Phoenix's Proposed Price Increase from 1st April 2004

A report to the DETI Minister from the Northern Ireland Authority for Energy Regulation

7th April 2004

Introduction

The Report which I have been asked to make is limited in scope to the magnitude of the proposed increase and the circumstances leading up to it. I have also been asked to include appropriate reference to the October 2003 increase. This is a short and quickly compiled report. It is not an inquiry and I have not sought or invited evidence or opinions from third parties. In so far as it has been practicable to do so, all the facts in the report have been verified. Statements that are opinion or conjecture will clearly be seen as such. The report does not contain any specific recommendations. But the need for action and change to re-focus the industry on a secure long term basis comes through in this report. The Authority would be happy to discuss with the Minister and the Department the measures which we believe are necessary.

This report consists of an introduction and four parts.

Part One is the background. The arrangements for the gas industry that were put in place in 1996 were the best that could be achieved at the time. But for the industry to succeed within the terms of the 1996 framework required such a conjuncture of circumstances that the industry was clearly from the beginning vulnerable to external shocks and liable to be de-railed if it was not carefully managed and nurtured by all those with a role or interest in its development. This needs to be understood. If it is not, re-founding the industry on a credible and sustainable basis will not be possible.

Part Two describes the actions taken by the industry's decision makers in 2003 and the first three months of 2004.

Part Three considers the extent to which any of the actions taken by any of the industry's decision makers may be open to review under the statutory powers of the Authority whether under its licensing powers or its powers under the Competition Act or the Enterprise Act. This report does not consider any remedies in law which might be open to other parties under

other legislation. Silence by this report on these matters should not therefore be taken to imply that we do not believe that there may not be other such remedies.

Part Four deals with the conclusions which we would draw about the background to the price increase and the actions of the parties.

Parts One and Two have been seen by Phoenix and the General Consumer Council (GCCNI) to ensure that there is no dispute about the facts of the matter.

Finally we remain convinced that - given the appropriate long term framework and the re-establishment of public confidence in the industry - the economic fundamentals of the gas industry are sound and its long term prospects are good.

Part One: The Background

1. Phoenix Gas began to supply its first gas customer in December 1996. It was from the outset caught between the need to price gas into the Northern Ireland energy market and the need to recover the investment which its shareholders had made and earn a return on that investment within the recovery period set in the licence, ie. by 2016.

2. Accordingly the overall approach was to price to what the market would bear and seek to grow volumes and connections as quickly as possible. The growth of the natural gas business in the seven years 1997 - 2003 inclusive has been rapid. (see Table1). During this period a total of 200,000 properties were passed and 65,000 customers started to burn gas. By the end of 2003 gas consumption had risen to reach the annual figure of 100 m therms and about 15000 customers per annum were being connected to the gas network. During this period the strategy of rapid growth through pricing to market appeared to be working.

3. An intrinsic part of the growth strategy was to establish customer confidence that the price would remain acceptable once Phoenix had converted large numbers of customers to gas. This consideration applied above all to domestic customers. Accordingly and with the support of Ofreg the initial price which Phoenix set for the average domestic customer was 53.8 pence (including VAT) per therm including standing charge, comparable with British Gas prices in Great Britain and competitive with oil. The domestic tariff combined a standing charge and a unit price. In 2000 Phoenix moved to a per unit charge and abolished the standing charge. In 2000 Phoenix also pledged itself to price stability under which domestic tariffs for the next three years would increase by no more than the rate of inflation. This pledge would have effect until October 2003 and was honoured by Phoenix. It meant that customers were being offered stable prices. The price of 53.8 per therm rose to 64p in October 2003 and to 77p in April 2004.

4. At this point it is relevant to record some of the differences between the economic circumstances of the gas industry in Great Britain and in the Phoenix licence area. At privatisation in Great Britain the industry was mature and had 18 million customers. It had been sold at a discount when it was privatised of around 30% and the return to be earned on its low notional asset base was lower than the allowed rate of return to Phoenix. By comparison Phoenix was - even under the most favourable circumstances - going to have a much less favourable gas sales to capital investment ratio for many years than the GB gas industry. It suffered three other distinct handicaps: a higher cost of capital; a requirement to recover its capital investment over twenty years rather than forty; and the cost of bringing gas through the gas interconnector which was itself seriously over priced. On the plus side Phoenix was a very modern gas industry and could offset for its customers the high cost of gas by ensuring that they used gas more efficiently than customers in Great Britain. It was moreover beginning its life free from the inefficiencies which might have crept into British Gas over the years; it was lean and efficient.

5. Success for the gas industry meant for the shareholders who made the investment earning their target rate of return of 8.5%. For Government it meant gas meeting the industry's objectives of contributing to the eradication of fuel poverty, improving consumer choice, lowering energy bills, improving air quality in Belfast and contributing to the reduction of green house and acid rain gas emissions.

6. It was evident that success required the growth of the industry to be as rapid as was physically practicable and that the key to growth was price and public confidence long term on what was said about price. Success therefore required either a sustained rise in the price of the incumbent fuels - especially oil - so that gas could be sold at a high price and still be competitive or - if that condition could not be met - for a longer term view to be taken by the investors of the period in which they would get their money back.

7. Ofreg recognised at least four years ago the need for a longer term financial framework for the industry. Phoenix also recognised the need for a change to the arrangements and discussions about a forty or forty-five year period for recovering the cost of the investment have taken place spasmodically over the last three or four years. While these discussions have developed a shared understanding of the industry's financial structure and operating environment, they have not yet resulted in an agreed view of the financial framework which would be fair to both customers and shareholders while at the same time facilitating the growth of the industry to the size that was originally envisaged.

8. In 2001 East Surrey Holdings (ESH) - a small English water company - acquired a 24.5% shareholding in Phoenix. ESH made no secret of their view that the attraction of Phoenix was as a business growth opportunity in which its shareholders were allowed to earn a return of up to 8.5% pre tax real until 2016. This rate of return – higher than the rate of return allowed to mature utilities – looked attractive to an English Water company assuming always that it was achievable in the market conditions which pertained. ESH also asserted that their investment horizon was long term and that the income stream and dividend growth that they were looking for were modest compared to other companies with utility sector interests. In the meantime, the other shareholders B British Gas and Keyspan B were finding the Phoenix investment fitting in less well with their overall investment portfolio and were frustrated by the accumulating evidence that profits from the business of the size they expected would take longer coming through than they originally envisaged.

Part 2

Actions of the Parties

1. At the beginning of 2003 Phoenix was in the last year of its price stability pledge. In the autumn of 2002 prices to domestic customers had risen in line with inflation but there had been some controversy over the adjustments between certain categories of user. This had led to public criticism of Phoenix by the GCC though not from Ofreg.

2. In March 2003 Centrica, who supplied Phoenix′s gas under a ten-year contract, designed to cover the period 1996-2006 indicated to Phoenix that they wished to avail of the provision of the contract to re-open it and raise the price for the last three years. The increase - if Centrica succeeded in obtaining their demands in full - would effectively increase the price by 8.5 pence per therm for the October 2003 contract price of 18.23 pence per therm to 26.73 pence B an increase of 47% above the contract price and as the normal contract already was 9% above the previous year, the year on year increase proposed by Centrica was 60%. Centrica also intended the new base price to be subject to the indexation of the original contract. Table 2 gives the price per therm in each contract year with Phoenix's estimate of the impact of the price in the two final years. The contract ends in 2006.

Table 1

Contract Year	Pence per Therm	Price per Re-Opener	Phoenix Volumes in Million Therms
1996/97	13.3		0.7
1997/98	14.85		11.7
1998/99	13.76		21.1
1999/00	12.89		38.3
2000/01	15.72		62.1
2001/02	17.58		76.8
2002/03	16.725		90.1
2003/04	18.23	26.73	100
2004/05 (f/c)*	20.6	29.1	
2005/06 (f/c)*	22.9	31.4	

(*This forecast has been provided by Phoenix. Centrica's view is that by 2005/06 the current (2003/04) contract price would have risen to just under 19p per therm (compared with Phoenix's forecast of 22.9p per therm), giving a price re-opener figure in 2005/06 of 27.5p per therm compared with Phoenix's 31.4p per therm.)

3. Phoenix informed Ofreg of the re-opener March 2003 indicating that it expected to successfully contest Centrica′s attempt to increase the price. Around the same time Phoenix informed Ofreg that they would have to increase prices in the autumn by 10.8%. This figure was made up of three components. The year on year inflation-linked increase would be 2.8%; 5% due to the wholesale price of gas as the price stability pledge had resulted in the revenues from the sale of gas not rising as fast as the cost of gas. Finally, there was a further 3% to contribute to "bringing the business into balance". That meant an increase to accelerate the return on investment up towards that allowed by the licence.

4. Ofreg′s discussions with Phoenix in the first half of 2003 on tariffs took place against a background of two separate discussions between Ofreg and Phoenix. One set of discussions was to identify a bidder for distribution licences for gas in the towns along the line of the north west and south north pipelines. The second was a discussion about the longer term refinancing of Phoenix. The longer term refinancing of Phoenix was regarded by Phoenix as being a necessary precondition for putting Phoenix into the position of being a credible licence holder for the gas distribution business outside Belfast. It also potentially encompassed the 3% component of the proposed 10.8% price increase which was about long term return on investment.

5. There were therefore four separate strands to the Phoenix/Ofreg dialogues of the first half of 2003. These were in no order of priority:

   (a) the Centrica re-opener;
   (b) the 10.8% proposed price increase;

(c) the preferred bidder for licences for the district towns;

(d) the long term financial restructuring of Phoenix.

6. While there were linkages between these strands, as it turned out Phoenix was not awarded preferred bidder status for reasons which had nothing to do with its long term financial structure.

7. Ofreg indicated B as did the GCC B a willingness to support a 7.8% price increase in the autumn of 2003 and commit to concluding in October the discussion on the longer term financial structure which Phoenix had been pressing for. In the context of general acceptance of a need for a longer term financial restructuring Ofreg did not examine the gas cost catch-up B the 5% - of the proposed price increase as it would have done if all else had been settled. As it was, during the late summer of 2003, Ofreg and Phoenix were able to agree on a financial model of the industry which reduced the scope for misunderstandings between Phoenix and Ofreg

8. In September ESH made an offer to buy out the other shareholders in Phoenix. This transaction was completed in December. Ofreg played no part in this sale which was overseen by the Department who were advised by Ernest and Young. According to the information available to Ofreg ESH paid a price for the balance of their shareholding in Phoenix which was below the full potential regulatory value of Phoenix but which was sufficient to ensure that the exiting shareholders secured the full value of their initial investment. While we have no precise information on this subject and while no member of the Energy Authority has seen the report which Ernest and Young made to the Department it would not appear that the purchasers obtained an explicit discount on the price of the sale on account of any perceived risk to the business from the Centrica contract re-opener.

9. The 10.8 price increase in the meantime took effect from the 1 October and was criticised by both Ofreg and the GCCNI. It is fair to say that although Phoenix was unable after the 1 October to provide the public with the degree of re-assurance about price stability which it had provided before 1 October, it did continue to market gas on a limited basis on the grounds of price stability. If Phoenix was concerned about the threat to price stability from the Centrica re-opener it gave no sign publicly of its concern.

10. However, while the management of Phoenix must have assessed the probability, scale and impact of the risk of losing, the circumstantial evidence would suggest that it was not until very late in the day - in March 2004 – that Phoenix considered that they were exposed to a risk of such magnitude that their claim of offering "stable prices" was lacking in either credibility or good faith. The apparent lack of a discount on the sale of Phoenix and the panicky decision to raise the provisional increase from 10% to 20% in early March are difficult to understand.

11. Phoenix did, however, inform Ofreg in January 2004 that they would have to increase tariffs by about 10% in April 2004 if they could not secure a long term agreement of their regulatory structure.

12. At no stage did Phoenix seek to involve Ofreg in its negotiations with Centrica even though it was known to Phoenix shareholders that Ofreg was involved in efforts to explore the scope for modifying Centrica's contract with Ballylumford power station. A suggestion by Ofreg that all the Northern Ireland contract issues should be discussed with Centrica together, was rejected by Phoenix's shareholders in the late summer of 2003.

13. Phoenix decided that the entire cost of the provision should be paid by tariff customers. When questioned, Phoenix provided two explanations for this. The first was that the non-tariff customers bought under contract. Until the contracts expired Phoenix could not increase their price. Secondly, they demonstrated that the price of gas to tariff customers

had risen more slowly than the indexation in the cost of gas to Phoenix. According to this argument, tariff customers were hitherto being subsidised by contract customers.

14. Rightly or wrongly, however, Phoenix have not hitherto been required to be in balance in respect of each customer category. Introducing a degree of cross-subsidy at this point may therefore be neither illegal nor improbable. It is certainly not in itself a licence breach. Establishing cost reflectivity is however a matter of considerable interest to Ofreg and we shall return to it in due course. At this stage we are not able to say definitely whether the allocation of all the cost of Centrica's price increase to the non-contract sector was justified.

15. Once Phoenix had decided that some provision had to be made against the possibility that Centrica would succeed there were questions of timing and about the amount. Phoenix first informed Ofreg in January 2004 that they would be seeking an increase. They informed the GCC around the same time.

16. It was the increase from 10% to 20% which occurred very late that has caused most questions to be asked. The decision appears to have flowed from a court action for a pre-action disclosure application which Phoenix lost on 5 March when they failed to obtain access to some internal Centrica documents. Further, in the lead up to 5 March Centrica had provided a further "without prejudice" offer to Phoenix which indicated a settlement price in excess of 8.5 pence per therm over the current price of 18.23 pence per therm. For reasons best known to those directly involved, this and the court decision appear to have triggered an over-reaction on the part of Phoenix's officers. The decision to raise the increase from 10% to 20% - which was tantamount to covering almost all the potential exposure - was announced on 19 March.

Part 3

The Authority's Legal Powers

1. The Authority's powers to act in this matter are set out in the Energy Order and the Competition and Enterprise Acts. The scope for action may be enhanced or diminished in each case by the precise terms and conditions in the licence of the licence holder whose actions are under scrutiny.

2. Regulators have a legal obligation to ensure there is sufficient provision on the regulated service to promote or facilitate competition, and to protect the interests of customers and consumers.

3. In the Northern Ireland electricity and gas industries the Authority regulates through the issue of licences to companies which, for example, contain conditions which prevent them from showing undue preference to, or undue discrimination against, any class of person.

4. Since 1 March 2000, in addition to this *ex ante* regulation, the Authority has new *ex post* powers under the Competition Act 1998 (CA 98).

5. CA 98 introduced significant changes in the way competition law is enforced in the UK. It is based closely on Articles 81 and 82 of the Treaty of Rome, and in enforcing CA 98 regulators have a duty to follow European precedents. The Act introduced two prohibitions: of anti-competitive agreements (the Chapter 1 prohibition) and abuse of a dominant position (the Chapter II prohibition). Compared to previous UK legislation, the Act provides stronger powers of investigation and the powers to impose a financial penalty on companies, of up to 10% of UK turnover for a maximum of up to three years for infringing the Chapter 1 or Chapter II prohibitions. The penalties are civil, not criminal, and are on undertakings, not individuals, although the Act creates criminal offences for individuals who, for example, obstruct an investigation, destroy evidence, or provide false information.

6. Examples of agreements that may be seen as anti-competitive under the Chapter 1 prohibition are:

    * fixing purchase or selling price

    *limiting or controlling production

    *applying dissimilar conditions to equivalent transactions with other trading partners, thereby placing them at a competitive disadvantage.

7. Examples of abuses of the Chapter II prohibition are:

    *excessively high prices (ie higher than would be expected in a competitive market)

    *discriminatory prices or other terms or conditions (different prices to different customers)

    *predatory prices (prices set so low as to force out competition or prohibit entry).

8. In addition to licence conditions and CA 98, the Enterprise Act 2002(EA 2002) which came into force in two stages (1/4/03 and 20/6/03) makes changes to CA 98 offering further powers to the competition process and consumer protection. Whilst EA 2002 is largely complementary to CA 98 with the Chapter 1 and Chapter II prohibitions remaining in force it introduces a criminal offence for individuals who engage in certain types of agreements as well as introducing the opportunity for consumer bodies, designated by the Secretary of State to make super-complaints, i.e. it allows bodies such as the GCCNI (when designated) to complain where they feel that features of a market are harming the interests of consumers. The EA 2002 also provides a power for the Authority to make a market investigation reference to the Competition Commission.

Phoenix

9. The Authority intends to consider the case against the price increase by Phoenix through licence conditions. We will request information from Phoenix leading to the increase and seek to match this against an appropriate licence condition to see whether is in breach of its licence.

10. If it has done something it should not have done but it appears that the licensing route does not provide an appropriate route to attack this gas price hike, then the Authority will consider an investigation under CA 98.

11. If neither the licencing route nor CA 98 can provide the necessary powers to combat this gas price hike, then additional licencing powers will be required to provide the Authority with the necessary teeth to deal with such matters in future.

Centrica

12. Centrica's position as the dominant gas supplier in Northern Ireland for both electricity and gas is self evident. Centrica's licence requires it to consult the regulator about any change to the terms and conditions of the Ballylumford contract. It would be entirely consistent with Centrica's dominant position in the natural gas market to insert a similar condition with regard to Centrica's contract with Phoenix.

13. More immediately relevant is the power under the licence to require Centrica to provide information about the contract and to the way in which they have managed it. Once the Authority has this information we will decide if there are grounds for taking action to challenge the price increase under any of the powers which may be available to us.

14. The powers available to the Authority mirror those which are available to Ofgem. They were designed with the mature competitive energy markets of Great Britain in mind. While many of the provisions are useful they are not customised to meet the requirements of the small pre-competitive energy market in Northern Ireland. Government and the Authority need to consider for the future additional statutory powers - particularly to impose licence conditions- which would be better tailored to securing the public interest in the circumstances which pertain in Northern Ireland.

Part 4

Conclusions

1. The present crisis arises from the attempt by Centrica to re-open its contract. In this sense the crisis has its origins in March 2003.

2. However, the impact of the event on Phoenix was magnified by the vulnerability of Phoenix to any form of cost shock - a vulnerability which is inherent in the 1996 licence and regulatory structure; this vulnerability does not appear to have been diminished by its change of ownership.

3. Phoenix was slow to respond to the threat in the re-opener given its potential impact on the business. The slowness of response may have been due to confidence in the strength of their position or it may have been a confidence that changes to the licence and regulatory structure were imminent. It may be attributable to distraction because of all the other things going on in 2003, including the sale of BG's and Keyspan's shareholdings and the outright purchase of the company by ESH.

4. In their reactions to the price re-opener Phoenix dealt with the issue as a contractual issue between two companies. Rightly or wrongly, Phoenix made no effort to engage the wider gas industry stakeholders on the issue, despite the potential implications for the gas industry in Northern Ireland of Centrica's dominance. Ofreg's tentative offer to link this issue to the Centrica LTI 3 issue in the summer of 2003 was firmly rebuffed. Whether any good would have been served by broadening the context of the Centrica re-opener will now never be known and it may be that Phoenix's decision to limit the discussion to an inter company dispute over the interpretation of a contract was correct.

5. Phoenix also failed to take into account the rise in the cost of gas which was implicit in the terms of their Centrica contract. Further retail gas price rises were inevitable in 2004 in the absence of a changed regulatory structure. Although these rises would have been above inflation, they might well - when taken together with the downward pressure of

changes to the regulatory framework - have been consistent with a Aprice stability@ claim by Phoenix.

6. Phoenix's response to the crisis as it came closer is open to criticism. The company went from making no provision for losing to a fifty per cent provision and then to making a hundred per cent provision. It did not seem to - as would be inevitable in a normal competitive market - feel that shareholders would have to absorb some of the discomfort of an increase in the cost of supply. Even if the proposed allocation of all the cost to tariff customers is the correct response in cost reflective pricing - and we have not had the time to fully investigate this point - the route by which Phoenix reached this conclusion is certainly unclear.

7. The doubling of the price increase by the management team represents more than an attempt by Phoenix to cover their future exposure. As the period April to September is the low season for gas and as Phoenix has already for 2003/04 (October to September) taken five sixths of its annual minimum take under the Centrica contract, Phoenix will, over the next six months, recover double the amount by which its exposure will increase during this period. Given that Centrica have not established their entitlement to increase their price, let alone received any money in respect of a possible increase, Phoenix's actions might be regarded as excessive.

8. Phoenix can best answer for themselves as to why the price rise is 20% rather than 10% for the next six months. One possible explanation is that Phoenix, following the October price rise, now takes a more aggressive view of the market here. Despite a bad public reaction the market recovered. Six months later gas volumes and customer growth were back on track. The public may not like Phoenix as much as they used to but gas is a good product that sells itself. Phoenix's current actions may be reflective of a different view of the market and of what the business can achieve when it prices to market.

9. The second possibility is that Phoenix's current financial structure following its acquisition by ESH removes from it the degree of protection that came from having two large companies owning it. Phoenix's growth and marketing strategy over the medium and longer term may now be subordinated to the short term requirement of its financial

backers. If this is the case - and there is some evidence that it is - it begs questions about the fitness of entrusting the task of developing the Northern Ireland gas industry to a company of this sort.

10. In summary, the starting point for the present crisis is Centrica's triggering of the re-opener clause which, as thing stand, will cause hardship to customers and place a further 6000 house holds in fuel poverty. This does not sit easily with Centrica's professional commitment both to customers and to the fight against fuel poverty.

11. Phoenix on the other hand, has been tardy and confused in its reaction to the crisis. It has been inconsistent and the doubling of the price increase looks like panic. Decisions appear to be driven by the requirements of its financial backers, rather than by a long term growth strategy.

12. In what started as a dispute between two companies over the terms of a contract there is a danger that the wider public interest will be lost sight of. Gas is the current fuel of choice in this phase of our energy evolution for all developed economies. It is the cleanest and most versatile of fossil fuels. The development of an extensive natural gas industry is essential for combating fuel poverty, reducing energy costs, economic development and minimizing pollution. A large gas industry means lower electricity costs. Until 2003, the potential of gas to do all these things was being demonstrated by Phoenix. Now we are at risk of letting them all slip away and indeed no matter what changes we manage to effect, public confidence in the gas industry has been damaged and some of that damage will not be easily restored.

13. The Centrica re-opener was a serious threat to the gas industry. Over three years it threatened to add £25m to Northern Ireland's energy costs under the very worst scenario. It was - given our pre-competitive nature and that the burden would have fallen mainly or entirely on customers - unreasonable and can and should be resisted. But taking a forty year view of the industry this was a blip which could be managed. It need not have been mortal. Yet through Phoenix's management of the situation and the reaction this provoked this episode is causing disproportionate damage to the industry and thus to Northern Ireland's economic, social and environmental development.

14. The success, failure or survival of a particular company is of no direct concern to Government. The fate of an industry whose success is to be the instrument for achieving a range of public policy objectives is. The fundamental issue remains that of achieving a long term structure for the natural gas industry which provides a secure investment regime for shareholders and a stable price regime for customers. The events of the last few weeks show that much more powerful levers are required to ensure that licence holders in the natural gas industry do operate in the public interest.