1.3.1; and

“Licensed Business” means the Licensed Conveyance Business and the Licensed Supply Business taken together.