The Proposed Acquisition of East Surrey Holdings plc

By

Kellen Acquisitions Limited –

Implications for Phoenix Natural Gas Limited

Response by Phoenix Natural Gas Ltd to the Consultation Paper Issued by The Northern Ireland Authority for Energy Regulation

13th June 2005

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1 Response by Phoenix Natural Gas Ltd to the Consultation Paper Issued by The Northern Ireland Authority for Energy Regulation

May 2005

In May 2005 the Authority published a consultation document on this issue and invited comments on four questions. Phoenix is writing in response to this consultation document. In particular, we are extremely concerned about the second question of whether the agreement reached with Phoenix in August 2004 should be reconsidered in the light of the Proposed Acquisition.

Phoenix does not believe that the Proposed Acquisition raises any implications for the 'Regulatory Agreement' reached with the NIAER (the 'Authority'). Furthermore, Phoenix believes that the Authority knows this to be the case and regardless of this has gone ahead and published what we consider to be a misleading document and appears to us to have accordingly pre-briefed the media and politicians.

As one of the largest major private investors in Northern Ireland, Phoenix, following the approach of Kellen, felt it was self-evident that Terra Firma's involvement would be good for the long-term development of gas in Northern Ireland. The greater access to capital that this move will facilitate should provide a stronger local base for the further development of Phoenix and the gas sector in Northern Ireland. This in turn will benefit consumers, the local economy and create jobs. To date around 4,000 jobs have been created as a result of Phoenix's investment in, and development of, the gas sector.

The New Regulatory Agreement

The new Regulatory Agreement was implemented in September 2004 and is binding on Phoenix and the Authority. It has been the basis of gas prices to customers in Phoenix's Licence area and Phoenix's new investment since 1st October 2004. A copy of the Regulatory Agreement is attached with each of its components annotated to show the status of its implementation.

The Regulatory Agreement reached by Phoenix and the Authority on 26th August 2004 reduced the distribution charge element of gas pricing by 47%. This has led to a projected saving for gas customers' distribution charges of £270m (in current prices) between now and 2016, savings that are already being realised by gas customers and have been since 1st October 2004. Overall the new Regulatory Agreement has had the effect of reducing the price of gas to domestic customers by approximately 20%.

There remains a responsibility on the Authority to ratify the Licence amendments that Phoenix has been operating under since 26th August 2004. It is the company's understanding that all of the lengthy technical work required to complete this final stage of the implementation has been completed and legally agreed, and it believes that ratification has been delayed by the Authority to create an impression that the Regulatory Agreement is not finalised or binding.

Mutualisation and cost of equity

The Regulatory Agreement includes a commitment by Phoenix to the mutualisation of its transmission asset. Phoenix has in recent weeks repeatedly and in writing given the Authority assurances that it will fulfil this commitment. The Regulatory Agreement on mutualisation recognises that the key element in determining the timescale for mutualisation is whether or not the sale of the asset to the mutual company will give rise to a tax charge. This tax issue is currently under joint close scrutiny by the Authority and Phoenix.

The benefits to customers of early postalisation have been recently projected at £30m. This compares to an immediate potential tax liability in the order of £40m. This highlights the significance of obtaining clearance for the appropriate tax avoidance scheme before implementing mutualisation. It is our understanding that the Authority agrees with

Phoenix that there is no point pursuing early mutualisation if the result is higher, rather than lower, charges to customers.

Under the Regulatory Agreement Phoenix also *"agreed to look at the possibility of a move to return on equity"*. Return on equity is not a concept used in any of the UK regulatory regimes for utilities and we are not aware that it is used anywhere in the world in relation to a non-mature utility like Phoenix. Therefore it presents difficulties both with regard to its acceptance by the providers of both debt and equity finance, and how it would work in practice within the UK regulatory model. It is a demonstration of Phoenix's commitment to customers, and its willingness to innovate, that it is prepared to explore this challenging subject with the Authority.

In its document, the Authority asks whether the above two matters can be completed before Kellen's acquisition and if not, whether they should be reflected in licence conditions. It also suggests that Terra Firma may take a different view to Phoenix on these matters. We find these unnecessary questions. Firstly, because these are complex matters with extended timescales already agreed with the Authority. Secondly, because Phoenix has informed the Authority in writing that it is happy for these terms of the Regulatory Agreement to be reflected in amended licence terms. Thirdly, because Terra Firma has confirmed its total commitment to the Regulatory Agreement to the Authority. Given these facts, it is difficult to understand why the Authority has raised these issues.

Premium to Regulatory Value

In its document the Authority comments on the value of Phoenix as part of Terra Firma's offer for ESH and the amount paid for Phoenix by ESH. It divides this difference between the amount paid and the Regulated Asset Value ("RAV") included in the Regulatory Agreement and the premium Terra Firma paid to RAV.

Any suggestion that value was created by the new regulatory Agreement is a fiction. The reality is that Phoenix surrendered a significant amount of value (approximately £60m) in the move from its original licence to the new Regulatory Agreement, which in large part represents the cost to Phoenix and ESH's shareholders of delivering the 47% reduction in the distribution price cap under the new Regulatory Agreement. The increase in the value of Phoenix during its ownership by ESH is as a result of ESH's investment in Phoenix since its acquisition of the business and

ESH's ability to negotiate an attractive price at the time it acquired the majority of Phoenix.

As regards any premium to RAV which may have been attributed by Terra Firma, in its document the Authority estimates this to be £43m and also invites Terra Firma to disprove the Authority's assumption that a material premium was paid. We have serious concerns about these statements because we believe important and relevant information has been omitted from the Authority's document.

Firstly, we are aware that Terra Firma on 15 April 2005 in London provided Messrs McIldoon and Lehmann with a breakdown of the commercial valuation (in confidence) and how it had arrived at its offer. We believe this breakdown showed a significantly smaller premium than £43m. This information was not challenged at that time, nor do we believe since. Therefore we are at a loss to understand why it has been ignored. It appears to us that the Authority has used an artificial and contrived number.

Secondly, the value of any regulated utility is a combination of its RAV and the Cost of Capital applied to the RAV. Phoenix's were negotiated as a pair in arriving at the Regulatory Agreement. It is disingenuous of the Authority to comment on them separately because to do so takes each out of its context and gives each a significance that it does not have.

Towards the end of Phoenix's negotiations with the Authority there were explicit negotiations as to whether, for presentational reasons, the combination of RAV and cost of capital should be flexed, and a range of costs of capital for 8.5% down to 7.9% with correspondingly higher RAVs was actually tabled (that is, a series of combinations of RAV and cost of capital which attribute the same value to Phoenix and result in the same gas distribution charge to customers). In the event it was the Authority that opted for the combination including a cost of capital of 8.5%.

The relevance of a range of combinations is that depending on what cost of capital is opted for the RAV, and therefore the premium to RAV, changes (in fact, a cost of capital sufficiently below 8.5% will produce a discount to RAV rather than a premium). In these circumstances, it is also entirely wrong for the Authority to query a cost of capital of 8.5%, particularly when it was the Authority itself that opted for 8.5% rather than a lower figure, and which in turn would have resulted in any alleged premium to RAV being significantly reduced.

Our concern is that the Authority omitted the above information because it undermines its arguments and the picture it is trying to present in its document.

The potential impact of the Authority's document

Phoenix sees the Authority's document as an attempt unilaterally to abandon a 40-year long-term agreement only months after it was concluded. Phoenix wonders if the Authority has given any thought to the impact its action could have on confidence in Northern Ireland, or what a dangerous precedent and disincentive its actions could have on future investment in Northern Ireland and not only in the gas industry.

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2 Annotated copy of 'Agreement' letter dated 26th August 2004 indicating status of implementation

26th August 2004

Richard Rodgers
Phoenix Natural Gas
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Dear Richard

Proposed New Regulatory Agreement

Outlined below are the key components of a new regulatory agreement between Ofreg and the Authority, which I hope reflects the discussions at our meetings on 29th July and 3rd August along with subsequent discussions. Apart from the amendments necessary to implement this Agreement, the Licence will remain unchanged.

As noted in Ofreg's previous letter of 28th May, Phoenix and the Authority are both agreed that our objective must be to create the conditions which will allow Phoenix to grow rapidly to at least the extent envisaged when it was established in 1996 and preferably to surpass those expectations by winning more customers than then anticipated in the licence area and by extending its activities into adjacent areas. We are also agreed that the key to success must be affordability and long-term price stability being so effectively enshrined in the new arrangements as to remove any grounds that may exist for scepticism on the part of existing or potential customers.

Key Components of Agreement:

- Moving to a forty year Regulatory Asset Base (RAB) starting 1st Jan 2004 with existing investment depreciating over forty years and future investment depreciating over the forty years which elapse from the time of making the investment – except of course for investments which have a much shorter economic life.

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

- An Opening Asset Value (OAV) of £139.57m (1stJan 04 discounted back to 1996 at 1996 prices) is agreed; this translates to a value of £294.77m on 1st Jan 2004 (Dec 03 prices).

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

- Starting on 1st Jan 2007, 5 year reviews of opex, capex and volumes. The rate of return fixed until 31st Dec 2016 with 5-year reviews thereafter.

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

- Agreement by Phoenix to mutualise transmission as soon as is feasible for up to £50m net of all taxes (1996 valuation). (£105.60m at 1 Jan 2004, Dec 03 prices) In the meantime (and in the absence of mutualisation) a Transmission Asset Base (TAB) of £36.15m (this translates to a value of £76.35m on 1st Jan 2004 (Dec 03 prices)) put into the postalised pot to be recovered by 2024 at 7.5% (real pre-tax) to 30th Sept 2016 and for Oct 2016 to Oct 2024 the cost of capital to be determined at formal review. The value of the TAB to be mutualised will be based on an annuity over 20 years on £36.15m (96 prices) plus £13.85m (96 prices) depreciated over 40 years from 1 Jan 2004. The initial Annual Required Revenue (ARR) is calculated on the basis of 7.5% to 2024. (A side letter on mutualisation and the ARR value to be sent from Ofreg – attachment 1.)

COMPLETE - since 1st October 2004, transmission revenue is being recovered at the Agreement reduced return of 7.5% on the Agreement Transmission Asset Value.

IN PROGRESS - mutualisation is in progress. Working to agreed timescales as per Dermot MacCann's letter of 4th March 2005, subject to no tax charge arising. Route to seek tax clearance has been agreed.

- Distribution £103.42m (this translates to a value of £218.42m on 1st Jan 2004 (Dec 03prices)) at 8.5% (real pre-tax) up 31st Dec 2016 and thereafter cost of capital determined at formal review.

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

- Ofreg will review the weightings attributed to P_1, P_2, P_3 and P_4, as it is believed that the current P_3/P_4 weightings should be increased.

IN PROGRESS - these weightings will be derived once the Licence Formula Condition is finalised.

- Phoenix has agreed to look at the possibility of a move to return on equity. It is believed that such a move has the potential to reduce the effective cost of capital. (A side letter on this to be sent from Ofreg -attachment 2).)

PENDING – it has been agreed with Dermot MacCann that discussions with shareholders on the possibility of a move to Return on Equity cannot be started until the final amended Licence is available.

- Phoenix will aim through a new distribution formula to achieve a long-term distribution price cap from 2007 onwards of no more than 21.76p (September 2003 prices for P1 and September 04 prices for 5p adjustments) for domestic customers based on the following adjustment to the long-term price arising from this agreement.

Long-term Price Current Agreement (P1)	26.76 p
Less P3/P4 adjustment	-3p
Less out- performance	- 2p
Total	21.76p

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

Achievement of mutualisation could reduce the 21.76p cap by a further 2p with the potential for further reductions from a move to return on equity. The P1 price of 26.76p above is based on adjusted regulatory weights from the 2002 price review of: - P1 1.218, P2 1.008, P3 0.467 and P4 0.407.

To the extent that the 2p out-performance anticipated post-2007 does not occur, Phoenix will take the risk on this up to 31st December 2016 . Ofreg see this as a quid pro quo for their foregoing the standard 5-year review of the rate of return until 2016. Any further out-performance by Phoenix in the period 2007-2016 will be shared between customers and Phoenix on a 50/50 basis with the benefits being reflected in the amended price caps derived from the planned reviews commencing Jan 2012 and 2016. The test as to whether the 2p out-performance is achieved will be as set out in Richard Rodger's letter to Dermot MacCann on 26 May 2004 and this will inform the re-forecasts in 2007 price review.

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

The intention is that in the gas year October 2005 to September 2006 Phoenix's distribution charges will be based on the long-term price cap.

- In order to smooth in price increases, the domestic price of gas for the gas year October 2004 to September 2005 will be mid-way (in real price terms) between the current price and Phoenix's current estimate of the domestic price of gas for the year October 2005 to September 2006.

COMPLETE – this was the approach taken in setting October 2004 tariffs.

- Phoenix will provide a set of forecasts up to 2007 for the regulated costs portion of the domestic tariff.

COMPLETE – this has been done.

- It is accepted that there is likely to be some under-recovery in the period up to 2007 (arising from anticipating the 2p reduction post-2007 or not charging to the Pt cap). Any under-recovery will be offset by 50% of out-performance achieved in the period 2004-07. Phoenix estimate out-performance of £9m in the period 2004-07- opex of £6.5m and volumes of £2.5m. Any under-recovery (over-recovery) will be rolled forward at the 8.5% rate of return and added to (subtracted from) the RAB in 2007. Post 31st Dec 2006 there will be no under-recovery (apart from inflation error adjustments) allowed. Any over or under-recovery will accrue interest at the rate of return, but will normally be recovered through adjusting prices in the following year.

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

- While there is need for further discussion on the detail, Ofreg are willing to accept a delay until 2007 in the introduction of supply competition for the domestic sector in order to allow the Phoenix supply business to continue to operate on a 'no profit/no loss basis'. This however is subject to agreement by DETI.

IN PROGRESS – public consultation on revised timetable is expected this summer.

- Ofreg and Phoenix will agree the technical details of the RAB model. Ofreg have developed a model that is designed to be consistent with the proposed new licence. It differs from the Phoenix model in minor ways. However it is Ofreg's view that both the Ofreg and Phoenix models produce the same long-term price caps.

  The formula will explicitly incorporate at each review the economic value of setting a deferred price profile in earlier control periods. This deferred price profile recognises that some costs in earlier periods need to be recovered in later periods. The present value, at the Distribution cost of capital, of such deferrals will be added to the depreciated asset value at each review.

  As a check at each Price Review short-term (5-year) and long-term (40-year) price caps will be calculated. The annual shortfall between the short-term and long-term price caps will be added to the year-end RAV and rolled forward at the Distribution cost of capital.

IN PROGRESS - 'Final' legal comments have been provided by Phoenix. Model and formula are ready for final sign-off.

- Ofreg accept Phoenix's proposal to re-allocate some opex from supply to distribution. This has the effect of reducing domestic gas prices in the short-term. Based on the agreed cost per customer in the current price control the allowed expenditure for incentives will be based on actual rather than forecast expenditure. We have agreed that adjustment for the time value of an underspend should be made at the next review.

COMPLETE - implicit in calculation of domestic tariff price from 1st October 2004.

- Ofreg agree to the increase in the forecast capex in 2004-07. The allowed expenditure will be based on actual rather than forecast spend. We have agreed that the adjustment for the time value of an under-spend should be made at the next review.

COMPLETE – an adjustment will be calculated at the end of 2006.

- Ofreg agree to move to a regulatory year ending 31st March subject to satisfying itself that the adjustment with respect to the one month lag in incomes is appropriate. If agreement can be reached on this matter, the year-end will become March with the above figures adjusted accordingly.

COMPLETE - it has been agreed that the regulatory year is to stay as per existing Licence.

The net effect of this deal should be in time to reduce distribution costs by 5.1p below what is currently being collected by Phoenix at the current selling price of 60.9p. Furthermore it aims to achieve a long-term distribution price cap for the tariff sector around 21p below that allowed by the current licence. It should provide, hopefully, sufficient headroom to allow Phoenix to move towards charging the market price for gas both in the short and longer terms while keeping final retail prices to consumers competitive.

Ofreg intends to produce the modified draft licence conditions by 31st October 2004.

Yours sincerely

Dermot MacCann
Deputy Chief Executive

3 NIAER Press Release 26th August 2004

niaer
NORTHERN IRELAND AUTHORITY
for ENERGY REGULATION

Press Release

NIAER AND PHOENIX REACH A DEAL ON LICENCE

Speaking on behalf of the Northern Ireland Authority for Energy Regulation, Dermot MacCann, the Deputy Chief Executive of Ofreg, said

‘ The Authority sees the agreement with Phoenix as good for both gas customers and Phoenix. It provides more stability than previously on that part of the customer’s final bill, which is regulated by the Authority. For domestic customers this is over 50% of the final bill. The remainder of the bill reflects the cost of gas purchased by Phoenix and this to a large extent reflects movements in the market price of gas, which like oil and coal can go both up and down.

On that half of a customer’s gas bill which is regulated the Authority has agreed a long-term price for domestic customers just less than 5p per therm (or 12%) below what Phoenix are charging today and some 20p per therm less they were entitled to charge under their current licence. The Authority envisages prices on the regulated part of the bill rising by no more than inflation and indeed, with the potential for efficiency improvements and other downward pressure on prices built into the agreement with Phoenix, it sees potential for increases of less than inflation if not decreases.

On that part of the bill which reflects gas purchase costs by Phoenix the Authority would envisage gas prices in Belfast remaining competitive with other fuels. In the short-term Phoenix’s recent deal with its gas supplier Centrica and in the longer term a fully competitive gas supply market should ensure that this happens. Furthermore the Authority sees the reductions agreed with Phoenix on the regulated part of the bill helping to moderate any future price rises resulting from the current high market price of gas.’

Notes

1. OFREG (the Office for the Regulation of Electricity and Gas) supports the Northern Ireland Authority for Energy Regulation (NIAER) the regulator of the Electrcity and Gas industries in Northern Ireland. NIAER's powers are derived from the Electricity (Northern Ireland) Order 1992, the Gas (Northern Ireland) Order 1996 both as amended by the Energy (Northern Ireland) Order 2003.

2. For further information please contact Alanna Riddell or Conall McDevitt at Weber Shandwick telephone 028 90761007 or 07770886933.

Department of Enterprise, Trade and Investment
www.detini.gov.uk

News Release

26 August 2004

DEAL STRUCK BETWEEN PHOENIX NATURAL GAS AND NIAER IS GOOD NEWS FOR NORTHERN IRELAND SAYS GARDINER

Economy Minister, Barry Gardiner, today welcomed the new licensing arrangement agreed between Phoenix Natural Gas and the NI Authority for Energy Regulation (NIAER).

Under the deal, Phoenix Natural Gas has extended its licensing arrangement with NIAER, from 20 to 40 years.

Mr Gardiner said: **"I welcome the announcement by Phoenix that it has reached an agreement with the NI Authority for Energy Regulation on the company's long term licensing arrangements. This is good news for gas consumers in Northern Ireland and provides the basis for greater stability in our growing natural gas industry.**

"Recent substantial price increases in global energy markets impact on us all, but this agreement helps to mitigate these effects and thus create a more stable foundation for capturing the economic, social and environmental benefits of natural gas in Northern Ireland.

"Combined with the recently announced settlement between Phoenix and Centrica on their wholesale gas supply contract, which resulted in the withdrawal of the company's proposed 20% price increase, this latest licensing agreement provides the basis for competitive,

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transparent and sustainable gas pricing arrangements in Northern Ireland for the foreseeable future.

“I congratulate both Phoenix Natural Gas and the NI Authority for Energy Regulation for their diligence, tenacity and effort in making this deal possible.”

NOTES TO EDITORS:

For further information please telephone DETI Press Office on
028 9052 9263.

5 GCC Press Release 26th August 2004

News Release…. News Release….

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25 August 2004

gas agreement can provide framework for a fair deal says consumer council

The General Consumer Council has welcomed today's news that the Northern Ireland Authority for Energy Regulation (NIAER) and Phoenix Natural Gas (PNG) have reached agreement on the future of the gas industry in Greater Belfast.

In July this year, PNG agreed terms on wholesale gas costs with its supplier, Centrica, which resulted in the proposed 20 per cent in year increase being withdrawn – a move widely welcomed by consumers and their representatives. This new agreement with the Regulator is the final part of a complete package that will bring more price stability for consumers.

Eleanor Gill, Chief Executive at the Council said: "We welcome this long term agreement which will provide consumer confidence in gas, now and in the future."

"The potential now exists to move forward with transparent and sustainable gas pricing. The next step will be to assess exactly how the deal will affect people's pockets. Although gas consumers will always be subject to fluctuating wholesale gas costs, the half of the bill which can be regulated will now be stable and should enable the lowest possible price to the gas customer."

"The Consumer Council believes that a growing, strong and sustainable gas industry here is vital, not only for domestic consumers, but also for the economy in general. The Council commends the work of both parties in achieving a long-term agreement."

PNG will review their tariffs in October. The Council is meeting with all parties involved including PNG, the regulator and the Department of Enterprise, Trade and Investment to ensure that future gas pricing policy and its implementation is in the interests of consumers.

ENDS

1. General Consumer Council media contact: Susie Brown, telephone, 028 9067 4807 or 07776 198226 or e-mail, susie.brown@gccni.org.uk
2. The General Consumer Council is an independent consumer organisation, working to bring about change to benefit Northern Ireland's consumers. The Council campaigns for high standards of service and protection and a fair deal for all. It also carries out research, gives advice and publishes reports and other publications. It deals with individual complaints about electricity, natural gas, coal and passenger transport.
3. For more information, visit our website at www.gccni.org.uk