Utility Regulator
ELECTRICITY GAS WATER

Information relating to the

Phoenix Distribution Price Control Review 2007 – 2011

Final Determination

Contents

Phoenix Natural Gas – Price Control Determination

Under Article 7 (1) of The Energy (Northern Ireland) Order 2003 the Authority hereby publishes information in relation to the third Phoenix Distribution Price Control Review.

1.1. Introduction & Background

The principle objective of the Utility Regulator is to promote the development and maintenance of an efficient, economic and co-ordinated natural gas industry in Northern Ireland. A fundamental part of this process is a five yearly review of the distribution operator's allowed revenues for operating, maintaining and growing the distribution network safely and efficiently. Phoenix Natural Gas Ltd ("PNG") has a conveyance licence[1] to operate a distribution network in the Greater Belfast and Larne areas and the costs in this report relate to those allowed under that licence.

In November 2006 the Utility Regulator and PNG finalised a regulatory agreement to facilitate a stable future for the growing gas industry in Belfast allowing the recovery of revenues over the next 40 years. Key aspects of this agreement were to agree the RAV[2] (including historic out performance, deferred capex and under-recovery), extend the recovery period from 20 years to 40 years and reduce the rate of return from 8.5% to 7.5%.

This price control represents the 3rd regulatory review that has been undertaken for PNG and will form the basis of distribution charges to be applied during the period 2007 – 2011 to all gas supply companies wishing to use the PNG Network. It is important to note that Phoenix Supply Ltd is undergoing a supply price control that will set a maximum retail price for all tariff customers in the Greater Belfast area.

Determination values relating to PNG's capital/operational expenditure as well as volume forecasts have now been derived and will be used to calculate the revenue that PNG will be able to recover over the next five years. These allowances are intended to allow PNG to operate and maintain the distribution network safely and efficiently and achieve the growth indicated by approved volumes and connections. It should be noted that the final determination includes a number of reviews that will ultimately impact on the values outlined in this document. If PNG disapply the additional reviews, we will ensure that any referral to the Competition Commission will include the whole package of Determination Values.

1.2. Form of Regulation

During the review, PNG proposed a move from the current mechanism whereby it is incentivised to maximize volumes in order to maximize distribution revenues ("weighted average revenue yield") to one where allowed distribution revenues are capped and a correction mechanism to reconcile revenues as a result of differences between actual and forecast volumes ("fixed revenue control") is introduced.

---

[1] On 1st January 2008 the licence was assigned to Phoenix Distribution Ltd.
[2] Regulatory Asset Value

This proposal has been accepted and it has been decided that over-recoveries of revenue will be rolled forward and given back to customers at the 7.5% rate of return currently specified within the PNG licence. Under-recoveries will be rolled forward at the base rate plus 1.5%.

As this new regime represents a significant reduction in risk to PNG (as the full recovery of costs will no longer be dependent on achieving the volume targets) a connections incentive mechanism is to be developed which will have the dual aim of incentivising the further expansion of the PNG customer base, while at the same time replacing the risk associated with the previously used "revenue yield" regime. In designing a connections incentive mechanism, the determined forecast connections as well as marketing and incentives allowances will be taken into consideration. PNG currently has approximately 105k customers and forecast connections & volumes are as follows:

Connections/Sector	**2007**	**2008**	**2009**	**2010**	**2011**
Owner Occupier	3,490	4,116	4,116	4,057	4,057
New build	3,227	3,199	3,191	3,191	3,191
N.I.H.E	1,994	1,994	1,087	1,006	997
IC < 2,500 tpa	398	406	408	408	408
IC 2,500 – 25,000 tpa	100	102	103	104	104
IC 25,000 – 75,000 tpa	8	8	6	3	3
Total Volumes 000's tpa	104,545	108,555	112,489	117,234	121,982

The Utility Regulator will continue to work with PNG over the coming months to develop the licence modifications that will be necessary in order to implement the above changes.

1.3. Impact of the Determination

It has been determined that PNG's revenue cap i.e. the amount of revenue[3] it can recover from customers over the next 5 years is as follows:

Real07 – £000's	**2007**	**2008**	**2009**	**2010**	**2011**
Allowed Revenue	£30,267	£31,692	£33,091	£34,759	£36,418
PNG Submission	£36,410	£38,243	£40,043	£42,180	£44,314

At present the above allowed revenue results in the following charges being applied for each category of customer:

Category	**Value (Real07)**
P1 – Domestic	34.40p
P2 – Small IC	30.96p
P3 – Large Firm	29.03p
P4 – Interruptible	14.60p

Before the Determination had been made, the P1 charge being levied on domestic customers was 40p per therm (Real07). As a result of this price control, this charge has dropped by approximately 14% to 34.40p per therm (Real07). A conveyance charge

[3] Opex, Capex and Return on RAV

statement for the period 1st January 2008 – 31st March 2008 has been published based on these values. We anticipate that a further statement from April to December 2008 will be published shortly.

1.4. Distribution Operating Expenditure (Opex)

Following an assessment of specific expenditure categories the following table sets out the Utility Regulator's decision for PNG operating costs for the period 2007 to 2011 including the application of efficiencies:

Opex (Real96)	**2007**	**2008**	**2009**	**2010**	**2011**	**Total**
Total Allowed (£'000)	£8,482	£8,995	£8,831	£9,071	£9,228	£44,607
PNG Submission	£10,082	£11,360	£11,769	£12,362	£12,955	£58,528

Some of the main issues considered when determining the above costs were as follows:

1.4.1 Efficiency Factor

It was decided to apply an efficiency factor of 2.5% to the majority of distribution operating expenditure with the exceptions of rates, advertising, marketing & PR, licence fee, incentives, rent and information technology. It was felt that PNG should be able to avail of significant efficiencies over the PC03 period due to e.g. expectations over potential benefits of adopting a Reliability Centred Maintenance approach to maintenance activities as well as ongoing general productivity improvements.

1.4.2 Network Maintenance

It is intended that the allowed costs in relation to maintenance will enable PNG to continue with the safe operation of the natural gas network. Maintenance costs had been forecast to increase significantly over the next 5 years due to the commencement of certain maintenance activities e.g. Battery & Domestic Regulator replacement.

A significant amount of this maintenance expenditure was made up of forecasts costs for work to be carried out by Phoenix Energy Services Ltd ("PES") – a subsidiary and main provider of maintenance services to PNG. It was decided to disallow an 11.62% "related party margin" in respect of all costs to be charged by PES.

1.4.3 Manpower

PNG had proposed significant increases in salaries throughout the price control period. Analysis by the Utility Regulator consultants has indicated that the current PNG remuneration package is competitive and the Croner Reward report supports this in suggesting that the PNG salaries are in line with market rates.

Having considered the PNG assertions regarding the high turnover of staff and recruitment difficulties, our decision is to apply a 1% real increase to the 2006 unit rates.

1.4.4 Introduction of Domestic Supply Competition

PNG's original forecasts included a provision for manpower increases and IT developments that PNG suggest it will incur as a result of supply competition. The Utility Regulator does not agree that PNG distribution will incur the majority of these costs as they are more likely to fall on the Phoenix Supply business. It has however been accepted that some costs are likely and it has been agreed to invoke a re-opener to the Price Control to allow the recovery of required and efficiently incurred costs subject to Utility Regulator approval.

For the purposes of calculating the above tariffs a ring fenced allowance of £75k has been included for direct opex relating to Supply Competition from 2008 onwards, with a ring fenced amount £100k per year also being included should additional costs be needed to switch PAYG customers.

1.4.5 Retrospective Costs

As part of the price control process it has been determined that a number of cost categories will be retrospectively adjusted depending on outturn data. These are summarised in Section 1.6.

1.5. Distribution Capital Expenditure (Capex)

Following an assessment of specific expenditure categories the following table sets out the Utility Regulator's decision for PNG capital expenditure for the period 2007 to 2011 including the application of efficiencies and real increases to the cost of labour and materials:

Capex (Real96)	**2007**	**2008**	**2009**	**2010**	**2011**	**Total**
Total Allowed (£'000)	£8,869	£8,665	£9,782	£10,187	£8,516	£46,019
PNG Submission	£10,792	£12,462	£13,951	£13,432	£11,090	£61,727

Over the next five years PNG have been forecast to construct approximately 34km of bulk mains, 13 District Governor Units, 367km of feeder & infill mains as well as provide meters and services to approximately 45,000 domestic properties.

Some of the main issues considered when determining the above capex costs were as follows:

1.5.1 Engineering Contract Uplift

PNG has stated that uplifts on previous outturn costs were introduced in the middle of 2006 to reflect the new costs within the DC03 contract. This uplift covers increases to both material and labour and applies to unit rates for mains, services and service installation. PNG has stated that these increases have been driven by worldwide pressure on the cost of parts and raw materials.

The Utility Regulator has accepted the unit rates that have been forecast by PNG.

1.5.2 Traffic Management Act

PNG had also included a 35% uplift in mains and services to reflect the proposed impact of the Traffic Management Act. Due to the uncertainty surrounding the potential consequences of this legislation, it has now been agreed to deal with these potential costs as part of the retrospective mechanism. In anticipation of these costs an amount of £4.5m has been included in the determination to take account of the potential costs for the period mid 2009 – 2011.

1.5.3 Deferred Capex

During PC01 PNG received an allowance for capital projects that where subsequently deferred to a future date. Most of these projects have been planned for post PC03 and the activity/forecast cost associated with these works has been removed from the PNG forecast revenue requirement. Consequently no revenue has been allowed going forward to take account of this activity and it will be up to PNG to finance these construction packages out of its own asset base, as it has already been given an allowance for this work at previous price controls.

During PC02 PNG significantly outperformed in relation to forecast quantities of feeder and infill mains. Although some of this out performance relates to efficiency savings, it has been determined that 96km of infill mains and 13km of feeder mains has actually been deferred to a future date. Consequently these amounts of mains have been deducted from the PNG allowance for the period 2007 – 2011 and once again it will be up to PNG to construct these mains using previously allowed revenue from its own asset base.

The Utility Regulator plans to further consider the appropriateness of deferred capex that has been planned for future construction and will review planned activity to ascertain when/if it will be carried out and if it would be in customers interests to use the allowances contained within the asset base for other construction activities.

1.6. Future Reviews

As part of the Determination it has been decided that a number of areas within the cost base will be subject to future review. Some of these reviews will form part of a retrospective mechanism while others may involve a re-opener.

Retrospective Adjustments:

1. **Rates** – Rates are currently calculated using a formula based on PNG's turnover. Our decision on Rates is to set the allowance based on the current formula and any variation in turnover will be accounted for retrospectively.

2. **Licence fees** – Licence fees will be treated on a pass through basis and any variation from allowances will be retrospectively adjusted.

3. **Advertising, Marketing, PR and incentives** – A retrospective adjustment will take account of any difference between actual and forecast costs (which have been capped) for 2007 & 2008. The appropriateness of the current allowance for 2009 – 2012 will be reviewed and may be adjusted accordingly.

4. **Traffic Mgt Act** – Costs have been included within the determination to take account of the potential impact of the Traffic Management Act. Any difference between this allowance and what the Utility Regulator considers appropriate will result in a retrospective adjustment at the next review.

5. **Numbers of Properties Passed** – The forecast number of properties passed within the determination has formed the basis for forecasting the quantity of feeder and infill mains to be laid. If the actual number of properties passed is less than forecast, the associated reduction in infill and feeder mains will result in a reduction to the current allowance.

6. **Connections** – The cost of connections above or below that forecast will result in a retrospective adjustment to allowed costs at the next review. In addition, a connections incentive mechanism is to be designed that will incentivise PNG to connect more customers than currently forecast.

Re-opener Reviews:

1. **Own Use Gas** – The PNG forecast for own use gas was accepted in the determination. These costs will be reviewed to consider the potential for an incentive mechanism, which may result in this cost line being re-opened going forward.

2. **Domestic Regulator Replacement** – The determination currently includes an allowance for the replacement of domestic regulators. The need for this activity is to be reviewed by PNG in 2009, the outcome of which may necessitate a re-opener to adjust the value of the current allowance.

3. **Recharges to other Phoenix businesses** – The recharging methodology used to apportion costs from PNG distribution to other Phoenix businesses will be reviewed and a re-opener will be considered to take account of any changes.

4. **Supply Competition Costs** – The determination includes an allowance for costs that may be incurred by PNG as a result of the continuing development of supply competition. Once the true scale and need for these costs becomes apparent, the determination will be re-opened to adjust the allowance currently provided.

5. **Unregulated Revenue** – Unregulated revenue relates to income earned by PNG for activities other than what it's licenced to undertake. These activities and the associated allocation of costs/revenues will be reviewed and may result in a re-opener going forward.

6. **Deferred Capex** – A proportion of the current PNG RAV is made up of deferred capex for projects that had been forecast at previous price controls. It is intended that these projects will be reviewed to ascertain whether or not they are actually needed and it may be decided to use the costs associated with these projects for other purposes.

7. **PAYG switchers** – The determination includes an allowance to facilitate customer switching (competition) in the PAYG sector. This activity may or may not be necessary and the determination allowance will be re-opened to take account of the efficiently incurred cost of this activity.

8. **Comber & Temple Quarry Costs**. – The PNG submission (less mgt fee) for costs associated with network extensions to Comber and Temple Quarry have been included in the determination subject to review. Once the appropriateness

of these costs has been assessed the allowance will be updated to take account of any changes to the forecast costs.

9. **Metering** – The weighted cost of a meter in the determination has been calculated based on 50% prepayment and 50% standard credit meters being installed. The appropriateness of this meter mix is to be reviewed and any change will be incorporated into the determination values.

10. **Large IC connections** – Connection costs associated with > 75,000 therm per annum connections will be reviewed and an appropriate unit rate calculated which will apply going forward.