# A RESPONSE TO:

## NIAER Consultation on:

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

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## Introduction

The Economic Research Institute of Northern Ireland (ERINI) welcomes the opportunity to comment on the Northern Ireland Authority for Energy Regulation (NIAER) Consultation. The document provides some information about the arrangements between NIAER and Phoenix Natural Gas but the latter in their response have put into the public domain a much greater volume of data relevant to the consultation including an annotated version of the modifications to their licence 'agreed' on 26 August 2004 which the NIAER now wish to revisit. In commenting on these matters it is not ERINI's intention to interpose itself in a dispute between the Regulator and Phoenix. Ultimately, it is the responsibility of the Regulator to determine the nature of the licence for a regulated utility and to defend its decision against challenge. No consultation can detract from that duty. ERINI's purpose is to analyse and challenge policies and actions that impinge on the public good. ERINI has also taken this opportunity to comment on the development of the natural gas industry in Northern Ireland and its regulation.

## Background

The natural gas industry in Northern Ireland is almost ten years old. It is an unusual industry in the sense that it has been driven by a tacit partnership between Government and the private sector rather than by market forces alone. The gas pipeline to Scotland (SNIP) upon which the entire industry has been dependant was an offshoot of the privatisation of the local electricity industry and was subsidised. More recently, the Northern Ireland Executive authorised an overt subsidy to extend the gas network to the North West and for a North-South pipeline to connect with the natural gas network in the Republic of Ireland. The same project effectively received a less transparent subsidy through the introduction of postalised charges. This means that the same price is charged no matter where on the network the supply is taken from. Thus, high cost consumers are subsidised by low cost ones having to pay more than is necessary for their gas. The twist is, that among the subsidisers are power stations who pass on these costs to electricity users. Thus, electricity consumers in, for instance, Fermanagh, who will probably never have an opportunity to use natural gas, effectively subsidise gas users elsewhere in Northern Ireland. Of the industry's 80,000 or so customers, some 24,000 are public sector Housing Executive properties. In short, this is an industry that Government has gone to considerable lengths to nurture and to protect in contrast to, for example, the oil business which has been given no support and which has lost customers to natural gas. The justification for this favourable treatment is the perception that natural gas has social economic and environmental benefits above other fuels and the industry, as an infant creation, needs protection to get established.

This is the general background against which the specific issue of the Phoenix Natural Gas licence should be viewed and it is one to which we will return later.

**Phoenix Natural Gas Original Licence**

Because it makes use of an expensive network that would be uneconomic to duplicate, many of the aspects of supplying natural gas emulate a 'natural monopoly' with only one firm occupying the market. The activities of that firm, which in Northern Ireland has been Phoenix Natural Gas, are regulated by means of a licence. The licence has to balance the need for the fledgling industry to invest and attract customers so that it can earn a return with the need to protect existing customers from excessive prices. The provisions given to Phoenix were based on a monopoly position for 20 years and included:

- An 8.5% real return on the asset base;
- The capitalisation of early years losses into the asset base;
- The opportunity to earn additional money through capital and operating savings as well as expanding the customer base beyond forecasts.

This was a generous arrangement by UK standards but it had two consequences. The first was an artificial inflation of the asset base on which returns could be made. By 2003 the base stood at £351 million, some £63 million more than Phoenix had actually invested. The second was the need for Phoenix to expand its customer base quite rapidly in order to have a reasonable hope of recovering its investment (at 8.5%) by 2016.

By 2004 it had become clear that Phoenix was most unlikely to meet the target of 2016 for recovery of its investment. At the same time Phoenix had, itself, been taken over by East Surrey Holdings (ESH) one of its minority shareholders in December 2003. This acquisition was approved by the Department of Enterprise Trade and Investment (DETI).[1] Almost immediately after the acquisition the new owners of Phoenix pressed for a large increase in gas prices for consumers to meet demands for higher charges from Phoenix's gas supplier, Centrica.

Negotiations between NIAER and Phoenix on revisions to the licence had started as early as 2002 but had not reached any conclusion. They are now reopened with greater urgency against the background of these new pressures.

The agreement, in principle, that emerged from these discussions consisted of:

- extending the life of the Regulatory Asset Base for Phoenix from 20 to 47 years to allow it to recover its investment;

- a reduction of the value of the asset base which, nevertheless, still left it well above the actual investment by Phoenix;

- an agreement that a proportion of the assets relating to the gas transmission system and valued at about £100 million would be mutualised, ie transferred to a not for profit company and refinanced by means of debt rather than equity with savings to the consumer;

[1] We understand the Regulator's views on the due diligence scrutiny of the purchaser was not sought by the department. It was of course within the Regulator's powers to seek much the same information from ESH as would be available in a due diligence but it is nevertheless curious and regrettable that the two bodies responsible for the natural gas industry could not share such information.

- a reconfirmation of the allowed rate of return, distinguishing between distribution assets (8.5% return) and transmission assets (7.5%); as well as movement from returns on the asset base to returns calculated on the equity of the company (the latter is barely described in the consultation document but may be similar to the US concept of putting a cap on the amount that can be taken from the company through the remuneration of equity).

Although this was a complicated deal the NIAER, judging by their press release of 26 August 2004, seemed satisfied with what had been agreed in principle. The new arrangements were simultaneously celebrated by the DETI Minister, the General Consumers' Council and Phoenix.

**The Kellen Acquisition**

Kellen announced its offer in April 2005. Since ESH has more than Phoenix as assets it has been necessary to infer some portion of the bid to the Phoenix assets. NIAER believe that regardless of how this is done the result seems to be a significant premium on the price ESH paid for Phoenix which the NIAER believe was £240 million. The premium implies that the purchaser is content that on their assessment of the risk inherent in the business a lower rate of return than that agreed with the Regulator would be acceptable. In turn this implies that the deal with the NIAER which the purchaser is aware of has de-risked the business to an extent which is out of line with that justified by the rate of return allowed by the deal.

In light of this information the NIAER now seeks comment on a range of steps it is minded to take in revising the licence agreement with Phoenix, including:

a. downward revisions of the allowed rate of return that Phoenix can earn on its asset base;

b. steps to ring-fence the operation and financing of Phoenix from the rest of the business that will be acquired from ESH;

c. restrictions on the dividend policy of the acquiring company to protect the natural gas industry in Northern Ireland;

d. requirements for the acquiring company to provide the Authority with information that might be pertinent to the future of the natural gas industry in Northern Ireland.

**Comments on the Specifics of the Consultation**

The purpose of having a Regulator is to emulate as far as possible by administrative means, the conditions that would pertain in a competitive market when this is not achievable because of the nature of the industry. A relevant factor is therefore to ask how hypothetically a competitive market would have treated Phoenix had it reached the same state as existed when it first sought revisions to its licence. The answer is, of course, that the market would not have treated the company generously. The business plan upon which Phoenix launched in 1996 was, for a variety of reasons, unlikely to be fulfilled and the market would have reacted accordingly. The regulator took the view that this should not happen for reasons that no doubt seemed valid at the time but the agreement that followed was based on best estimates rather than firm market information because the latter was not available. New information has now become available which is market related and appears to vitiate the assumption underpinning the agreement between Phoenix and the NIAER. That at least is the argument that the NIAER are now making. This in turn is disputed by Phoenix as a partial and biased presented of events.

It is an established fact in the world of utility regulation that the company being regulated always knows more about its business that the regulator. It is also inherent in these ‘principal / agent’ relationships that the company has an incentive to seek advantage (rent) through persuading the regulator to take a more generous view of its licence arrangements. NIAER are well aware of both of these problems and the need consequently to approach any licence negotiation with caution and a healthy scepticism of any information it acquires. On the other hand NIAER has imposed upon it an obligation to support the development of the natural as industry in

Northern Ireland. Striking a balance between these responsibilities when working with limited information is a difficult task. However, the NIAER has a duty to take account of the best information they can obtain when considering the granting of a licence that confers a monopoly for a period of almost 50 years. Northern Ireland has bitter experience of the costs of entering into legally binding long-term energy contracts on information that is flawed. To the extent, therefore, that the arrangements agreed on 26 August 2004 are not already legally binding prudence suggests that the NIAER are entitled to revisit this agreement.

The other balancing factor that the NIAER will need to take very serious account of in deciding how to proceed is the effect of their actions on regulatory risk. Investors in sectors of the economy that are subject to regulation are acutely sensitive to the prospect of the regulatory regime becoming unstable. If they cannot plan with confidence on regulatory decisions holding for a reasonable period of time they will seek a premium on the rate of return to compensate for this risk. In some cases investment will be withheld if the regulatory regime is thought to be too unstable. The NIAER will, therefore, need to weigh the consequences of reopening negotiations on the Phoenix licence both for existing customers and future investors in the industry.

Beyond these obvious points it is difficult to go further. The NIAER consultation paper presents the Authority's view of what has transpired but there will almost certainly be other views and further information relevant to this matter that has not been disclosed. Indeed, it is difficult to read the NIAER paper without some suspicion that the Authority feels it has made an error in agreeing, even provisionally, to the amendments to the Phoenix licence and now wishes to recover from that position with as much public support as it can muster.

**General Comments on the Development of the Natural Gas Industry**

Although it is still a very young industry, natural gas in Northern Ireland is now moving beyond an infant status. In order to give it a fair wind the industry has been accorded an elevated status by government and supported by a range of measures including subsidies and a statutory obligation to promote its growth. The problems with Phoenix and the passage of time suggest that this would be an opportune moment to take stock of what has been achieved in terms of benefits for consumers, the economy and the environment from this policy and the costs that have been incurred in pursuing it. Specific aspects of support for the industry have, of course, been subject to standard appraisal requirements though the results have never been published. To our knowledge, however, there has not been a comprehensive appraisal of the industry in the round. As the industry heads towards its second decade now would be a good time to start such work. ERINI would be willing to assist both DETI and the NIAER in this task.