Sale of Phoenix Natural Gas Limited

Proposed Acquisition by Northern Ireland Energy Holdings Limited

June 2007

1.0 Introduction

This paper sets out the issues raised by the proposed acquisition of the regulated gas transmission company, Phoenix Natural Gas Limited, by Northern Ireland Energy Holdings Limited ("NIEH"), a 100% debt financed company limited by guarantee.

Currently, Phoenix Natural Gas Limited owns and operates both distribution and transmission assets and it is proposed that, either prior to or simultaneously with the acquisition taking place, the distribution assets will be transferred to a new entity, Phoenix Distribution Limited ("PDL") and Phoenix Natural Gas Limited will be renamed Belfast Gas Transmission Limited. For ease of reference, this entity will be referred to as 'Phoenix Transmission' in this paper. The correct company name is, however, used in diagrams referring to the company structure.

Phoenix Transmission (owned by Terra Firma, a private equity firm) currently owns the Belfast Transmission Pipeline ("BTP") which runs from Ballylumford in Island Magee to Tory Town near Carrickfergus, and across Belfast Lough to Knocknagoney, near Holywood. The BTP transports high pressure gas from the Scotland to Northern Ireland Pipeline to three pressure reduction stations at Larne, Tory Town and Knocknagoney, where gas is introduced into the Greater Belfast gas distribution system and to an offtake for the North West Pipeline located at Middle Division at Carrickfergus.

As part of the agreement reached with the owners of Phoenix Transmission in November 2006 to reform their regulatory regime, it was agreed that the Phoenix Group would sell its transmission business.

NIEH, the owner of both the Moyle electricity interconnector and the Scotland to Northern Ireland Pipeline, has been identified by Terra Firma as the preferred purchaser of Phoenix Transmission. The proposed acquisition will be undertaken by Belfast Gas Transmission Financing plc ("BGTF")**,** which will be incorporated as an indirect wholly owned subsidiary of NIEH.

The Northern Ireland Authority for Utility Regulation[1] ("the Authority") invites views from all interested parties on the acquisition of Phoenix Transmission and particularly seeks comments on whether the acquisition is in the interests of consumers.

At this stage, the Authority's preliminary assessment is that NIEH's proposed acquisition of Phoenix Transmission will deliver significant consumer savings.

[1] Formerly known as the Northern Ireland Authority for Energy Regulation (NIAER)

Any representations or objections with respect to this paper may be made on or before Tuesday 24th July 2007 and should be addressed to:

Brian McHugh
Queens House,
14 Queen Street,
Belfast,
BT1 6ER.

or electronically to: brian.mchugh@niaur.gov.uk

Unless specifically requested otherwise, responses may be published on our website. Respondents should therefore clearly mark any part of their response (or, if appropriate, the whole response) they wish to remain confidential. If this is the case then the respondent must submit an edited version of the response for publication.

2.0 Background

Mutualisation involves the transfer of a private sector company (funded by a mixture of equity and debt) to a not-for-dividend company limited by guarantee ("CLG"), which has no shareholders and instead has a group of Members. Significant cost savings can be made from such transfers, as CLGs are typically financed solely with debt. Given the absence of equity and, therefore, the need to distribute profits, with appropriate regulatory support the CLG can raise capital at a very low all-in cost, producing significant savings for the benefit of consumers. However, achieving these benefits also entails transferring to consumers certain risks normally retained by the shareholders.

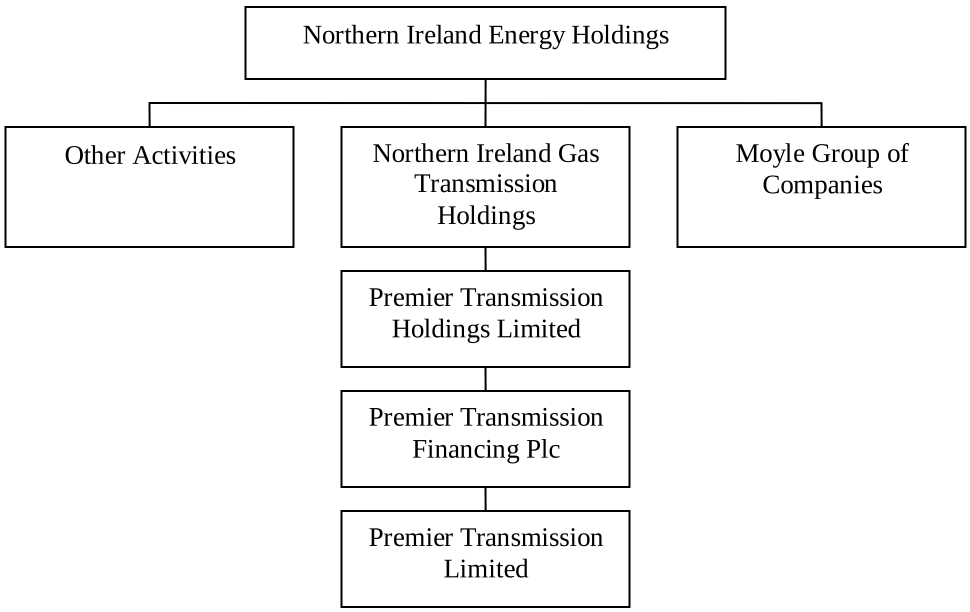
NIEH is a CLG which was formed in January 2005 to acquire and hold important energy infrastructure assets for the benefit of the energy consumers of Northern Ireland. NIEH owns the Moyle Interconnector which links the electricity systems of Northern Ireland and Scotland, and the Scotland to Northern Ireland Pipeline ("SNIP") which runs from Twynholm in Scotland to Ballylumford in Northern Ireland. The acquisition of Moyle Interconnector Limited in 2003[2] and Premier Transmission Limited ("PTL") in 2005 have both been funded by long-term bond finance and are obvious benchmarks for the proposed acquisition of Phoenix Transmission by NIEH.

The Authority must assess any proposed transfer of ownership against its legal duties as outlined in the Energy (Northern Ireland) Order 2003. In relation to its gas functions, the Authority's principal objective is to promote the development and maintenance of an efficient, economic and coordinated gas industry in Northern Ireland A critical question

[2] In 2003 Moyle Interconnector Limited was re-financed and acquired by Moyle Holdings Limited. Northern Ireland Energy Holdings was then formed in January 2005 in preparation for the purchase of Premier Transmission in March 2005. Moyle Holdings Limited then joined the NIEH Group in October 2005.

facing the Authority is therefore, whether the interests of consumers are prejudiced by moving from the current equity financed model of ownership of Phoenix Transmission to a new CLG ownership structure. In analysing any potential risks to consumers, the Authority will have regard to the extent of the compensating benefits for consumers. It should be noted that the Authority has previously analysed these issues in 2005 and concluded that the benefits to customers outweighed the risks. However we feel it is important to revisit these questions at this point and examine how mutualisation has operated in the intervening period.

Prior to the proposed purchase of Phoenix Transmission, the structure of NIEH is as follows:



3.0 Operational Performance of PTL under Mutualised Structure

The Authority indicated as part of our approval of the PTL transaction in 2005 that we would closely monitor the performance of PTL under mutualisation. While we recognise that the period that has elapsed since the mutualisation of PTL is limited, we still feel that an analysis of operational costs at this point is worthwhile in the context of extending the mutualisation model. While a perfect counterfactual is always difficult, the operational costs of PTL under the equity driven model (we refer to this company as “BG PTL” here) provide a reasonable benchmark to judge mutualisation performance. We would emphasise that this analysis is preliminary but it should provide a useful indication of performance relative to an equity-owned company.

We have compared actual PTL operational costs in 2005/6 with the BG PTL operational costs for their final year of operation (2004). We have done this with reference to the BG

PTL licence which sets out how much operational expenditure they were allowed to recover. This was made up of (i) a Predictable element of £2.19m (in September 2006 prices) calculated according to a formula, and (ii) an Unpredictable element consisting of all other costs. Where we considered the Unpredictable costs to be uncontrollable, e.g. licence fees and rates, we have used the current PTL figures as we see no reason why they would have been different for BG PTL.

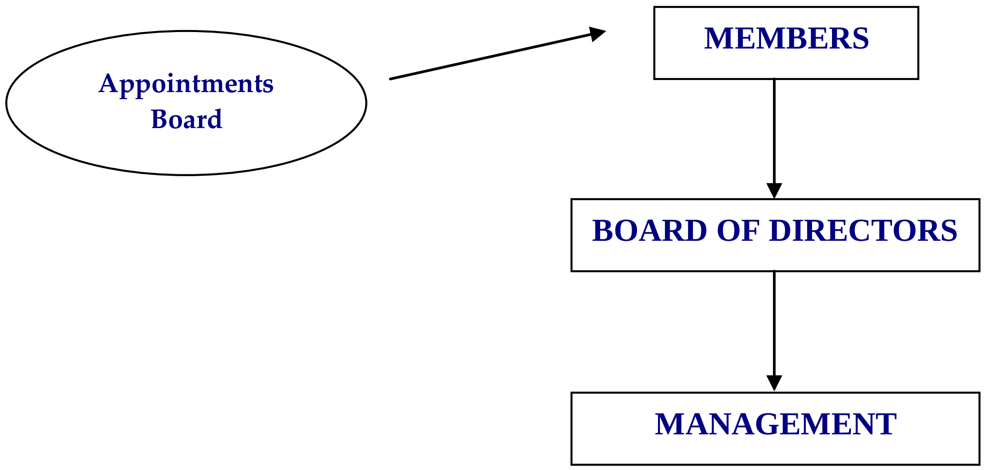
The result is a counterfactual figure of £9.9m for BG PTL compared to actual figure of £8m for PTL. The mutualisation of PTL assumed an ongoing operational saving of £1m per annum which indicates an extra £900k out-performance by PTL since mutualisation. It could be debated whether this saving represents the inefficiency and profit margin of BG PTL or the efficiency of the new company, but it is clear that the NI customer benefits through reduced tariffs. If this continues until 2021 (the year when the BG PTL licence was due to expire) it would increase the NPV of the PTL mutualisation by £10.8m. Even with the health warning above that this represents only preliminary Authority analysis, it indicates that the mutualisation model is capable of operating at an efficient level. The Authority plans to continue monitoring performance and will publicise more detailed analysis in future as further data becomes available.

4.0 Proposed Structure of Phoenix Transmission Acquisition

No equity investment will be issued to fund the proposed acquisition of Phoenix Transmission, and an acquisition by NIEH will, therefore, be 100% debt funded. This is possible from a creditworthiness perspective, because the borrower operates in a corporate structure which does not include shareholders operating the company for a profit motive, and where the borrower's revenues are derived from a supportive regulatory environment. In this case, Phoenix Transmission's entire cost base – including the cost of debt – would be permitted, by Licence and applicable regulation, to be passed through to end-users.

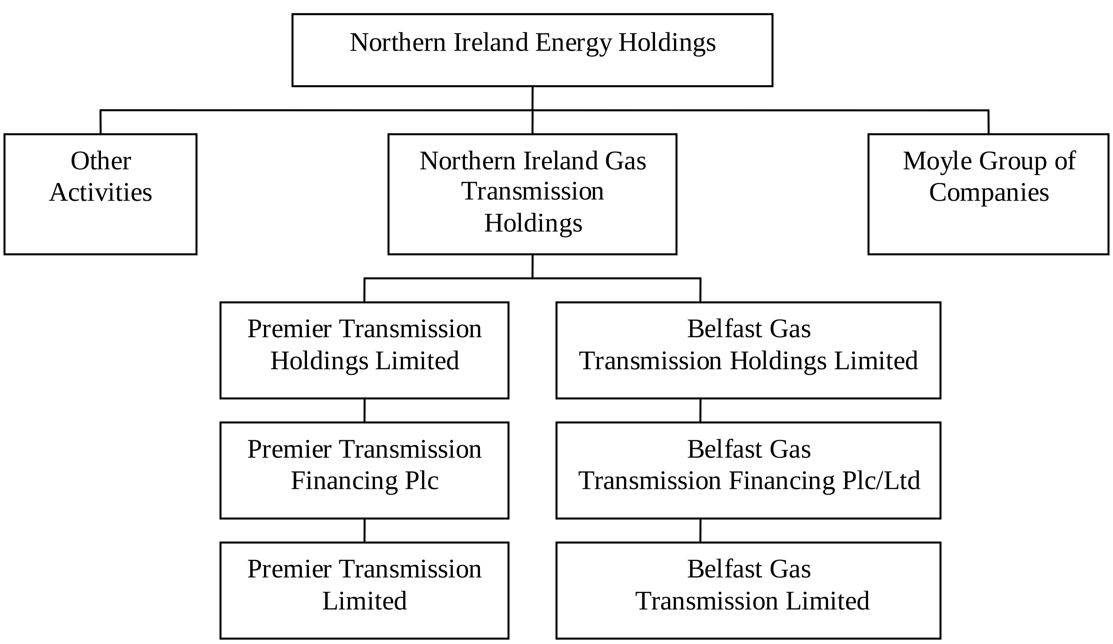
NIEH has no shareholders, it instead has "Members". These Members carry out many of the same functions as shareholders in a typical company. A further key difference with NIEH is that instead of operating for the purpose of returning a profit for the benefit of shareholders through dividends, its Members have the responsibility of ensuring that any profit/surpluses generated from the CLG's operations are used solely for reinvestment in the business, or, more specifically in this case, in reducing charges to consumers. Any profits/surpluses generated by Phoenix Transmission will be subject to a licence condition similar to PTL's licence condition 3.1.6 ('Approved Surplus Determination'). This ensures that the re-investment of surpluses is subject to Authority approval.

The corporate structure of NIEH is as follows:



When NIEH was set up, its Appointments Board appointed the Members, whose role is to act in a similar way to shareholders of an equity funded company. The Members in turn appointed the Board of Directors. The Members oversee the Board of Director's performance and the Board monitors and is responsible for management performance. Members are not entitled to receive dividends and, other than their liability to pay £1 upon a winding up of the company, have no financial interest in the company.

Any proposed purchase of Phoenix Transmission by NIEH would mean that Phoenix Transmission would operate within this corporate structure. Therefore in comparison to its current structure outlined in section 2, if NIEH were to acquire Phoenix Transmission then the 'position' of Phoenix Transmission within the NIEH structure would be as set out in the following diagram. As mentioned above, the existing Phoenix distribution and supply businesses intend to retain the 'Phoenix' band-name, and therefore, Phoenix Transmission would be renamed "Belfast Gas Transmission".



NIEH's subsidiary, Northern Ireland Gas Transmission Holdings Limited ("NIGTH"), would establish an SPV, Belfast Gas Transmission Holdings Limited ("BGTH"), which would be a wholly owned subsidiary of NIGTH. In order to meet the requirements of the financers (and consistent with the structure which was adopted for both Moyle and SNIP), BGTH would in turn establish a wholly owned subsidiary, BGTF, in order to raise the debt (either through an issue of bonds or through a commercial banking facility) which will be used to fund the purchase of Belfast Gas Transmission Limited ("BGTL"). BGTL will be a directly wholly owned subsidiary of BGTF.

It is therefore envisaged that NIEH's ownership of BGTL will be structured identically to PTL, in that PTL was acquired by Premier Transmission Financing Plc, a wholly owned subsidiary of Premier Transmission Holdings Limited which in turn is a wholly owned subsidiary of NIGTH.

5.0 Proposed Licence Structure

The mutualisation of Phoenix Transmission will require the grant of a new conveyance licence consistent with the structure of the acquisition and the requirements of a mutualised company. This matter has been discussed in our January 2007 consultation paper and our April position paper[3], where we outlined our proposal to use the current PTL conveyance licence as a template for the new Phoenix mutualisation conveyance licence with some amendments. The Authority still considers this to be the appropriate licence structure and will issue the statutory public notice for review should the acquisition go ahead.

The proposed purchase would require the Phoenix Transmission gas conveyance licence to be revoked in order to grant a new licence based on mutualisation arrangements. At this point it is envisaged that any other regulatory agreements, in terms of directions, etc., will closely follow the precedent set by PTL.

6.0 Proposed Operation of Phoenix Transmission Acquisition

Upon completion of the proposed acquisition by NIEH, the day-to-day operations of Phoenix Transmission, which are currently carried out by directly employed Phoenix staff located at the company's offices in Belfast, will be undertaken by the PTL staff located at the NIEH offices in Belfast. PTL has confirmed that, in the short term at least, no additional staff will be required to meet any additional work associated with the acquisition and operation of the BTP.

[3] "Sale of Phoenix Transmission Business" January 2007, and "Phoenix Transmission Licence: Utility Regulator Position Paper" April 2007.

The bulk of Phoenix Transmission's existing operations and maintenance activities are currently undertaken by service providers. In addition, certain IT functions and systems maintenance and development are also outsourced. The proposed acquisition by NIEH will have the potential to enable a streamlining of the number of contracts required for the operation of the NI transmission network, creating significant efficiency savings. For example, it may be possible to have only one Maintenance and Emergency Response Contract ("MERC") for SNIP and BTP, as opposed to one per pipeline.

The proposal to transfer the ownership of Phoenix Transmission into a mutualised corporate structure, and the associated financing, will have no impact on the postalised regime with the common tariff continuing to apply for designated pipelines. In fact, the presence of Postalisation provides for a large element of revenue security and will therefore be a condition precedent to closing the financing.

7.0 Risks and Benefits of Phoenix Transmission Acquisition to Northern Ireland Consumers

This section assesses the value in economic terms of re-financing Phoenix Transmission via a 100% debt financed CLG, weighed against the potential additional risks to consumers.

The benefits of the mutualisation of Moyle and SNIP have been substantial and have kept Northern Ireland energy prices lower than they would otherwise have been. Moyle's mutualisation in 2003, resulted in NPV savings to consumers of £19.0m as a result of the lower financing costs. Moyle has also operated since that date without requiring a contribution from NIE transmission customers to cover its costs. The mutualisation of PTL in March 2005 resulted in NPV savings of £41.5m, and has operated since mutualisation at 100% availability. Section 3 examines PTL's operational performance since mutualisation in some detail. The performance of the Moyle and SNIP businesses provides comfort that the 100% debt funded structure can work successfully.

The Authority's preliminary analysis has identified the following potential key benefits of the proposed acquisition of Phoenix Transmission:

- lower financing costs will be achieved, delivering a lower cost of capital;
- a more streamlined Northern Ireland Postalised Network due to there potentially being one less Network Code;
- reduced complexity for shippers because, if the proposed acquisition is successful, then SNIP and BTP will effectively be operated as one system and will therefore remove duplication; and
- Lower operating costs as there is potential for there to be fewer contracts (MERC, vendor maintenance, ALO, etc.), lower staffing costs, lower office costs, etc.

Against this, in a typical CLG, given the absence of profit-motivated shareholders, there is the concern that incentives for efficiency may be weaker than they would be, were the owners motivated by maximising profits, and this may lead to higher operational expenditures. The Authority oversaw the implementation of robust corporate governance arrangements for NIEH in 2005 after public consultation[4] and is content that the risk of higher operational expenditures has not manifested itself. We will ensure that the Phoenix Transmission licence will contain adequate provisions to ensure appropriate corporate governance similar to condition 3.2 of the PTL licence.

The Authority is committed to providing regulatory oversight of the NIEH group of companies to ensure that all aspects of the structure are performing satisfactorily. This will include initiating a review of the corporate governance arrangements of NIEH to ensure that they continue to meet GB best practice. It is crucial that this corporate governance structure is aligned to consumers' interest thereby ensuring the benefits from the acquisition are maintained and the potential savings from the proposed acquisition are maximised with the aim of protecting the interests of Northern Ireland consumers.

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i. Benefits

The amount of savings to consumers depends on the assumptions made for the alternative option, which is to maintain the status quo.

The NPV approach is the standard method for reducing future benefits to a present value. However this is a function of the discount rate chosen[5] and the inter-temporal distribution of savings that is the extension, if any, of the debt recovery period relative to the current capital recovery period in the Phoenix Transmission licence.

Savings are likely to accrue from two sources:

a. Capital Savings

Lower financing costs will be achieved, delivering a lower cost of capital which will lead, all other things being equal, to a substantially lower cost of gas transmission through the postalised system, in turn benefiting all gas consumers. As a benchmark NIEH's mutual structure enabled a cost of capital of 2.46% (real) to be achieved in the 100% debt-financed acquisition of PTL in March 2005.

4 "The Proposed Company Struture of Northern Ireland Energy Holdings: A Consultation Paper", July 2005.

5 The Authority's NPV analysis in this context uses "social time preference rate" to discount future benefits. Social time preference is defined as the value society attaches to present as opposed to future consumption. 3.5% is the UK treasury current estimate of the social time preference (Green Book). Using a 3.5% discount rate £1 benefit today is considered twice as valuable as £1 in 20 years or 4 times that in 40 years.

Under its current licence, Phoenix Transmission is entitled to recover its asset value until 2024. The rate of return is set at 7.5% real pre-tax until 2016, after which it can be set by the Authority pursuant to the licence. Given this allowed rate and the current level of long-term interest rates it should be possible to refinance at a considerably lower rate of interest, thereby achieving significant gains to consumers. As part of the 2006 agreement[6] it was agreed that the underlying asset value of the transmission asset was £95m. This figure will be adjusted at point of sale to take into account revenue received, additional capital expenditure, inflation and other factors. This will be subject to Authority approval but it is likely that the final asset value will be in the region of £97m.

The transaction costs associated with the acquisition are estimated to be approx £4m, including legal, technical, financial advisors, etc., and we estimate reserves to be £9m, which is a similar figure to PTL. These will also need to be funded from financing.

The estimated total amount of debt to be raised is made up as follows:

Opening Asset Value	£97m
Reserves	£9m
Transaction Costs	£4m
Total (excl. wrapping fee)	£110m
Wrapping Fee *	£2m
Total (incl. wrapping fee)	£112m

* Monoline fee is an annual charge which may be paid over time or as a one-off charge upfront (as the NPV of future payments)

If we examine the benefits from a gas industry perspective which compares the cost of the £95m financed at 7.25%[7] over 17 years compared to £110m at 2.5% over 35 years the NPV of the transaction equals £23.5m**.** As a sensitivity analysis, if we assume the market rate achieved by the bond is 3% and the appropriate counterfactual is 7%, this still results in NPV savings of £13m.

b. Operating Cost Savings

On top of these savings generated from funding the capital expenditure at a lower cost of capital, the Authority believes that there are further savings in operational expenditure from the proposed acquisition. We envisage a number of operating cost savings from the proposed acquisition:

- A more streamlined Northern Ireland Postalised Network due to there being a licence obligation to work towards the removal of a Phoenix Transmission Network Code. We believe that, if achieved, this will bring additional benefits to customers through reduced operational costs and will eliminate

[6] For further information see NIAUR Press Release of November 2006.

[7] This figure is an estimate of the average rate of return under the current licence which is set at 7.5% until 2016 and to be reviewed thereafter.

barriers to entry for suppliers to NI as they will have to sign up to one less code.
- Potential lower operating costs as there will be no need for two maintenance contracts, two IT systems, two sets of office costs, two land agents, etc. There will also be lower staffing costs as Premier Transmission will, at least in the short term, not be hiring more staff to cover additional work load associated with operation of Phoenix Transmission.

The current Phoenix Transmission operating costs amount to £1.2m, but some of this is made up of uncontrollable costs such as rates and licence fees. If we assume that savings from lower operating costs amount to £300,000 per annum this equates to an NPV to transmission consumers of £6m. The reduced size of the Phoenix group may partially offset some of this gain through reduced economies of scale feeding through to higher unit prices in the distribution business. However we feel that this will be significantly less than £300,000 per annum, and any such increase is offset by the inclusion of Phoenix 7 bar pipelines in the transmission RAB.

The immediate benefit of the proposed acquisition of Phoenix Transmission by NIEH as a result of the capital and operating cost savings outlined above will be seen through a reduction in the forecast Postalised Tariff for 2007/08. Based on preliminary figures we estimate that that the Phoenix required revenue will fall from £10.4m to £6m. This would reduce the forecast capacity and commodity charge for 2007/08 by circa 10%. Obviously the move from recovering revenue by 2042 rather than 2024 is going to benefit current customers to a greater extent. As discussed in section 8 below we believe that it appropriate for all generations who use to pipeline to pay for it.

ii. Risks

<u>Soft budget constraint on operational expenditure</u>

To improve the rate at which the proposed acquisition can be financed, as in the case of PTL, NIEH has proposed that the normal regulatory control over any allowed operational and maintenance expenditure accrued by Phoenix Transmission is removed. The financial markets are sensitive to the risk of regulatory intervention. The possibility of the Authority disallowing the CLG from recovering from consumers certain incurred costs is likely to substantially increase the cost of finance. Furthermore, if this possibility remained, Phoenix Transmission would be required to increase its available liquidity facilities and reserves, to protect it against any regulatory disallowance.

To prevent these additional costs being placed on the cost of acquisition, the Authority, as with the Moyle and SNIP arrangements, accepts the removal of standard regulatory control conditions over operational expenditure. The Authority believes that the resulting transfer of risk onto consumers, through potential inefficient costs, can be limited through corporate governance licence conditions, similar to PTL, and discussed in section 4 above. With most of the operations being out-sourced, the potential for significant inefficiencies will be minimal with appropriate procurement arrangements. The analysis in section 3 above also provides reassurance that the mutualisation model can operate efficiently.

The Authority will continue to monitor the performance of the mutualised companies in a transparent fashion to ensure public confidence in the arrangements. This will take the form of an ex-ante review of Controllable Operational Expenditure, similar to Condition 3.1.6 in PTL Licence. This review will be on the same basis as a Price Control for other gas conveyance licences and so will provide an important indicator of Phoenix Transmission performance under the new regime.

8.0 Funding of Acquisition

In order to comply with the Authority's requirements for the grant of a new licence, NIEH will need to demonstrate that it has made reasonable efforts to assure itself, and to demonstrate to the Authority's reasonable satisfaction, that it has accessed the lowest cost of capital available in the debt markets for the type of financing contemplated. As a result, NIEH asked RBC Capital Markets ("RBC"), its financial advisor, to analyse the cost competitiveness of a range of Bond and Bank loan options, using publicly available information and its knowledge as a market participant in the international debt markets.

The following assumptions were made by RBC regarding the credit:

Credit Parameter	Outcome Assumed
Leverage	100% debt funded
Credit Rating Achieved	'A' Category
Cash Liquidity Requirements	18 months debt service (total)
Minimum & Average ADSCR	2.00x
Adverse Regulatory Events	Cash trapping provisions

RBC reviewed three Bond and four Bank loan options across three different potential maturities, as follows:

Index-Linked Liabilities	Fixed Rate Liabilities
Unwrapped Bank Loan with swap	Unwrapped Bank Loan with swap
Wrapped Bank Loan with swap	Wrapped Bank Loan with swap
Wrapped Index-linked Bond	Wrapped Fixed Rate Bond
Wrapped Fixed Rate Bond with swap	

After discussions with RBC and after reviewing all options, the Authority is minded to support the following financial structure:

- Index Linked Wrapped Bond
  The wrapped bond market offers a liquid and competitive pricing solution for debt based on current market analysis. This analysis has taken into account wrapping and other costs.

- Tenor of 35-40 Years
  To ensure inter-generational equity, the Authority would like to match the tenor of repayments on assets with the lifetime of those assets. Sometimes this needs to be weighed against the increased costs of longer tenors. However in today's market the yield for long term debt is very competitive and so the Authority supports a longer term tenor than allowed for previous projects. A final decision will be taken closer to date of completion dependent on market conditions.

- Increasing Profile
  The Authority sees no reason to change the bond repayment profile from that agreed for PTL which was an increasing profile of approximately 2% per annum. This roughly matches increases in gas volumes and so ensures an equitable spreading of repayment costs for the asset.

9.0 Role of the Authority

The Authority's principal roles in the proposed acquisition of Phoenix Transmission can be summarised as follows:

- to revoke the current Phoenix Transmission Licence upon completion of the sale of the Phoenix Transmission company;

- to issue a new conveyance licence to Phoenix Transmission, incorporating conditions consistent with the requirements of both Postalisation and the financing, including a minimum expiry date reaching beyond the end of the financing period that is finally adopted;

- to review and approve the financing structure proposed by NIEH and RBC, with particular regard to the quantum and deliverability of consumer savings; and

- to continue to monitor NIEH to ensure the relative incentives are in place for the management of Moyle, SNIP and BTP.

10.0 Timetable

It is envisaged that complete transaction sale will be finalised by the end of September. This will require the granting of a new conveyance licence by the Utility Regulator and the revoking of the existing Phoenix Transmission conveyance licence. Should the Utility

Regulator decide to proceed, the public notice for the granting of the conveyance licence will occur towards the end of July.