Utility Regulator

Phoenix Supply Price Control, 2007 - 2008

Final Determination

April 2008

TABLES

1. INTRODUCTION

This paper sets out the Utility Regulator's final determination on the first price control undertaken for Phoenix Supply Ltd in 2007 and 2008. This determination is only for Phoenix Supply Ltd. and does not apply to any other suppliers currently in the greater Belfast area or to any new entrants. The paper takes into consideration the issues raised previously by Phoenix Supply Ltd. (August 2007, December 2007 and February 2008) and the issues raised by interested parties during the public consultation.

According to the terms of the Phoenix Supply licence[1] Phoenix Supply Ltd must apply to the Utility Regulator for consent for a maximum average price that it can charge for gas supply. It was originally envisaged that this request would apply for a calendar year and so the price control work has thus far been based on a calendar year. However, Phoenix Supply Ltd. have now confirmed that the tariff timetable is from 1st May 2008 to 30th April 2009. Therefore we see little merit in establishing the Utility Regulator view of the maximum average price for the calendar year.

However, the Utility Regulator will use the principals established within this determination to review the request by Phoenix and give or withhold consent to the average maximum price from 1st May 2008 to 30th April 2009. In consenting to the gas cost element of the maximum price we will review relevant data provided by Phoenix Supply Ltd. for the period 1st May 2008 to 30th April 2009. We plan to review and determine on the Phoenix request before the end of April with the new tariffs to be effective from 1st May 2008.

To derive best estimates of the allowed expenditure for the calendar years 2007 and 2008 the Utility Regulator in discussion with Phoenix Supply Ltd. has reviewed each element of the forecast supply operating costs and associated information. Since the publication of the interim determination, Phoenix Supply Ltd. has provided updated gas volumes for 2007 and revised forecasts for 2008. These revised volumes are included in the calculation of the allowed expenditure.

Based on these figures calculated for the calendar year the supply operating cost pence per therm is 6.20p in 2007 and 6.05p in 2008.

2. SCOPE OF THE PRICE CONTROL

In response to the interim determination paper, some parties queried the rationale for the selection of only customers who consume less than 25,000 therms per year for inclusion in the price control. The Utility Regulator has decided that competition from alternative fuels is not sufficient to protect the interests of this segment of the gas market. In addition, although customers in the Phoenix licensed area became eligible to choose an alternative supplier since January 2007, there has been an absence of new entrants to the domestic gas supply market. We have taken the view for this price control that competition is sufficiently robust for the contract market i.e. customers who consume more than 25,000 therms a year, therefore, this segment of the market is not covered by the price control. The Utility Regulator will continue to monitor the development of the market to assess if price regulation is necessary and that its' scope is appropriate.

[1] Condition 2.4.1, 'Control over Charges in the absence of competition'. Licence for the Supply of Gas in Northern Ireland, granted to Phoenix Supply Limited, by the Northern Ireland Authority for Energy Regulation, 19 December 2006.

3. FORM OF REGULATION

As previously stated in section 1 under the terms of their licence Phoenix Supply will apply to the Utility Regulator for consent to a maximum average price per therm which will be charges for gas supply to tariff customers in a 12 month period. These are:

- the cost of using transmission systems and the Phoenix Distribution system
- the cost of gas
- the operating expenditure of the supply business
- the margin on turnover to be earned by the supply business

The charge supply companies must pay for using the Distribution system is set by the Utility Regulator as part of the Distribution Price control review and constitutes around 40% of the average price per therm.[2]

Much uncertainty exists about future gas prices, therefore the Utility Regulator has considered the extent to which it might be necessary to protect Phoenix Supply from large increases in gas costs, ensuring that it can finance its regulated activities while also ensuring a smooth path of prices for customers where possible. In order to mitigate the risks associated with a large divergence between forecast gas costs and the actual wholesale prices of gas, the Utility Regulator proposes to implement a trigger mechanism. This mechanism will adjust the maximum average tariff if wholesale gas prices diverge from the forecast gas costs sufficient to cause a 5% increase in the maximum average tariff. This is set out in section 7.2. The gas costs will be for the period from 1st May 2008 to 30th April 2009 and the Utility Regulator will review these costs under the principals identified in section 7 and give or withhold consent to the maximum average price.

In setting the allowed level of operating expenditure the Utility Regulator aims to ensure that the level of operating expenditure is reasonable and that Phoenix is incentivised to improve the level of efficiencies in their business over time. The level of operating expenditure and the level of efficiencies to be achieved by Phoenix are outlined in section 5.

The Utility Regulator proposes to allow Phoenix a margin on turnover of 1.3% in 2007 and 1.5% in 2008. The rationale for this is set out in section 8.

For any over/under recoveries of costs (excluding gas costs) incurred by Phoenix it is there will be a correction mechanism similar to what OFGEM have applied in their distribution price control review; this is outlined in section 9.1. In addition, those costs over which Phoenix Supply Ltd. has limited control will be included in a retrospective mechanism, which will adjust forecast costs for actual costs when the audited accounts are received.

4. SUPPLY EXPENDITURE

Table 1 includes the figures proposed by Phoenix Supply Ltd., in their original submission, for supply expenditure allocated to the tariff sector. In the submission provided by Phoenix Supply Ltd. for 2007, the percentage allocation of the supply expenditure to the tariff sector is assumed to roll forward to 2008. The table also includes the Utility Regulator's final determination for the calendar years 2007 and 2008 for allowed supply expenditure. These figures are in 1996 prices.

[2] Phoenix Natural Gas Ltd., Distribution Price Control Review 2007-2011, Final Determination, NIAUR, February 2008

Table 1 Submission from Phoenix

Proposed Supply Expenditure allocated to the tariff sector	2007 £(000's)	2008 £(000's)
Phoenix Supply Ltd. Submission	3,080	3,148
NIAUR Initial Determination	2,587	2,664
NIAUR Final Determination	2,589	2,691

The final determination results in a supply operating expenditure pence per therm of 6.20p in 2007 and 6.05p in 2008 (nominal prices): In discussion with Phoenix, the Utility Regulator reviewed each element of the forecasted supply operating costs and associated information to derive best estimates of the costs for 2007 and 2008. Since the interim determination Phoenix Supply Ltd. have provided revised volume figures which have been included in the calculation of the final determination figures in table 1. The impact of using the revised volumes was a revision to the bad debt allowance which in turn impacted on the allowed expenditure. An efficiency factor has been applied to the allowed supply costs in 2008 as explained further in section 5.1. Billing and manpower represent the greatest proportion of supply costs in 2007 and 2008 46% and 31% respectively.

4.1 Efficiency factor

The price control is designed to incentivise Phoenix Supply to create efficiencies within their business. The Utility Regulator has decided that an efficiency factor of 2.5% is appropriate for the supply business. We have considered the methodology used by OFGEM to generate the efficiency factor during the recent Gas Distribution Price Control Review (December 2007) and the efficiency factor recently set by the CER for Bord Gais Supply. OFGEM set an efficiency factor of 2.5% and the efficiency factor set by CER in 2007 was 4%. However, as part of the Bord Gais Services 5 year regulatory review the CER is considering an efficiency factor for the 2007-12 revenue period which will include a frontier efficiency and lie within the range of international comparisons of between 0.5% and 4.2%. The proposed decision is an efficiency factor of 2.5%.

In line with OFGEM the Utility Regulator has applied real price effects, which produces on average a net efficiency effect of 0.9%. Real price affects have been applied directly to manpower. The net efficiency factor of 0.9% has been applied to all other costs except for rates, office costs, advertising and PR, licence fee, IT, billing, insurance and human resources and capital expenditure.

In response to the interim determination paper, some parties questioned the suitability of applying the same efficiency factor as that applied by Ofgem with some suggesting it should be higher and some lower. The Utility Regulator is still of the opinion that 2.5% is an appropriate efficiency rate for Phoenix Supply Ltd.

4.2 Recharges

A significant proportion of Phoenix Supply costs are the result of recharges from the Phoenix distribution business. We have accepted the Phoenix recharging methodology and applied it to the costs set out in our Phoenix distribution price control determination. The recharging methodology will be reviewed to ensure it is still the most appropriate way of recharging the Phoenix Distribution costs going forward and a re-opener will be considered as appropriate.

5. APPORTIONMENT OF SUPPLY COSTS

As tariffs for contract customers are outside the scope of the control we have apportioned the supply costs between tariff and contract customers. The drivers used to apportion supply costs are set out in table A1. The supply operating expenditure figures within the consultation paper exclude any supply operating expenditure attributable to the contract sector. Areas where costs are high, such as billing, apply predominantly to tariff customers accounting for the high proportion of supply costs apportioned to tariff customers.

The apportionment of supply costs will be retrospectively adjusted between tariff and contract, on the basis of actual outturn volumes, customer numbers, number of bills generated, number of meter reads and revenue where appropriate.

6. TREATMENT OF GAS COSTS

6.1 Gas cost pass through

The Utility Regulator agrees with the proposal made by Phoenix Supply Ltd. for a gas cost pass through system that will take into consideration gas costs and volumes. Gas prices will be based on the forward curve and take into account any forward purchases made by Phoenix. The actual gas purchase costs incurred by Phoenix will be recoverable within its supply tariffs. As detailed in Section 1, the gas costs will be submitted by Phoenix Supply Ltd as part of their submission for the maximum average price. The Utility Regulator will review the gas costs using the principals laid out in this determination and give or withhold consent to the maximum average price under the Phoenix Supply licence condition 2.4.1.

6.2 Trigger mechanism

The Utility Regulator wishes to avoid a situation where final tariff prices diverge significantly from wholesale prices. Phoenix state that they do not have the reserves necessary to carry under recovery for the period of the control and the Utility Regulator wishes to minimise the extent of the correction factor. Consequently, we propose a mid year review of gas tariffs if Phoenix can demonstrate that, the WACOG[3] has diverged from forecast to cause a rise in the annual maximum average tariff of greater than 5%. We feel that the figure of 5% strikes an appropriate balance between ensuring gas prices reflect market movements and avoiding the mechanism being so small as to create an automatic trigger every year. The Utility Regulator may adjust the allowed maximum tariff to take account of the movement in gas prices and either allow any under recovery to form part of the trigger mechanism and be recovered in the following six months or in the following year. The Utility Regulator may approve a review outside of six months if it is regarded to be in customers' interests.

7. SUPPLY MARGIN

In October 2006, it was agreed that a preliminary supply margin of 2% would be set as an interim figure until the completion of the supply control. At that time it was uncertain as to the level of competition, which would be experienced after full market opening in January 2007. The Utility Regulator has assessed the business risks faced by Phoenix including capital at risk and working

[3] The WACOG is the weighted average price of gas for the year based on the forward price of gas and any purchases already made.

capital and the likely impact of competition. We have balanced this assessment with other aspects of the control – such as the pass through of gas costs - which reduce the level of risk Phoenix faces. Accordingly, the Utility Regulator proposes that the margin on turnover for the Phoenix Supply Business will be 1.3% in 2007 and 1.5% in 2008. This reflects our view that there is presently little competition in the domestic market, but that competitors are expected to enter the market in 2008.

Taking into consideration the business risks that Phoenix was likely to experience in 2007 (including capital at risk and working capital) and the absence of any competition in the gas market the Utility Regulator will set a gas supply margin of 1.3% for 2007. The supply margin will increase to 1.5% in 2008 based on the assumption that competitors may then enter the gas market. As Phoenix Supply Ltd. have over recovered in 2007 the difference between the preliminary 2% supply margin and the final 1.3% supply margin, this over recovery will be deducted from allowable costs when setting future tariffs. The consumer will therefore, recoup the over recovery in the form of a lower tariff than would have been the case if the over recovery had not occurred.

Some of the responses to the interim determination questioned the percentage set for the supply margin for Phoenix Supply Ltd. in 2007 and 2008. In response to this comment the Utility Regulator is satisfied that the chosen percentage is reasonable and is consistent with the supply margins applied in GB and RoI. In GB, the last supply price control was set in 2000 and the profit margin on turnover was 1.5% (gas costs were not allowed as a passthrough). In 2007/2008, the gas margin in RoI is set at 2% in the context of gas market opening. The gas margin in RoI takes account of the costs of gaining new customers whereas in NI, the cost associated with obtaining new customers will be included in gas distribution costs and will be allowed for within the pass through system.

In determining the allowable supply business costs the Utility Regulator has applied a cash flow methodology, which allows Phoenix to earn a margin on turnover, in addition to operating and capital costs financed on a pay as you go basis.

8. TREATMENT OF UNDER/OVER RECOVERY

8.1 Correction mechanism

A correction mechanism will be implemented to deal with under and over recoveries as a result of incorrect volume forecasts. If Phoenix Supply Ltd. over/under recover because of a change from their forecast gas volumes then a two tier correction mechanism will apply. The mechanism is similar to that which OFGEM have implemented for GB gas distribution. The dead band (the range at which the standard interest rate is applied) has been reduced from 5% in the initial determination to a final determination of 3% as gas costs are no longer covered by the correction mechanism but are to be treated as a pass through.

- If Phoenix Supply Ltd. over recovers by more than 3 per cent, an interest rate of 3 per cent higher than the base rate will be applied;
- If Phoenix Supply Ltd. over recovers by less than 3 per cent, an interest rate of 1.5 per cent higher than the base rate will be applied;
- If Phoenix Supply Ltd. under recovers by less than 3 per cent, they may recover interest at a rate of 1.5 per cent higher than base rate; and
- If Phoenix Supply Ltd. under recovers by more than 3 per cent, they may recover interest at base rate.

The base rate is the rate set by the Bank of England. Inflation costs (assumed at 4% RPI for 2008) will be treated as a pass through. Upstream and distribution costs will be treated as a pass through in the correction mechanism.

8.2 Retrospective Mechanism

There are a number of costs over which Phoenix supply has limited or no control. These are licence fee and billing costs (including bad debt, bill printing and postage, transactions and meter reading). To ensure that Phoenix Supply are allowed enough revenue to cover the actual costs incurred for the licence fee and billing we propose to include these costs in a retrospective mechanism. The mechanism will adjust forecast costs for actual costs when the audited accounts are received from Phoenix.

The bad debt costs will be set at 1% of credit revenues. There will be a retrospective adjustment for the actual number of transactions and meter reads. The actual licence fee when available will be used to adjust the forecast fee.

9. OUTCOME

As discussed in the introduction Phoenix Supply Ltd. is now proposing to request a maximum average tariff based from 1st May to 30th April (rather than calendar year).The Utility Regulator has determined the operating expenditure and supply margin that form part of the maximum average price. Phoenix Supply Ltd will submit their maximum average price including gas costs to the Utility Regulator for the period from 1st May 2008 to 30th April 2009. The Utility Regulator will base their decision on consent to the proposal made by Phoenix Supply Ltd. if it is consistent with the principles of the Phoenix Supply licence and the principals laid out in the determination.

One of the issues raised in the consultation responses was the importance of beginning the analysis for the 2009 price control review as soon as possible in 2008. The Utility Regulator acknowledges the importance of completing the analysis for the 2009 price control to ensure the final determination is made prior to the next review. Work on the 2009 price control will begin as soon as the 2007-2008 final determination has been completed.

APPENDIX 1

Table A1 Drivers applied in the apportioning of the supply costs

Cost	Driver
Network Maintenance	Avg. no. burning customers (supplied)
Manpower	Load in therms and number of bills generated
Fleet Costs	No. of cars
Travel and Subsistence	Direct manpower cost
Rates	Direct manpower cost
Office Costs	Direct manpower cost
Telephone and Postage	Avg. no. burning customers (supplied)
Stationery	Manpower numbers
Advertising Marketing and PR	Avg. no. burning customers (supplied)
Licence Fee	Load in therms
Information Technology	Avg. no. burning customers (supplied)
Professional and Legal Fees	Supply Gas Revenue
Billing Bank Fees and Charges Bad Debt Provision Quantum Bill Printing Third Party Debt Recovery Compensation for Incorrect Billing Paypoint Libra Meter Reading	 Average No Burning customers Credit Turnover All tariff No bills generated No bills generated No bills generated All tariff All tariff No. meter reads
Entertainment	Manpower numbers
Insurance Commercial All Risks - Section A to E Computer Breakdown & Loss Fidelity Guarantee EL PL PL Excess Employers Liability Group Personal Accident & Travel Commercial combined (Marine Pipeline) Includes BII Other insurance Directors & Officers Car	 Turnover Computer Breakdown & Loss No Employees No of employees No of employees No of employees turnover/customers No of employees No of Directors No Cars
Human Resources	Manpower numbers

APPENDIX 2

RESPONSES RECEIVED TO THE INTERIM DETERMINATION PAPER

FOR THE

PHOENIX SUPPLY LTD. PRICE CONTROL

NIE ENERGY SUPPLY

Response to NIAUR Consultation Paper

Phoenix Supply Price Control, 2007 – 2008

Initial Determination

19 March 2008

NIE Energy Supply (NIEES) welcomes the opportunity to comment on NIAUR's proposed interim price control for Phoenix Supply Ltd.

NIEES notes that there is a strong retrospective dimension to this interim arrangement, which is not ideal from the point of view of clarity and transparency of the regulatory decision making process. However, it is recognised that supply price control review processes can take a significant time to work through (eg NIEES's current price control review began with a efficiency questionnaire process in April 2007 and is now reaching a conclusion with the licence modifications being agreed. – a 12 month process).

Therefore, in order to facilitate a timely and orderly process with respect to NIEES's post March 2009 price control determination, we would urge NIAUR to schedule the review process as soon as possible in 2008, particularly if efficiency analysis and best practice benchmarking exercises are to be undertaken as part of the process (as indicated in NIAUR's Forward Workplan).

NIEES also notes the proposed implementation of a deregulation boundary in the context of the natural gas retail market in Northern Ireland (ie 25,000 therms). NIEES is currently in discussion with NIAUR regarding the implementation of such a boundary in the context of the electricity retail market, and this gas threshold may serve as a useful reference.

With reference to the guiding regulated net margins, we note that NIAUR has recognised the need to adjust the margin headroom up as the market becomes more open. Clearly the natural gas market in several years behind the electricity market with respect to competition in Northern Ireland, nevertheless, such a principle is important in striking the right balance between creating proper conditions for active supply competition and protecting the best interests of customers.

Airtricity Response to

Phoenix Supply Price Control 2007-2008

Consultation on Initial Determination

Phoenix Supply Price Control 2007-2008

Consultation on Initial Determination

Introduction

Airtricity welcomes this opportunity to comment on the Authority's interim determination on the Phoenix Supply price control, although we are unclear as to why this consultation process is only now taking place; more than halfway through the period covered by the control.

We support separation of the market into regulated and unregulated segments and agree that price regulation is required to protect the interests of smaller customers. In principle we support price cap regulation but the proposal for subsequent application of adjustments will distort the market and can only undermine development of competition. Clearly there has been a considerable amount of background work undertaken in development of this price control, but we are disappointed at the lack of detail provided in the consultation. Without better definition of, for example, bill printing and meter reading costs, or quantification in relation to total allowed revenue, the scale of regulatory price risk posed by retrospection is unquantifiable.

We note the Authority's expectation that ten percent of Phoenix customers will be lost to competition in 2008, but it is not clear how a price control that offers minimal commercial return to the incumbent, in exchange for revenue certainty over time, can nurture competition. Indeed the NIE Supply price Control specifically suggested that there is a low risk of competitors entering the NI gas market. Regulation should be a proxy for competitive market discipline in cases of market failure, but we believe the current proposed determination would perpetuate an enduring administered monopoly regime, rather than usher in a transition to the complex risk and reward balance of a real competitive market environment.

In summary, our concerns are threefold;

- lack of transparent price formation – allowed tariff price is adjusted for factors specific to the incumbent, posing unquantifiable risk for market entrants,
- price level – supply margin for 110,000 customers offers insufficient return for a small, standalone business, and
- lack of a regulatory impact assessment of the effect of the proposed Determination on stakeholders; including potential market entrants.

In addressing these issues, we refer extensively to the DG Competition Report on Energy Sector Inquiry (January 2007), in which they are considered in the context of a comprehensive analysis of the European energy market.

Transparency of price formation

In the absence of any background supporting information in Sections 4 and 5, we have assumed that most of Phoenix' average of 104.5k regulated customers[4] are domestic and that the average domestic gas bill is around £920/annum, based on information from Domestic Retail Market Report (Ofgem 169/07). This report states that the average saving for customers switching supplier is £55 for customers with online accounts, double the average allowed Phoenix supply cost/customer of £27[5]. Experience suggests that an entrant supplier would typically have to offer a saving of up to 10% on tariff cost, in order to persuade customers to change supplier. On the basis of Ofgem published data that suggests the Phoenix allowed supply cost is around 3% of final tariff, an entrant would therefore have to offer annual savings of up to £90; almost seven times the £13.50 allowed profit margin per customer. Such a saving could only be achieved if gas for supply could be obtained at a significant discount to the market prices proposed for Phoenix gas costs.

The basic proposed price level is not the only issue impacting any potential market entrant. Given weather effects, or the highly likely failure to lose customers in line with target, the provision for retrospective revenue adjustment could cause allowed revenue to drop by£3 or more in 2009; additional to any movements in Phoenix' costs over which they have *"limited or no control"*, and that pose further competitive risk to a new entrant.

Lack of transparency in calculation of the allowed gas cost is a further issue. While stating that the cost of gas is a pass-through component of the tariff, it is not clear whether this cost is based on outturn spot purchase costs, some measure of market price, any defined hedging strategy, or the existence of current long or short-term contracts. Without this information, a market entrant is unable to quantify the probability or scale of interim tariff adjustment, or future clawback of assessed over-recovery.

The consultation includes the somewhat surprising statement that, *"in NI, the cost associated with obtaining new customers will be included in gas distribution costs and will be allowed for in the pass through system"*. While it is unclear what these costs represent, it seems unlikely that the statement is intended to mean that the sales and marketing costs of new entrants will be paid for by the Distribution pipeline business. The only conclusion must be that the Authority expects Phoenix to be allocated all newly-connected customers automatically. Whatever the intention, the clear message is that the tariff gas market is not intended to be a level playing field and that some incumbent costs will be paid for by the customers of independent suppliers, through this Distribution/Supply cross-subsidy that is illegal under European law but apparently sanctioned by NIAUR.

There is an undoubted lack of transparency in the forward path of incumbent prices, based on

[4] allowing for the assumed 10% competitive customer loss spread evenly over the year

[5] The figure of £27 nay be upwardly influenced by non-domestic customers, but the Consultation provides no guidance on supply cost allocation between customer classes, eg whether this is based on customers service or other costs.

this cross-subsidy, the unforecastable inter-temporal impact of internal Phoenix Supply outturn costs and lack of any consideration of competition issues when choosing other pricing parameters. Experience in the electricity market confirms that revenue regulation results in price volatility for customers and margin volatility for independent suppliers that has undermined development of competition; there is no reason why it should do otherwise in the gas market. This issue is not confined to the NI energy market. Last year's Competition Directorate Energy Sector Report concluded,

> *"Effective and transparent price formation is needed in order to deliver the full advantages of market opening to consumers. Many users have limited trust in the price formation mechanisms…*[6]*"*

We conclude that new entrant cost and regulatory risk will make entry to the NI gas market highly unattractive, unless the final Determination acts more as a proxy for market forces than a confirmation of the status quo. This draft offers minimal prospect of benefit to customers over the longer term.

Price level

We are concerned that the apparent sole focus of the consultation is the Authority's wish, *"to avoid a situation where final tariff prices diverge significantly from wholesale prices"*. There is a real difference between a theoretically-open market and one in which competition is actually encouraged and in which there is pressure to reduce costs through investment and innovation.

The allowed margin of 1.5%, for a business with a customer base of under 100k customers is unsustainably low for a standalone utility business of this size; part of an overall cost-plus pricing design that seems likely to incentivise inefficient gas purchase and payment of dividends, rather than competitive purchasing, acceptance of market risk and investment in systems to improve customer service. It contrasts with an allowed margin of 1.8% for NIE Supply. While the extra 0.3% of margin for NIE Supply was justified[7] on the grounds of, "a higher degree of risk of competitors entering the market", it is hard to understand how the Authority can express the view that it expects entry in the gas market to result in 10% of customers switching Supplier in 2008 (a fair target in a genuinely competitive market), meanwhile setting prices based on an expectation of continuing monopoly. Clearly therefore, the proposed Phoenix margin is not intended to represent the realistic level of return that would be found in a competitive market of this size.

We have already raised our concern over the transfer of Phoenix Supply customer acquisition costs from the Supply business to the Distribution business, in relation to transparency of the price formation process, but it is also an artificial restriction of the "competitive space" within the overall tariff. If competition were to develop, customers of independent suppliers would be paying their own costs plus those of the incumbent; representing an artificial erosion of independent suppliers' gas and supply margins and a

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[6] DG Competition Report on Energy Sector Inquiry, January 2007.http://ec.europa.eu/comm/competition/sectors/energy/inquiry/full_report_part2.pdf
[7] NIE Supply Price Control 2007 – 2009 Decision Paper, 5 December 2007

further restriction of competition by adding to the regulatory assessment that the incumbent's business is low risk. This is unacceptable.

The allowed Phoenix cost to serve also appears low in comparison with NIE Supply, which has some five times the number of customers over which to spread its fixed costs. The consultation does not seem to acknowledge the dis-economies of scale that follow from a relatively small customer base and that would, in normal circumstances, result in a higher cost to serve.

In addition to our concerns over margin, allowed revenue and cross-subsidy, on the basis of our electricity market experience, we believe that the proposed retrospective price adjustment provision will be a major barrier to the development of competition in this market. Section 3 indicates that the mechanism for this retrospective adjustment of cost is based on the Ofgem Distribution price review, yet fails to indicate an understanding of the difference between pricing for a natural monopoly service and price control for a (theoretically) competitive commodity. Retrospection is highly price distortive and results in competitors being penalised for incumbent forecasting error/weather elasticity/customer mix issues that bear no relation to their own businesses.

Selection of the chosen "efficiency factor" lacks rigorous justification. Section 5 confirms that the proposed efficiency factor is based on an Ofgem assessment of a completely different type of business, with a significantly different order of magnitude. Similarly the CER determination that set the Bord Gáis factor assumed, *"the scale economies that BGS currently enjoys (and which smaller entrants may not)*[8]*"*. There is no independent assessment of the extent to which the low-margin Phoenix business, without the volume of profit required to support significant investment in business improvement, can deliver the assumed level of efficiency improvement.
Overall, we believe that this draft determination takes no account of European policy on the promotion of competitive (as distinct from open) markets. Through an opaque pricing mechanism incorporating retrospective price adjustments and pricing levels that assume risk-free margins, the proposed Phoenix price control delivers regulated tariffs that are below the level that would be expected in a truly competitive market of this size. The DG Competition Report concluded,

> *"…regulated supply tariffs below market prices discourage new entry."*[3]

We concur.

Regulatory impact assessment

UK non-departmental public bodies are encouraged to follow the Cabinet Office Code of Practice on Consultation[9] and we believe that the Authority should follow its recommendations as matter of course. Criterion 6 of the Code requires that, "your consultation follows better regulation best practice, including carrying out a Regulatory

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[8] DIRECTION TO BORD GÁIS ENERGY SUPPLY ON ELEMENTS OF THE NDM 5-YEAR REGULATORY REVIEW 2007/08 - 2011/12 APPLICABLE TO 2007/08 (CER/07/129)
[9] Cabinet Office Code of Practice on Consultation http://www.berr.gov.uk/files/file44364.pdf

Impact Assessment if appropriate". Such an assessment should "highlight the costs, benefits and risks of the proposal".

Given the importance of this draft determination to development of competition in gas supply in NI and the impact on the long term benefit to customers, we believe that a regulatory impact assessment of the proposals would be highly desirable. Such an assessment could not have failed to conclude that, if implemented, the draft Determination will entrench the Phoenix monopoly, seriously hinder market entry and act against the long-term interests of customers.

In reaching this conclusion, we refer to European analysis that has determined that competition is in the best interests of customers and that price control regulation can undermine development of competition. Three European policy objectives for energy supply are competitiveness, security of supply and sustainability. The DG Competition Report[10] found that these policy objectives are "closely interlinked and complementary" and that, "competitive markets provide the necessary signals for investment, which leads to supply security in the most cost efficient manner".

The report also found that,

> *"In several Member States, regulated tariffs have generated adverse effects for the development of competitive markets, since they have been set at very low levels compared to market prices and cover a large part of the market, thereby effectively leading to re-regulation."*

While competition can exist in parallel with regulated price regimes, the report states in relation to electricity markets that these,

> *"are no threat to a liberalised supply market and its participants as long as regulated energy prices are comfortably above the level implied by wholesale market price levels. This differential allows for (new) suppliers without any local generation to source on the wholesale market and make attractive supply offers compared to the regulated energy tariff. However, Member States could be tempted – especially in periods of rising wholesale prices – to set the supply tariffs below the corresponding wholesale benchmark to ensure lower price levels for customers. Whilst there may be short run benefits to (certain categories of) consumers, such supply tariffs have adverse effects for competition and thus for consumers in the longer run. New suppliers with no access to own generation are effectively squeezed out from the market, as they can no longer market electricity purchased on wholesale markets. Accordingly no competition based on merits can take place for these customers freezing the market position of incumbent operators."*

[10] DG Competition Report on Energy Sector Inquiry, January 2007, (page 5) http://ec.europa.eu/comm/competition/sectors/energy/inquiry/full_report_part2.pdf

In view of the importance of this draft Determination for NI gas customers, we believe that it should have explicitly explored competition issues in relation to both the form and level of price regulation that is proposed for Phoenix gas supply. We would also have expected some assessment of the factors that might promote or discourage market entry and an evaluation of the reasonable balance between securing minimum cost in the current price settlement, as against the medium/long-term customer benefit of facilitating entry by one or more new suppliers

Summary

The draft Phoenix price control Determination provides no margin headroom for entrants to recover the cost of customer acquisition, nor to earn a market rate of return commensurate with the actual risk of a genuinely competitive market. As such, we believe that the most likely outcome of its implementation would be a continuation of the current monopoly. We hope that the Authority will reconsider its approach to regulation of this market.