Consultation on Third Price Control for Phoenix Supply Ltd (PSL)

INTRODUCTION

Aim

The aim of this paper is to seek respondents' views on the principles that will be used to determine the third Phoenix Supply Ltd (PSL) price control. This price control will take effect from 1 January 2012.

Why do we have a price control?

PSL has a licence to supply gas. Under the terms of this licence the Utility Regulator ("the Authority") has the power to control how much PSL can charge for gas; these controls apply when customers are not protected by competition.

"2.4.1 Control over Charges in the absence of competition

If consumers of different cases or classes of cases or for different areas, whose consumption of gas at any premises is reasonably expected not to exceed 2,197,500 kilowatt hours in any period of twelve months:
(a) do not have the opportunity of taking a supply of gas from another gas supplier (or if there is such an opportunity it does not safeguard the interests of consumers); and
(b) the Authority determines that competition from fuels other than gas is not safeguarding the interests of those consumers;
then the Licensee shall take all reasonable steps to secure that in any period of 12 months the average price per therm of gas supplied to such consumers shall not exceed a maximum price to which the Authority has consented"

What is a price control?

PSL must apply to the Utility Regulator for consent to a maximum average price. This maximum average price is made up of the following elements.

- Distribution Costs
- Transmission Costs
- Gas Costs
- Under/Over Recovery
- Supply operating expenditure
- Margin

A price control determination will set out how each of these costs will be treated in the maximum average price. The following table shows how these costs are treated in the current price control.

Cost	Treatment of Cost
Distribution	Pass through
Transmission	Pass through
Gas Costs	Pass through
Over/Under Recovery	Pass through
Supply Operating Expenditure	Prescribed figure
Margin	Set at 1.5%

Pass through costs are costs which PSL will pass straight through to the consumer so they will bear no risk on these costs. The supply operating expenditure figure is determined by analysing a submission from PSL to determine which costs are wholly, necessary and exclusively required for the business of supplying gas. The margin is determined by the capital risks the company faces and benchmarked against margins applied to similar companies.

To date PSL have always set a tariff which is the maximum average price. PSL may choose to set a tariff which is less than the maximum average price. However any over or under recoveries will be based on the maximum average price. The Utility Regulator is of the view that PSL will not be allowed to distort prices by charging a lower price now in order to increase the price later with inflated under recoveries.

REVIEW OF CURRENT PRICE CONTROL

The current price control was set for a period of three years from 1 January 2009 to 31 December 2011. This price control has offered real benefits to gas consumers in Northern Ireland.

Comparison with GB

Traditionally gas prices in Northern Ireland (NI)are more expensive than in Great Britain (GB). This is caused by the higher transportation charges to bring gas across the Irish Sea. However prices in NI are currently lower than in GB. The following table shows a comparison of gas costs in GB, ROI and NI. This is based on the standard tariff of each company against a standard average usage.

Tariff	Average cost[1]
GB average (Big 6 companies[2])	£795
NI - Phoenix Supply Ltd	£714
RoI - Bord Gais	£842

From January 2009 the PSL tariff has decreased by 19% to date, due to decreases in the cost of gas. In GB the average tariff has decreased by 8.7% over the same period.

[1] Calculated at annual 20,500kWh usage as per Ofgem Decision Letter *Revision of typical domestic consumption values* 5 November 10.

[2] Big 6 companies; British Gas, EDF Energy, Eon, npower, Scottish and Southern Energy and Scottish Power

The PSL prices are lower than GB prices because of the decisions made in the current price control concerning the treatment of gas costs and margin.

Control of margin

In November 2010 Ofgem estimated that gas supply companies in GB were achieving an average margin of over 10%[3]. The margin determined in the price control for PSL is 1.5%. Based on a like for like comparison of standard tariff and standard usage this translates to a net margin per customer of £70 in GB and £9 in NI. PSL customers are protected from increased margins by the price control.

Robust scrutiny of costs

The Utility Regulator analysed PSL's price control submission against actual costs and forecast requirements. We used external information and benchmarking where appropriate. The final determination removed 25% of supply operating costs from the original PSL submission.

Efficient purchase of gas

We review PSL's gas purchasing strategy and regularly monitor their gas purchases against the forward market to ensure PSL is efficient in its gas purchasing.

Over/under recovery mechanism

This mechanism makes certain that customers are paying an accurate amount for the gas they use. It ensures that any over recoveries are returned to the customer or under recoveries are recouped through the tariff in a reasonable time frame.

Tariff Review

The price control contains a trigger mechanism to allow a tariff review should a change in the wholesale cost of gas cause a significant change in the tariff. In October 2009 this mechanism was used to bring about a 19% decrease in the tariff after a substantial fall in the wholesale cost of gas. Further tariff reviews have been carried out to ensure that the PSL tariff is reflective of the wholesale cost of gas.

Timescale

The three year timescale was chosen for two reasons

- The Regulator was of the opinion that there would be no effective competition in the market before end 2011
- This timescales provided a period of regulatory certainty for potential new entrants and for PSL
- The longer timeframe reduces the burden of information on both PSL and the Utility Regulator in producing price controls

[3] Ofgem; Electricity and Gas Supply Market Report 26 November 2010

DECISIONS FOR THIRD PSL PRICE CONTROL

On 1 November 2010 firmus energy began supplying gas to domestic customers in the greater Belfast area. This is the first time that domestic customers have been able to switch to another gas supplier.

While competition exists in this early form it provides no substitute for a price control. We are of the view that a well designed price control will ensure that customers are not at risk from inflated margins, whilst still allowing new suppliers to enter the market. Effective competition in the gas market will bring many benefits in terms of better service, innovation and price benefits; however, ineffective competition is more likely to increase prices as companies charge increased margins. Competition in the GB market has brought increased profit margins, a confusing array of tariffs to make comparison difficult and little variation between standard tariffs. Indeed, Ofgem announced on 26 November 2010 that they would undertake a review of the effectiveness of the GB retail market following the recent profit announcements from GB supply companies.

The Utility Regulator will closely monitor competition in the domestic gas market. The Retail Unit are working on a project, known as Roadmap, which will consider the future regulatory approach to the retail market.

Scope of Control

Previous price controls for PSL have applied to those customers with an annual gas consumption of less than 25,000 therms. These properties are mainly domestic and small industrial and commercial customers.

In the market for customers using more than 25,000 therms per annum there is competition in two forms; from other fuel sources (primarily oil) and from other gas suppliers. There are currently four gas supply companies operating in this market, although PSL continues to supply the main share of customers, around 80%. Over the next few months the Utility Regulator will be reviewing the market for customers using more than 25,000 therms to establish if competition is effective in this market. The results of this review will form part of the final determination.

Q1	What are respondents' views on the scope of this control?

Duration of Control

The current PSL price control is for a three year period. At the beginning of this control there was no competition in the market. Since then the market has opened to allow other supply companies to supply gas to those customers using less than 25,000 therms per annum.

For the forthcoming price control the Utility Regulator proposes a five year period with a review at three years. The Utility Regulator believes that this time period is the optimum for PSL, the Utility Regulator and the market as;

- It encourages supply companies to find innovative ways to reduce costs
- The maximum average price will act as a safeguard ensuring that if there is no effective competition over this timescale customers will not be paying increased prices
- This provides a period of regulatory certainty for suppliers in the market and potential new entrants
- If there is effective competition then all parties should be pricing below the maximum average price removing the need for the price control
- PSL can choose to price below the maximum average price in order to compete

Q2	What do respondents consider to be an appropriate timeframe for this control?

Tariff Review

The current price control includes a trigger mechanism. This mechanism triggers a tariff review if the weighted average cost of gas rises sufficiently so as to cause a 5% change in the tariff. This was to mitigate the risk to PSL of a divergence between forecast costs and actual costs. The mechanism also allows for the Utility Regulator to initiate a review, to either increase or decrease the tariff, if it is believed necessary.

The Utility Regulator intends to establish the trigger mechanism as a prescriptive tool. For this purpose we seek views from respondents on the following issues.

Firstly what percentage change in the tariff is necessary to trigger a review, and the timescale over which this rise would be calculated? For example when the increase in gas costs over a 12 month period causes an increase in the tariff of more than 5% a tariff review will be initiated. It is our intention to maintain a low figure for the percentage change, in order to reduce the build up of over/under recoveries.

The Utility Regulator considers that the trigger mechanism should be symmetrical, that is the same percentage change will prompt a review either to increase or decrease the tariff.

The Utility Regulator intends to establish the mechanism so that either party can initiate a review when the trigger point is reached. Also in line with the previous price control the Utility Regulator will retain the flexibility to initiate a review at any stage where we believe it is necessary.

Q3	What are respondents' views on the trigger mechanism?

Tariff Structure

Condition 2.4.1 of the PSL Gas Supply Licence states that for each different class of customer PSL must ensure that the amount charged does not exceed the maximum average price. The Utility Regulator believes that a review of the current PSL tariff structure is required to ensure that the licence condition is being met.

For credit customers the tariff structure is in two parts; one price for usage up to 2,000kWh and another price for usage above this. This structure means that customers will pay a different average price per therm based on their usage, with lower users paying more. The Utility Regulator is seeking to ascertain that this average price paid by consumers equates to the maximum average price as per the licence. We will also review prepayment charges to ensure the average price equates to the maximum average price per therm.

The review will ensure that

- the tariff structure is cost reflective
- it is based on forecast annual usage
- that no class of customer is paying above the maximum average
- that there is a limit on the deviation from the maximum average for lower users

Q4	What are respondents' views on the tariff structure?

K Factor

During the current price control various costs such as gas costs, distribution and transmission charges are treated as pass through. This means that PSL can recover any under spend or pass any over spend back to the consumer, this amount is known as the K factor. We consider pass through to be an appropriate mechanism for those costs over which the company has little control and intend to use this going forward in the next price control. We are of the opinion that this mechanism reduces risk to both the consumer and the company which is reflected in the margin.

The k factor will attract interest at an appropriate rate both on over recoveries , where it will be paid by the company, and on under recoveries where it will be paid to the company.

We believe that the trigger mechanism is an effective mitigating tool to prevent K factor from becoming so large as to skew the tariff either upwards or downwards and affect the competitive environment. This is because the trigger mechanism will operate to initiate a tariff review whenever gas costs, which make up the largest component of K factor, increase or decrease significantly. Thereby ensuring the tariff remains cost reflective.

Q5	What are respondents' views on K factor?

Bad Debt

Bad Debt refers to that debt which is unrecoverable from customers. For the current price control the Utility Regulator reviewed PSL's policies and procedures regarding debt management and determined a level for bad debt at 1% of credit revenue. This level was set to allow PSL time to review their policies to ensure they maximised the use of the debt mitigating measures available to them.

The Utility Regulator considers PSL to be in a favourable position concerning bad debt as it has a number of methods at its disposal to mitigate against bad debt occurring. Firstly the number of customers with existing prepayment meters ensures that these customers cannot build up debt, also PSL can install a prepayment meter to prevent the accumulation of debt where they have identified an issue. Additionally, PSL have the use of Quantum meters which allow them to agree a payment plan with customers to repay the debt. PSL also has arrangements in place with debt recovery parties to trace and recover debt. Given these measures the Utility Regulator considers that unrecoverable debt relates only to undiscovered theft of gas and untraceable customers.

In relation to undiscovered theft the Utility Regulator is minded to allow additional meter readings so that theft can be discovered at an earlier point. This will also assist with billing accuracy and ensure that debt does not arise from the ongoing use of estimates.

Q6	What are respondents' views on bad debt?

Efficiency Factor

The Utility Regulator aims to design the price control to incentive PSL to create efficiencies. In order to achieve this, an efficiency factor is applied to PSL's allowed costs. During the current price control an efficiency factor of zero is applied. This decision was based on the rationale that PSL has requested additional monies for new projects. The Utility Regulator determined not to allow these new costs but to allow PSL to fund these activities from creating efficiencies throughout the business.

To determine an appropriate efficiency factor for the next price control we intend to benchmark against other supply companies (e.g. NIE Supply) and distribution companies.

Q7	What are respondents' views on efficiency factor?

Supply Margin

The current margin set for PSL in the 2009 – 2011 Price Control is 1.5%. This margin is on allowable turnover. This margin was determined based on the business risks faced by PSL including working capital, the likely impact of competition and the treatment of costs within the price control.

We consider that the level of risk for PSL is low given that so many costs within the maximum average price are pass through; this means that PSL can recover the total value of these costs from customers. This is particularly true for gas costs where the trigger mechanism operates to minimise PSL's exposure to increased costs.

Also we consider working capital risks to be included in the margin, as per the previous price control. Therefore, the Utility Regulator proposes to retain a 1.5% margin for the duration of the next price control. The Utility Regulator does not believe that margins need to be increased in order to facilitate competition. Nor do we believe that customers should pay increased prices caused by higher margins.

Q8	What are respondents' views on supply margin?

Questions

Q1 What are respondents' views on the scope of this control?

Q2 What do respondents consider to be an appropriate timeframe for this control?

Q3 What are respondents' views on the trigger mechanism?

Q4 What are respondents' views on the tariff structure?

Q5 What are respondents' views on K factor?

Q6 What are respondents' views on bad debt?

Q7 What are respondents' views on efficiency factor?

Q8 What are respondents' views on supply margin?

RESPONDING TO THE CONSULTATION

The utility Regulator welcomes responses to the specific questions posed in this consultation and any additional comments respondents may wish to make in respect of the proposed price control. Please send comments by   to:

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Individual respondents may ask for their responses, in whole or in part, not to be published, or that their identity should be withheld from public disclosure. Where either of these is the case, we will ask respondents to also supply us with the redacted version of the response that can be published.

As a public body and non-ministerial Government department, we are bound by the Freedom of Information Act (FOIA) which came into full force and effect on 1January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in consultation responses can be put into the public domain. Hence, it is now possible that all responses made to consultations will be discoverable under FOIA – even if respondents ask the Utility Regulator to treat responses as confidential. It is therefore important that respondents note these developments and in particular, when marking responses as confidential or asking the Utility Regulator to treat responses as confidential, should specify why they consider the information in question to be confidential.