Utility Regulator Minded to Position on

Phoenix Supply Price Control, 2012 - 2016

June 2011

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1. Introduction

1.1 Aim

The aim of this paper is to set out the Utility Regulator's minded to position on the third price control for Phoenix Supply Ltd (PSL). This price control will take effect from 1st January 2012.

1.2 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; the price control serves as a proxy for effective competition in its absence.

"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 (75,000 therms per annum) *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"

1.3 What is a price control?

PSL must apply to the Utility Regulator for consent to a maximum average price. This price will apply to the regulated tariff sector which is those customers using less than 25,000 therms per annum. This is typically domestic and small industrial and commercial (I&C) customers.

This maximum average price is made up of the following elements.

- Distribution Costs
- Transmission Costs
- Gas Costs
- Under/Over Recovery
- Supply operating expenditure applicable to the tariff sector (see section 4.3)
- Margin

The Utility Regulator will use the principles established within its price control determination to review the costs submitted by PSL in its tariff review and give or withhold consent to the average maximum price.

1.4 Methodology

This is the third price control for Phoenix Supply Ltd. The first price control was for the period from 1 January 2007 to 31 December 2008, the second for the period from 1 January 2009 to 31 December 2011.

In January 2011 the Utility Regulator issued for consultation a paper on the high level issues regarding this price control. We received four responses to this consultation from

- The Consumer Council
- firmus energy
- NIE Energy Supply
- PSL

This consultation and the responses can be found in Appendix 2.

In establishing our minded to position as set out in this paper we have considered the detailed submission of costs provided by PSL and all supporting information. The previous price controls and the historic actual costs of PSL. Additionally we have taken into consideration the responses to the initial consultation.

All costs in this paper are in 2010 prices unless stated otherwise.

The minded to figures will be updated on receipt of the 2010 actuals from PSL, expected in July.

2.0 Timescale

In our consultation we proposed a five year price control with a review after three years. Of the responses received two considered five years to be an appropriate timescale, one considered it to be inappropriate, suggesting instead a one year price control with the option to remove within year and the final respondent commented that it was difficult to select an appropriate timescale without further information.

This position is in line with the policy position paper shortly to be published by the Retail and Social section within the Utility Regulator.

There will be a review at three years to establish if the price control should be reopened at that point. The review will examine such items as

- Volume
- Market share
- Policy position of the Utility Regulator

3.0 Scope

The previous price control applied to domestic and I&C customers with an annual gas consumption of less than 25,000 therms per annum. Those customers using above 25,000 therms per annum were deemed to be operating in a competitive market with competition available from other fuel sources and from other gas suppliers.

The Utility Regulator continues to monitor this sector for customers using more than 25,000 therms. We have examined the margin achieved by PSL in this market sector, the behavior of suppliers and customers in the market and the number of supply companies operating in the market. On this basis we the Utility Regulator is minded to continue with the current arrangements for regulation for consumers below 25,000 therms per annum only. However, the Utility Regulator will continue to monitor the market above this level closely and review the decision if there is evidence that competition is not effective in the over 25,000 tpa market.

In the high-level price control consultation the Utility Regulator questioned if there was rationale for increasing the scope of the price control to cover all customers. The respondents agreed that the over 25,000 therms per annum sector should remain outside the scope of the price control. To date around 20% of customers in this market have switched.

4.0 Forecast Gas Volumes

PSL have included forecast volumes of gas flowed and numbers of customers in their submission. Within this they have made assumptions on the impact of competition. PSL assume that by 2012 20% of domestic customers will have switched to an alternative supplier and by 2013 30% will have switched remaining at 30% for the rest of the control period. PSL have also made assumption of the number of new connections which is in the region of 5,000 customers connecting to PSL each year.

The Utility Regulator is minded to accept these volume forecasts. PSL are incentivised to forecast volumes accurately by the correction mechanism (see section 9.4). Additionally the majority of items for which volumes and customer numbers are a cost driver are retrospectively adjusted for the actual figures. These include billing costs such as meter reading, bill printing and postage and bad debt. Additionally the apportionment between tariff and non tariff customers may change based on actual volumes, this apportionment is also retrospectively adjusted.

The Utility Regulator is minded to approve these volumes. PSL will be allowed to present revised volume assumptions at each tariff review period.

5.0 Expenditure Analysis

5.1 PSL Submission

The following table shows the PSL submission for the five year period of the price control. All figures are in 2010 prices.

Table 1 PSL Submission from 2012 to 2016 (£'000s)

Cost	**2012**	**2013**	**2014**	**2015**	**2016**
Network Maintenance	£323	£322	£322	£323	£325
Manpower	£1,647	£1,667	£1,687	£1,703	£1,721
Fleet Costs	£68	£68	£69	£69	£69
Travel and Subsistence	£20	£20	£20	£20	£20
Rates	£43	£43	£43	£43	£43
Office Costs	£222	£217	£212	£208	£218
Telephone & Postage	£53	£42	£43	£44	£46
Stationery	£48	£48	£47	£49	£50
Advertising, Marketing and PR	£338	£335	£334	£335	£337
Licence Fee	£68	£68	£68	£68	£68
IT	£259	£170	£169	£179	£178
Professional and Legal Fees	£174	£181	£159	£159	£159
Billing	£2,973	£2,515	£2,332	£2,465	£2,476
Entertainment	£16	£16	£16	£16	£17
Insurance	£65	£65	£65	£65	£65
Human Resources	£45	£40	£41	£42	£43
Capex	£13	£13	£118	£13	£13
PSL 12 Submission	**£6,375**	**£5,830**	**£5,745**	**£5,801**	**£5,848**

5.2 Efficiency Factor

The Utility Regulator aims to design the price control to incentivise PSL to create efficiencies. In order to achieve this, an efficiency factor is applied to PSL's allowed costs. As part of their submission for PC02, the current price control, PSL requested additional monies for projects to be carried out. The Utility Regulator determined that these additional monies should not be allowed but instead an efficiency factor of zero was applied. This was to allow PSL to fund these projects through the identification of efficiencies.

We consider that an efficiency factor is appropriate for this price control given the timescale of the control and the fact that inflation is pass through. We are minded to apply an efficiency factor of 2.5% of total operating expenditure. This efficiency factor was used by Ofgem in the Distribution Price Controls from 2007 to 2012. In setting this efficiency factor Ofgem had regard to the impact of frontier shift and catching up on the costs of the GDNs.

Full competition was introduced to the GB market in 1999. Currently there are around 40 supply companies operating in the GB market. In the Greater Belfast Market competition began in November 2010 when firmus energy entered the market. Currently there are only two companies operating in the market.

The Greater Belfast market is at a much earlier stage than the GB market, therefore the Utility Regulator considers that there are efficiencies to be made from following advances in the GB market in terms of

- Technological progress
- Best practice.

We also consider that the pressure brought by increased competition should lead to increased efficiency.

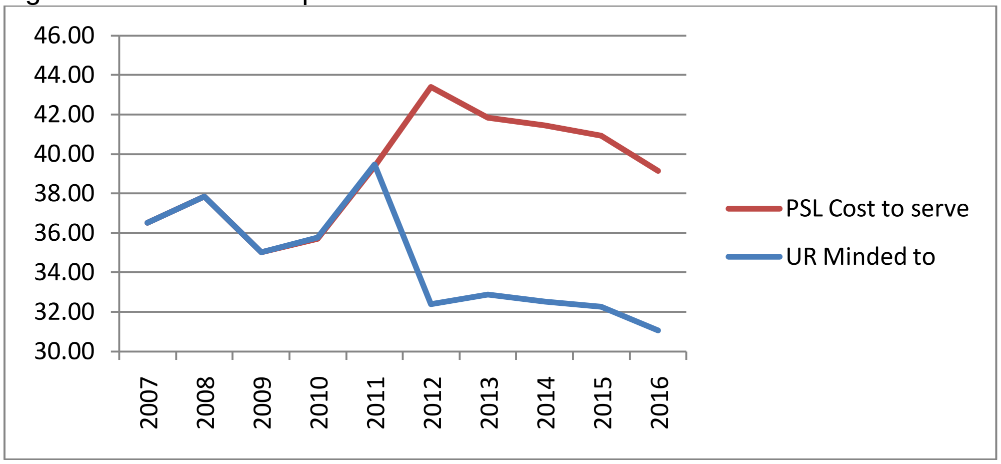
Additionally PSL have requested monies for information technology projects. The Utility Regulator is minded to allow these monies, at an appropriately benchmarked rate. Based on the rationale from the previous price control these costs would not have been allowed and PSL would have been expected to fund them from efficiencies. As these costs will be allowed we consider it is appropriate to include an efficiency factor.

PSL consider that an efficiency factor of zero is appropriate. They cite a low cost to serve customers when compared to RoI and GB, a low cost business model and increasing competition as sufficient rationale for acting efficiently without the need for further incentive.

However the PSL submission shows the cost to serve per customer increasing rapidly at the beginning of the next control period. While it decreases over the control period it remains above the current level. We consider that this cost demonstrates that there are efficiencies to be made within the business.

The graph below shows the historic actual cost to serve to 2011, and the forecast cost to serve based on the PSL submission and the Utility Regulators minded to position.

Figure 1 Cost to Serve per Customer 2007 to 2016



5.3 Apportionment of Costs

The costs submitted by PSL refer to the costs for both tariff and non tariff customers. It is therefore necessary to apportion these costs so that the correct costs are charged to tariff customers and to non tariff customers. In order to apportion the costs we examine the most appropriate cost driver for that cost and apportion on that basis. For example for manpower we will estimate how much time for each employee grade is spent on tariff and non tariff and apportion costs accordingly. The following table shows the cost drivers we have used to apportion costs.

Table 2 Cost items and their respective drivers

Cost Item	Cost Driver
Network Maintenance	All tariff
Manpower	Manpower Numbers
Fleet Costs	No. of cars
Travel and Subsistence	Manpower
Rates	Manpower
Office Costs	Manpower
Telephone and Postage	Avg. no. burning customers (supplied)
Stationery	Avg. no. burning customers (supplied)
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	Load in therms
Entertainment	Manpower numbers
Insurance	Load in therms
Human Resource	Manpower numbers
Capex	Avg. no. burning customers (supplied)
BILLING COSTS	
Bank fees & charges	Load in therms
Gas Cards	All tariff
Qntm, Pypt & Libra Service Charges	All tariff
Billing Transaction Costs	All tariff
Bad Debt Allowance	No. bills generated
Billing Bad Debt	All tariff
Billing Printing and Postage	No. bills generated
Billing Meter Reading	No meters read

The following table shows the allocation of total costs between tariff and non tariff (contract) sectors over the period of the control.

Table 3 Apportionment of Operating Costs

Year	2012	2013	2014	2015	2016
Tariff	83.9%	82.1%	81.6%	83.6%	82.8%
Contract	16.1%	17.9%	18.4%	16.4%	17.2%

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

5.4 Treatment of Operating Costs

In the previous two price control the Utility Regulator has scrutinised each cost line contained within the PSL submission and made a final determination on each cost line based on the costs incurred in previous years, the costs forecast to be incurred and any other relevant information.

In total there are sixteen cost lines within the PSL submission. Of these eight cost lines make up more than 94% of the total cost. The remaining eight cost lines, identified below, are to be rolled forward at an average of the last four years actual costs (2007 to 2010). We are content that this methodology is sound having scrutinised the costs robustly in the previous two price controls. The costs allowed are broadly in line with those allowed in the previous price control. The PSL submission and the Utility Regulator Minded to position for these costs can be seen in the two tables below.

In respect of Licence fees these will be retrospectively adjusted for the actual amount charged to PSL.

Table 4 PSL Submission of Rolled Forward Costs (£'000s)

	2012	**2013**	**2014**	**2015**	**2016**
Fleet Costs	£68	£68	£69	£69	£69
Travel and Subsistence	£20	£20	£20	£20	£20
Rates	£43	£43	£43	£43	£43
Telephone & Postage	£53	£42	£43	£44	£46
Stationery	£48	£48	£47	£49	£50
Licence Fee	£68	£68	£68	£68	£68
Insurance	£65	£65	£65	£65	£65
Human Resources	£45	£40	£41	£42	£43
PSL Submission	**£410**	**£394**	**£396**	**£400**	**£404**

Table 5 UR Minded to Position on Rolled Forward Costs (£'000s)

	2012	**2013**	**2014**	**2015**	**2016**
Fleet Costs	£55	£55	£55	£55	£55
Travel and Subsistence	£16	£16	£16	£16	£16
Rates	£44	£44	£44	£44	£44
Telephone & Postage	£33	£33	£33	£33	£33
Stationery	£39	£39	£39	£39	£39
Licence Fee	£65	£65	£65	£65	£65
Insurance	£57	£57	£57	£57	£57
Human Resources	£28	£28	£28	£28	£28
UR Minded to Position	**£337**	**£337**	**£337**	**£337**	**£337**

5.5 Entertainment Costs

PSL have submitted the costs for entertainment. In line with their treatment in the distribution price control the Utility Regulator is minded to disallow these costs.

Table 6 Entertainment Costs

	2012	2013	2014	2015	2016
PSL Submission	£16	£16	£16	£16	£17
UR Minded to Position	£0	£0	£0	£0	£0

5.6 Network Maintenance

Network maintenance costs relate to the costs charged to the supply company from the distribution company. These costs relate to meter exchanges, (where more than one meter is exchanged at a property per year), meter tampering, meter box repairs, disconnection costs. It also includes the cost of energy care, which is offered to elderly customers and relates to the provision of adapters and equipment.

In the previous price control the Utility Regulator allowed only costs relating to Energy Care as PSL had previously presented the remaining costs as relating to meter exchanges. As the costs of meter exchanges are covered by PNG for the first meter exchange at a property in a year, the Utility Regulator disallowed these costs.

The following table shows the PSL submission for Network Maintenance and the Utility Regulator minded to position.

Table 7 Network Maintenance Costs (£'000s)

	2012	2013	2014	2015	2016
PSL Submission	£323	£322	£322	£323	£325
UR Minded to Position	£230	£191	£139	£139	£139

The majority of costs within the submission relate to the tampering of meters by customers. PSL have requested monies for over 500 meter tampering incidents each year. Meter tampering represents a danger to consumers and the public at large and therefore PSL must attempt to minimise the levels.

The Utility Regulator is minded to allow 75% of the proposed costs for the next year, reducing to 25 % over the next three years. PSL must evaluate its policies on meter tampering to reduce the levels of meter tampering and to minimise the cost of handling each incident. Other costs have been rolled forward at an average of the last three years actual costs.

5.7 Advertising Marketing and PR

PSL have requested a significant increase in their marketing allowance, with the majority of the additional costs relating to marketing. It is the view of the Utility Regulator that customers should not finance either retaining or attracting other customers to PSL. As a result we have disallowed all those costs which relate to marketing the company.

Furthermore we have disallowed any recharge of advertising costs from PNG. PNG advertise in order to attract new customers to connect to the natural gas market. This benefits all supply companies as new customers are seeking a natural gas supply.

Costs have been allowed for customer literature, advertising production and running costs (relating to customer literature) and market research.

Table 8 Advertising and Marketing Costs (£'000s)

	2012	2013	2014	2015	2016
PSL Submission	£338	£335	£334	£335	£337
UR Minded to Position	£59	£58	£59	£59	£61

5.8 Information Technology

The following table shows the submission from PSL for IT expenditure. With the exception of costs related to PAYG meter customers the Utility Regulator is minded to allow all IT costs. We consider that allowing these costs will aid PSL in continuing to strive towards an efficient business. These costs are in support of all PSL's requirements for running their business including but not limited to billing, customer switching and day to day operational matters.

From August 2011 all Pay As You Go customers will be able to switch supplier. PSL have identified changes to be made to their system to improve switching. The Utility Regulator is minded to allow the PAYG related IT cost in 2012. However these will be scrunitised to ensure they are wholly necessary and will be considered separately.

Table 9 Information Technology Costs (£'000s)

	2012	2013	2014	2015	2016
PSL Submission	£259	£170	£169	£179	£178
UR Minded to Position	£172	£170	£171	£180	£178

5.9 Capital Expenditure

The following table shows the PSL submission for capital expenditure costs and the Utility Regulators minded to position.

Table 10 Capital Expenditure (£'000s)

	2012	2013	2014	2015	2016
PSL Submission	£13	£13	£118	£13	£13
UR Minded to Position	£13	£13	£13	£13	£13

In 2014 PSL have included the costs for a billing server, the Utility Regulator is minded to allow these costs. However as with the PAYG costs in 2012 the costs will be scrutinised to ensure they are an appropriate level.

5.10 Legal and Professional fees

PSL have requested monies for legal and professional fees for areas such as NTS Exit Reform, gas contract, climate change levy etc. The Utility Regulator has considered the submission provided by PSL. We consider that PSL have not provided enough detail on the costs included, for example the breakdown of costs or any rationale for why costs should be incurred annually. Therefore the Utility Regulator has allowed one off costs for the following items.

- Climate Change Levy
- NTS Reform
- Gas Contract
- Common Arrangements for Gas

Other costs have been rolled forward at an average of actual costs for previous years. Ongoing costs include the costs relating to gas purchasing including advice and review, markets information, and costs relating to regulatory advice and security issues.

The Utility Regulator is minded to allow the following costs for legal and professional fees.

Table 11 Legal and Professional Costs (£'000s)

	2012	2013	2014	2015	2016
PSL Submission	£174	£181	£159	£159	£159
UR Minded to Position	£138	£133	£118	£118	£118

5.11 Office Costs

The Utility Regulator is minded to allow the proposed office costs as these are in line with costs previously incurred.

Table 12 Office Costs (£'000s)

	2012	2013	2014	2015	2016
PSL Submission	£222	£217	£212	£208	£218
UR Minded to Position	£222	£217	£212	£208	£218

5.12 Manpower

The table below shows the PSL submission for manpower costs and numbers.

Table 13 Manpower (£'000s)

	2011	2012	2013	2014	2015	2016
Number FTE	55.00	56.50	55.50	56.00	56.50	57.50
Total Cost ('000)	£1,612	£1,647	£1,667	£1,687	£1,703	£1,721
Cost per FTE ('000)	£29.300	£29.150	£30.036	£30.125	£30.142	£29.930

In the previous price control PSL was allowed for 2011 a staffing level of 51.5 staff, in addition during the control period PSL was allowed an additional two grade nine level staff to facilitate competition. The Utility Regulator will therefore take 53.5 FTE as its starting position.

PSL have stated that their salary levels are low. We compared the grade 9 salaries with call centre operative's salaries as detailed in the ASHE[1] report. We found the gross salaries figures to be broadly in line with those contained in the ASHE report. The ASHE report also states that salaries in Northern Ireland are the lowest in the UK. Between 2009 and 2010 the ASHE report shows that salaries increased by less than inflation. PSL's submission shows that over the same period salaries either rose or remained at the same level.

PSL have proposed to increase basic salaries by more than inflation over the next few years in order to attract and retain staff. The Utility Regulator does not see any justification for an above inflation rise in salaries. Instead the Utility Regulator proposes to roll forward the 2011 salary at inflation. As with all other costs manpower costs will be reduced by the 2.5% efficiency factor. We consider this to be an appropriate level for salaries going forward.

[1] Annual Survey of Hours and Earnings (ASHE) report 2010 results
http://www.statistics.gov.uk/statbase/Product.asp?vlnk=1951

PSL have proposed to increase the level of credit control support by 1.5 FTE in order to minimise bad debt costs. The Utility Regulator is minded to allow this additional cost. The Utility Regulator considers that this additional credit control support will allow PSL to manage their debt more effectively. See bad debt section 4.13.2.

For customer switching activities PSL have proposed an increase of 1.5 FTE. The Utility Regulator is minded not to allow this additional cost. Switching levels are closely monitored by the Utility Regulator and additional resources for switching will be provided as considered necessary.

The following table shows the Utility Regulator's position on manpower.

Table 14 Utility Regulator Minded to Position on Manpower

	2011	2012	2013	2014	2015	2016
Number FTE	53.50	53.00	52.50	53.00	53.00	53.00
Total Cost ('000)	£1,558	£1,498	£1,494	£1,494	£1,496	£1,497
Cost per FTE ('000)	£29.125	£28.259	£28.464	£28.197	£28.222	£28.241

5.13 Billing Costs

The PSL submission for billing costs includes the following costs.

Table 15 Billing Costs PSL Submission (£'000s)

	2012	2013	2014	2015	2016
Gas Cards	£44	£41	£40	£41	£43
Third Party Debt recovery	£102	£81	£68	£71	£74
Bad Debt	£1,050	£829	£705	£718	£735
Transaction Charges	£285	£262	£255	£266	£276
Transaction Costs	£384	£349	£336	£348	£357
Bill Printing and Postage	£302	£275	£269	£280	£292
Meter Reading	£653	£588	£570	£587	£605
Bank Fees	£154	£90	£90	£154	£95
Total	**£2,973**	**£2,515**	**£2,332**	**£2,465**	**£2,476**

The Utility Regulator is minded to allow the following costs. These costs are detailed below.

Table 16 Billing Costs UR Minded to Position (£'000s)

UR Minded to Position	**2012**	**2013**	**2014**	**2015**	**2016**
Gas Cards	£44	£41	£40	£41	£43
Debt management allowance	£100	£100	£100	£100	£100
Bad Debt	£321	£291	£283	£288	£294
Transaction Charges	£285	£262	£255	£266	£276
Transaction Costs	£384	£349	£336	£348	£357
Bill Printing and Postage	£299	£276	£270	£280	£290
Meter Reading	£522	£468	£454	£468	£481
Bank Fees	£51	£51	£51	£51	£51
Total	**£2,005**	**£1,837**	**£1,789**	**£1,842**	**£1,891**

5.13.1 Gas Cards

The Utility Regulator is minded to allow these costs.

5.13.2 Bad Debt Costs

In the previous price control, the Utility Regulator determined a bad debt level of 1% of credit revenue for PSL. At this time the Utility Regulator reviewed the policies and procedures which PSL had in place to manage debt and determined that these required improvement. The Utility Regulator considered 1% of credit revenue to be over and above the level actually required by PSL and intended to reduce that figure in this price control.

For this price control period PSL have requested a level of bad debt ranging from 1.25% to 0.89% of total revenue. This can be seen in the table below.

Table 17 PSL Submission on Bad Debt (£'000s)

	2012	**2013**	**2014**	**2015**	**2016**
Bad Debt	£1,050	£829	£705	£718	£735
Bad Debt as % of Revenue	1.25%	1.07%	0.92%	0.90%	0.89%

PSL presented to the Utility Regulator on bad debt, in particular on the current economic climate and the difficulty in receiving money from customers once that customer is in debt.

While PSL provided information on their processes for managing debt they provided no information on how they prevent customers getting into debt, or on their systems and metrics for identifying those who are at risk of getting into debt. The Utility Regulator considers that PSL's policies and procedures should be focused on preventing debt and on seeking to help those customers who are having difficulty paying their bill.

Additionally we believe that PSL should have robust monitoring in place, in order to effectively manage customers who are at risk of getting into debt, in debt and at risk of not repaying their debt.

The Utility Regulator engaged consultants to investigate the debt levels in Great Britain for comparison against those in PSL. This report focused on the debt levels experienced in GB companies, the levels of prepayment meters and best practice debt management.

The Utility Regulator considers that PSL has a range of options available to it to mitigate bad debt levels including credit checks on new customers, prepayment meters to allow customers to pay as you go and quantum meters to recover debt. The level of prepayment meters in the Greater Belfast Area is significantly higher than those in Great Britain as can be seen from the following table.[2]

Table 18 Percentage of customers by payment method

	Credit	Direct debit	Prepayment
Scotland	30	57	14
England & Wales	33	55	13
Great Britain	32	55	13
Phoenix Supply Ltd	18	22	60

This factor alone should indicate that PSL's debt levels are below those seen in GB. However, Ofgem[3] state that in June 2009 just over 5% of gas customers were repaying a debt. In June 2009 for PSL this figure was around 14%. Furthermore when we compare the debt figures from PSL with those from Centrica[4] we can see that PSL's levels are higher. In 2010 Centrica had a combined debt level (domestic and business) of 9.54% of total revenue. For the same period PSL had a debt level of over 12% (tariff customers only). This evidence demonstrates that PSL's debt management process requires further investigation.

The Utility Regulator is therefore minded to allow a bad debt level of 1.0% of credit revenue. This is in line with the position set out in the previous control. The Utility Regulator considers that PSL has had opportunity to improve its processes and monitoring and levels of bad debt should therefore be decreasing, however is mindful of the current economic climate and the difficulties for some customers in paying their bills. This is shown in the table below.

[2] Great Britain information from http the DECC Quarterly Energy Prices – March 2011. Table 2.5.2 http://www.decc.gov.uk/en/content/cms/statistics/publications/prices/prices.aspx

[3] The Ofgem report Review of suppliers' approaches to debt management and prevention June 2010 http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents1/Debt%20Review%20Report.pdf

[4] http://www.centrica.com/files/reports/2010ar/index.asp

Table 19 Utility Regulator Minded to Position on Bad Debt (£'000s)

	2012	2013	2014	2015	2016
Bad Debt	£321	£291	£283	£288	£294
Bad Debt as % of Credit Revenue	1.00%	1.00%	1.00%	1.00%	1.00%

In addition to the bad debt allowance PSL have also requested monies for third party debt recovery agents. PSL have evidenced to us that third party debt recovery yields little results, and the tactics employed by many of these agencies have come into question over the last number of years. The Utility Regulator proposes to grant PSL an allowance for each year of the price control of £100k in order to establish improved debt prevention and management techniques. We would strongly encourage PSL to seek out best practice and innovative solutions to avoiding debt and dealing with it when it does occur. This allowance is ring fenced solely for debt management and prevention and PSL will have to evidence to the Utility Regulator how this money has been spent and the benefits achieved from it.
We would also encourage PSL to liaise with other organisations who may be able to help customers with their debt and other financial difficulties, and to provide ways of helping customers manage their energy bills now and in the future.

In addition the Utility Regulator has also allowed additional manpower costs for increased credit control staff.

5.13.3 Meter Reading

Meter reading costs will be treated as a retrospectively adjusted cost based on the actual number of meter readings. An allowance is made for the number of meter readings per customer by payment type. These are shown in the table below.

Table 20 Number of Meter Readings

Payment Type	Number of Meter Readings
Standard Credit	4.0
Direct Debit	4.0
PAYG	1.3
Quantum	1.3

The number of meter readings for direct debit customers has increased from one to four per year. This is to reduce the amount of estimation on direct debit bills and to allow direct debits to be amended where consumption patterns are changing.

Meter Readings are carried out by PSL's associated company Phoenix Energy Services (PES). The Utility Regulator will therefore disallow any profit element from this charge. We have also benchmarked the meter reading charges of PSL against those of NIE. The PSL charges are over 30% higher than NIE for domestic properties and over 170% higher for industrial and commercial properties. The Utility Regulator recognises that every property will have an electricity meter while not every property will have a gas meter, however we note that the average cost of meter reading includes all properties ie rural and remote properties. Therefore we are minded to use the NIE rate for domestic readings, and the PES rate less profit margin for I&C and special reads. The PES profit margin is calculated at 11.6% as used in the previous price control.

Table 21 Meter Readings (£'000s)

Meter reading	2012	2013	2014	2015	2016
PSL submission	£653	£588	£570	£587	£605
UR minded to position	£522	£468	£454	£468	£481

5.13.4 Printing and Postage

Printing and Postage costs will also be retrospectively adjusted for the actual number of bills received. As with meter reading costs the number of direct debit statements received by customers each year will increase from one to four. Additionally PSL have submitted costs for the inclusion of annual statements for PAYG customers. The Utility Regulator is minded to allow these additional costs.

Table 22 Printing and Postage Costs (£'000s)

	2012	2013	2014	2015	2016
PSL submission	£302	£275	£269	£280	£292
UR minded to position	£299	£276	£270	£280	£290

5.14 Utility Regulator Minded to Position

The following table shows the Utility Regulators minded to position on operating costs and capital expenditure for the period of the price control.

Table 23 Utility Regulator Minded to Position (£'000)

Cost	**2012**	**2013**	**2014**	**2015**	**2016**
Network Maintenance	£230	£191	£139	£139	£139
Manpower	£1,498	£1,494	£1,494	£1,496	£1,497
Fleet Costs	£55	£55	£55	£55	£55
Travel and Subsistence	£16	£16	£16	£16	£16
Rates	£44	£44	£44	£44	£44
Office Costs	£222	£217	£212	£208	£218
Telephone & Postage	£33	£33	£33	£33	£33
Stationery	£39	£39	£39	£39	£39
Advertising, Marketing and PR	£59	£58	£59	£59	£61
Licence Fee	£65	£65	£65	£65	£65
IT	£172	£170	£171	£180	£178
Professional and Legal Fees	£138	£133	£118	£118	£118
Billing	£2,005	£1,837	£1,789	£1,842	£1,891
Entertainment	£0	£0	£0	£0	£0
Insurance	£57	£57	£57	£57	£57
Human Resources	£28	£28	£28	£28	£28
Capex	£13	£13	£13	£13	£13
UR Minded to Position	**£4,674**	**£4,450**	**£4,332**	**£4,392**	**£4,452**
Efficiency Factor	2.5%	2.5%	2.5%	2.5%	2.5%
Minded to Position	**£4,557**	**£4,339**	**£4,224**	**£4,282**	**£4,341**

6.0 Gas Costs

The wholesale cost of gas and the associated costs of purchasing gas make up more than 55% of the final price of gas to customers. This section details the Utility Regulators minded to position on each element of gas costs.

6.1 Wholesale Gas Cost

In the consultation paper we proposed that wholesale gas costs should be treated as a pass through cost. We consider that in the wholesale gas market PSL is a price taker; in that it has no control over the price of wholesale gas. Therefore it is appropriate that wholesale gas costs are treated as pass through. Respondents broadly supported that gas costs should remain as pass through. One party commented on the need for transparency of PSL's gas purchases. The Utility Regulator considers details of gas purchasing to be commercially sensitive and that publishing such information will not benefit the consumer. Gas markets are liquid and transparent for those in the market, therefore parties can all buy gas at the same price. It is the timing of purchases of wholesale gas which will lead to a difference in the cost and this is an area of competitive advantage for companies.

The Utility Regulator will monitor closely the build up of over and under recoveries and will act to ensure these remain at a low level so as not to distort prices. (see section 6.3)

The Utility Regulator is minded to allow wholesale gas costs as a pass through cost. As part of the pass through arrangement we expect PSL to provide us with the following information.

- On an annual basis the PSL gas purchasing strategy with advice from a third party expert source (as allowed in professional fees).
- On a monthly basis details of gas purchases on an ex ante and ex post basis for both tariff and non tariff customers.
- Full details of any over/under recoveries

6.2 National Transmission System Transportation Charges

These are the costs associated with transporting gas through the National Transmission System (NTS) in Great Britain. These charges are set and published by National Grid. The Regulator is minded to allow these costs as pass through.

6.3 Unaccounted for Gas

The Utility Regulator is minded to allow the level of unaccounted for gas as a pass through of the Shrinkage Factor published by Phoenix Natural Gas Ltd.

6.4 Credit Support

PSL have submitted a breakdown of their required credit costs to finance the purchasing and conveyance of gas. These include credit charges to Premier Transmission Ltd, Belfast Gas Transmission Ltd, Phoenix Natural Gas Ltd and Total Gas and Power Ltd. PSL have submitted the cost of credit support to be 1.03ppt , to be treated as pass through for the actual cost of credit support incurred. The Utility Regulator wishes to incentivise PSL to secure the more economic forms of credit support. Currently the most expensive form of credit is that to support the distribution charge paid to its associated company PNGL, accounting for more than half of the total credit costs. PSL have stated that they cover their obligation under the Network Code to provide credit cover by prepaying Distribution charges two months in advance. They have stated that this is charged at a rate of 8% but provided no rationale or evidence for this rate. We have set a rate at 2% for credit cover for distribution charges, in line with the rate charged for letters of credit. Therefore the Utility Regulator is minded to allow a cost of credit set for the period of the control at 0.54ppt.

6.5 Energy Balancing

PSL buy a proportion of their gas requirements in advance of the month and the remainder within the month. The energy balancing amount is a figure included within the tariff to account for the cost of buying gas within the month as opposed to on the forward curve. The actual wholesale cost of the gas remains pass through, this figure is to ensure the tariff accurately reflects the impact of the timing of purchasing the gas. PSL have proposed an energy balancing figure of 15% premium on the wholesale cost of gas within the tariff, based on 40% of gas purchased within the month. For the last tariff the actual increased cost of gas within the month, over the amount allowed in the tariff, was on average 10%. Therefore the Utility Regulator is minded to allow an energy balancing figure of 10% premium on the wholesale cost of gas within the tariff on 40% of purchases for the month.

7.0 Network Costs

Network costs are the charges for the use of the transmission and distribution systems. In previous price controls these costs have been set as pass through costs. The Utility Regulator is minded to allow transmission and distribution costs to be treated as pass through.

The costs for the transmission system are those costs involved in bringing gas from Scotland to Northern Ireland, via the Scotland to Northern Ireland Pipeline. They also include the costs for bringing gas to the distribution network areas. These costs are published on the Premier Transmission website at http://www.premier-transmission.com/. The Utility Regulator reviews and approves these costs.

The costs for the distribution system are those costs associated with moving gas throughout the Greater Belfast Area to homes and businesses. These can be found on the Phoenix Natural Gas website at http://www.phoenixnaturalgas.com/naturalgas/transportation-services/conveyance-charges/. Distribution costs are also subject to price control by the Utility Regulator. The next price control period will be from 1 January 2012 and a consultation paper will be published over Summer 2011.

8.0 Tariff

The tariff is the amount that PSL charges to its customers for gas. This can be set at or below the maximum average price. Section 1.3 details how the tariff is made up. Table 6.1 below shows the Utility Regulators minded to position on the treatment of those costs which make up the tariff.

Table 24 Treatment of costs

Cost Element	Treatment
Transmission	Pass through
Distribution	Pass through
Gas Costs	Pass through
K factor	Pass through
Supply Operating Costs	Determined by price control
Margin	Determined by price control

8.1 Tariff Process

The tariff is reviewed on a bi annual basis in April and October. The costs detailed above will be analysed against the forecast cost to establish whether a change in the tariff is required. Typically it is movement in the wholesale cost of gas which will lead to a change in the tariff as the other costs are more readily forecast. The tariff process involves the Utility Regulator, PSL, the Department of Enterprise, Trade and Investment and the Consumer Council for Northern Ireland. This process is detailed in Appendix 1.

8.2 Trigger Mechanism

In addition to the bi annual tariff review the Utility Regulator is minded to establish a trigger mechanism in line with previous price controls. The aim of this trigger mechanism is to initiate a tariff review should the cost of gas vary significantly from the cost forecast within the tariff.

In the previous price control the mechanism triggered a review when the price of gas increased so as to increase the tariff by 5%. The Utility Regulator considers the 5% level to be an appropriate level as volatility in the wholesale market could necessitate to a number of tariff reviews in a year. Tariff reviews can be costly and complex for the company.

The trigger mechanism will operate to allow the Utility Regulator to initiate a tariff review should the wholesale cost of gas change, either increase or decrease, so as to change the tariff by 5%. Where a review is initiated by the trigger mechanism the tariff review group will look at not only the wholesale cost of gas but a number of factors including

- Volatility in the wholesale gas market
- Time since last tariff review
- Level of k factor
- Amount of gas purchased by PSL

The Utility Regulator retains the flexibility to initiate a review at any stage it believes in is the interest of customers.

8.3 K factor

The treatment of costs as pass through means that PSL is allowed to recover the actual costs incurred. Where actual costs vary from those forecast PSL can charge any under recoveries or return any over recoveries to customers through the tariff. This amount of over or under recovery is known as the k factor. The Utility Regulator intends that the k factor should remain at a minimum level to avoid distorting the PSL tariff and affecting the competitive environment. The bi annual tariff reviews and the trigger mechanism will ensure that the tariff remains close to the actual costs and therefore minimises the k factor.

At each tariff review the Utility Regulator will publish the k factor to allow for transparency.

8.4 Tariff Period

The tariff usually runs for a 12 month period. Historically the cost of gas has been higher for the winter months than the summer. There is evidence that this is changing with the increase of storage and greater availability of LNG leading to a flatter forward curve. A 12 month tariff encompasses all the seasons and therefore spreads the costs of the more expensive winter gas over the summer months. A shorter tariff period may lead to increased rises and falls in tariff. The tariff process set out in Appendix 1 allows the Utility Regulator to review various time scales for the tariff period including 12, 18 and 24 month periods. This allows the Utility Regulator to assess the impact of changes in the forward curve and smooth the path of prices for customers. Additionally the Utility Regulator can assess the impact of the k factor on the tariff and choose a time period over which the k factor will have minimal impact.

8.5 Structure

The current PSL tariff structure is based on a two tiered tariff, with one amount charged up to a limited number of units and a second amount charged for every unit used above that. Pay as you go customers pay a flat tariff; the same amount for each unit used. PSL calculate the tariff on a weighted average basis, based on the number of customers on each tariff and the average usage per customer type.

The Utility Regulator acknowledges that the tariff structure can be based on best estimate of usage based on the previous years actuals. We require PSL to evidence that the assumptions used to create the tariff structure ensure that the weighted average price is equal to or less than the maximum average tariff.

9.0 Margin

The Utility Regulator proposed in its consultation paper to retain the current margin of 1.5% for the period of this control. Two of the respondents agreed that the current margin is appropriate, the other two argued that increasing competition will lead to stranded costs and companies unable to recover all their k factor. As stated above in section… The Utility Regulator considers that the trigger mechanism and bi annual tariff reviews are effective tools for minimising the k factor and reducing the likelihood of stranded costs.

PSL state that they require a margin of a minimum of 5%. They cite the example of GB companies achieving margins of around 10% as being closer to the margin that should be allowed at this stage. In the last price control for British Gas in 2000 Ofgem applied a 1.5% margin. The Utility Regulator considers this to be an appropriate benchmark. There is currently les competition in the market in Greater Belfast than in the GB market at that stage and only one other operating supply company.

The 1.5% margin has been in place since 2008 (previously 1.3% in 2007). It takes into account the risks the company is exposed to and the working capital requirements of the company. It is in line with the margin applied to other regulated companies, 1.7% proposed for NIEES, 2% for BGE. The Utility Regulator does not consider that the risks to the company have changed so as to warrant an increase in the margin.

In relation to the variance between the margin set for NIEES and PSL this can be explained by the comparative size of the markets, as the gas market is smaller. The gas market is also at an earlier stage of development. Additionally there are increased working pressures on NIEES due to the purchasing regime of the SEM which requires that purchases of wholesale energy are paid for every four days.

10.0 Reconciliation

On an annual basis the Utility Regulator will reconcile the costs allowed in the price control with the actual costs incurred by PSL and determine a reconciliation amount to be returned to customers or received from customers.

This reconciliation will take into account

- Retrospective items
- Maximum average price
- Rate of Interest applicable
- Correction Mechanism

10.1 Retrospective Items

The retrospective items are those items detailed in the operating costs section above which will be adjusted for either actual costs or actual performance.

These costs are

- Licence Fee
- Billing Costs
  - Bad Debt (adjusted for actual credit revenue)
  - Transaction costs (adjusted for actual number of transactions)
  - Meter reading costs (adjusted for actual number of meter reads)
  - Bill printing costs (adjusted for actual number of bills)
- Inflation
- Apportionment of costs

10.2 Maximum Average Price

The amount of revenue received by PSL will always be reconciled to the maximum average price. Therefore if PSL choose to charge less than the maximum average price any difference in costs will be funded from the margin. Also if PSL charge more than the maximum average price any difference will be returned to the customer. It is important to note that in this situation PSL will be considered to be in breach of their Gas Supply Licence.

The Utility Regulator will review any situation where a difference in actual revenue versus the maximum average price is caused by the tariff structure. This would be caused where PSL have underestimated the amount of gas a customer will consume annually. This can be seen in the example below. In this example the maximum average price is 3.33p/kWh. Using an estimate annual usage of 12,000kWh PSL set their tariff structure at 5ppt for the first 2,000kWh and 3ppt for every kWh used after that. Following a cold winter the actual usage turns out to be 17,000kWh meaning that PSL only received an average price of 3.24p/kWh.

Table 25 Example of Tariff Structure

Estimated Usage 12,000 kWh			
	p/kWh	Usage	Cost (£)
Up to 2000 kWh	5.00	2000	100
Over 2000 kWh	3.00	10000	300
Total Usage		12000	400
Maximum Average Price p/kWh		3.33	

Actual Usage 17,000 kWh			
	p/kWh	Usage	Cost (£)
Up to 2000 kWh	5.00	2000	100
Over 2000 kWh	3.00	15000	450
Total Usage		17000	550
Maximum Average Price p/kWh		3.24	

Where PSL have charged less than the maximum average price the Utility Regulator will require evidence that;

- The tariff structure was based on sound principals
- A fundamental change occurred which affected the underlying assumptions

On this basis the Utility Regulator may allow PSL to recoup the variance between actual revenue and the maximum average price.

10.3 Rate of Interest applicable

Any reconciled amounts, whether to be returned to or collected from the customer will be rolled forward at an interest of LIBOR plus 1.5%. This rate will also apply to any gas costs have been over or under recovered. This rate of interest is set to reflect the cost to PSL of financing the under recovery or the benefit to them of holding any over recovery. It is different to the rate set in the correction mechanism below, which is set at a penal rate to incentivise PSL to forecast volumes accurately.

10.4 Correction Mechanism

In a calendar year any allowed expenditure (with the exception of gas costs) not incurred or exceeded because of inaccurate forecasts of volume etc. will be addressed at the end of the year through a correction mechanism. For any over recoveries PSL incur we propose to continue to use the two-tier mechanism determined in the previous price control. This methodology is similar to that used by Ofgem in the 2007 Distribution Price Control. The two tier mechanism is as follows:

- If PSL over recovers by more than 3 per cent, they suffer an interest rate of 3 per cent higher than the base rate;
- If PSL over recovers by less than 3 per cent, they suffer an interest rate of 1.5 per cent higher than the base rate;
- If PSL 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 PSL under recovers by more than 3 per cent, they may recover interest at base rate.

The base rate used is the rate set by the Bank of England and will be taken as the July figure.

The Utility Regulator will allow PSL to submit updated volumes at the beginning of each tariff period.

11.0 Outcome

The following tables show the PSL submission compared to the UR minded to position in terms of the operating cost per therm.

Table 26 Outcome based on PSL Submission

	2012	2013	2014	2015	2016
PSL Submission (£'000)	6,375	5,830	5,745	5,801	5,848
Allocation	83.9%	82.1%	81.6%	83.6%	82.8%
Tariff Costs (£'000)	5,331	4,770	4,672	4,836	4,825
Operating Cost per therm	9.23	9.13	9.07	8.63	8.62

Table 27 Outcome based on Utility Regulator Submission

	2012	2013	2014	2015	2016
UR Minded to Position (£'000)	4,557	4,339	4,224	4,282	4,341
Allocation	83.9%	82.1%	81.6%	83.6%	82.8%
Tariff Costs (£'000)	3,824	3,563	3,448	3,581	3,594
Operating Cost per therm	6.62	6.82	6.69	6.39	6.42

12.0 Responding to the Consultation

The Utility Regulator welcomes responses to the items raised in this consultation and any additional comments respondents may wish to make in respect of the proposed price control. Please send comments by 26 August 201l to:

Lesley Robinson
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ER

Or email lesley.robinson@uregni.gov.uk

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.

Appendix 1

PSL Tariff Review Process

Introduction

The aim of this document is to create a process for future Phoenix Supply Ltd (PSL) tariff reviews. The tariff review process is a consultative one which involves PSL, Utility Regulator (UR), Department of Energy, Trade and Investment (DETI) and Consumer Council for Northern Ireland (CCNI). All parties bring their expertise and opinion in relation to the needs of PSL, the needs of the consumer and the wider impact on the economy. It is important, therefore, that all parties are aware of and in agreement with a formal process. PSL set a tariff in April each year, followed by a tariff review in October. There have also been occasions where the cost of gas has changed significantly so as to make a review at other times of the year necessary. This process will provide a robust procedure to ensure that all parties are consulted in a timely, prescribed and comprehensive manner for both anticipated and unanticipated tariff reviews. A tariff review is the process of analysis and discussion of the PSL tariff to consider if a change to the tariff is needed, and to decide the magnitude and timing of any change.

Requirement for process

According to the terms of the Phoenix Supply licence[5] PSL must apply to the Utility Regulator for consent to a maximum average price which it can charge for gas supply over a 12 month period. Within the PSL price control (PC02) is also a trigger mechanism which allows PSL or the Utility Regulator to undertake a further tariff review.

> *'A review of gas tariffs will take place if Phoenix can demonstrate that the weighted average cost of gas (WACOG) has diverged from forecast sufficiently to cause a rise in the annual maximum average tariff of more than 5%. The WACOG is calculated as the weighted average price of gas for the year based on the forward price of gas and any purchases already made by PSL. As a result of the review the Utility Regulator will allow an adjustment to the maximum tariff to take into account the movement in gas prices. If events are such that the Utility Regulator believes a review, whether to increase or decrease the tariff, would be in customers' interest then we would retain the flexibility to initiate such a review.'*[6]

Over the next few months the Utility Regulator will be consulting on the next PSL price control. The trigger mechanism will form part of this consultation, in particular if the 5% threshold is appropriate.

[5] 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.

[6] Utility Regulator Decision on Phoenix Supply Price Control, 2009 – 2011. February 2009

Elements of the tariff

The following table shows the makeup of the PSL tariff and the treatment of these items.

Element of Tariff	Treatment of Cost
Transmission	Pass through - analysed as part of tariff review
Distribution	Pass through - analysed as part of tariff review
Gas Costs	Pass through – weighted average taken on prescribed five days
Over/under recovery	Analysed as part of tariff review
Supply Open	Set in price control
Margin	Set in price control

Process

The tariff announcement date must be 30 calendar days plus five working days before the effective date of the new tariff. The process will start seven weeks before the intended tariff announcement date for formalised reviews. Where the trigger mechanism is activated the tariff review process will start. To start the process PSL and the Utility Regulator will agree the analysis of the tariff. This analysis will be based on the principals set out in the price control, including elements such as gas costs, over/under recovery, transmission and distribution costs. PSL will provide analysis for the tariff over the timescales requested by the Utility Regulator. These will vary depending on the timing of the review and the rationale for the review. The Utility Regulator considers it essential to be flexible in this analysis so as to best show the impact of the forward gas curve on the tariff and the impact of over/under recovery.

The weighted average cost of gas (WACOG) in the final tariff will be calculated based on

- gas already purchased by PSL
- volumes still to be purchased at a price taken at an average of five working days on the forward curve.

The five working days will commence seven working days before the tariff announcement date. For example for a new tariff on 1 April 2011 the tariff announcement date will be 23 February and the five working days will be 14 to 18 February 2011.

February 2011

Sun	Mon	Tue	Wed	Thu	Fri	Sat
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28					

The Utility Regulator considers that flexibility is essential when considering the data set to use for setting the tariff. Where the market is highly volatile the Utility Regulator may consider it appropriate to use a different set of dates or change the basis for setting the tariff.

Meetings

During the process there will be at least one meeting for all parties. The Utility Regulator will present the result of the analysis of the tariff. The parties will discuss the consultation paper, comment on preferred options, agree the way forward and arrange subsequent meeting(s) in line with dates for the final tariff decision. The parties will also discuss media issues, timings of announcements and related issues. These meetings will be minuted with a record of the meeting forwarded to all parties.

Timing of Tariff Reviews

All other things being equal there will be a tariff review in

- February (for an April tariff change)
- August (for an October tariff change)
- Any occasion where trigger mechanism is activated

The Utility Regulator retains the flexibility to initiate a review where it considers it to be necessary.

If, as a result of analysis, PSL and the Utility Regulator propose that there should be no change to the tariff the process will still be followed. All parties will meet to discuss the results of the analysis and to discuss the media and related issues associated with the announcement.

Once the tariff decision has been announced the Utility Regulator will publish a review of the tariff decision, including comparisons with other suppliers and regions.

Tariff Review Process

1. Analysis

12 weeks before a new tariff date PSL to provide Utility Regulator with

- Draft consultation paper
- Detailed tariff analysis for timescales requested by Utility Regulator
- Over/under recovery analysis
- Analysis of transmission and distribution charges

The Utility Regulator will inform all parties that this information has been received from PSL

2. Meeting with Utility Regulator and PSL

Within one week of analysis being received Utility Regulator and PSL meet to agree analysis and consultation paper. Final analysis will use gas figures for five workings days commencing seven working days before the tariff announcement date. These dates will remain flexible particularly where the market is volatile.

3. PSL Tariff Analysis Consultation Paper

10 weeks before a new tariff date PSL to circulate consultation paper to all parties with information on

- Elements of tariff
- Analysis
- Over/under recovery
- PSL preferred option

4. Meeting with PSL, CCNI, DETI and Utility Regulator

Within one week of receipt of paper all parties to meet to discuss consultation paper, comment on preferred options, agree way forward and arrange subsequent meeting in line with dates for final tariff decision. This meeting will be minuted with record of the meeting forwarded to all parties.

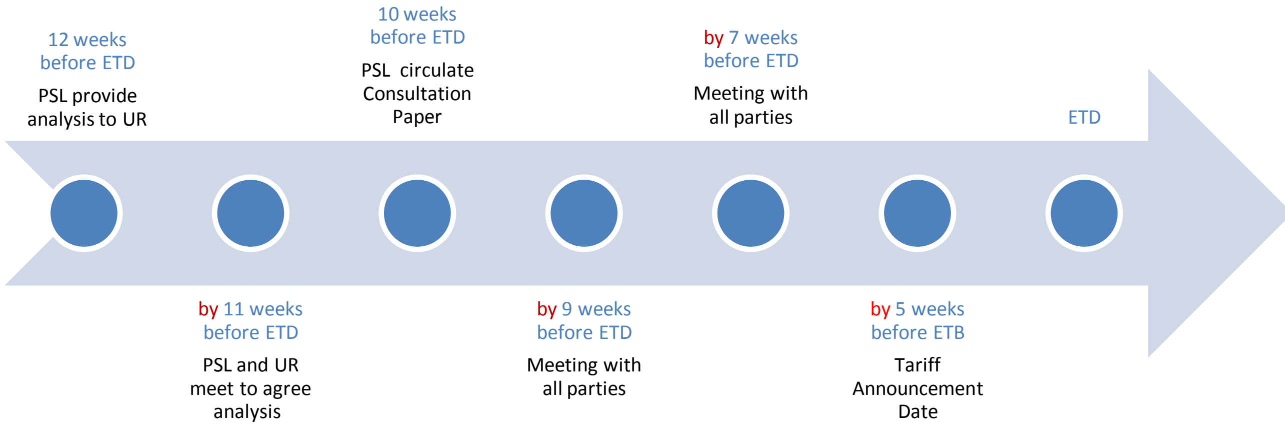
5. Meeting with PSL, CCNI, DETI and Utility Regulator

At least seven weeks before the new tariff date all parties meet to agree tariff, timings of press releases and statements from all relevant parties.

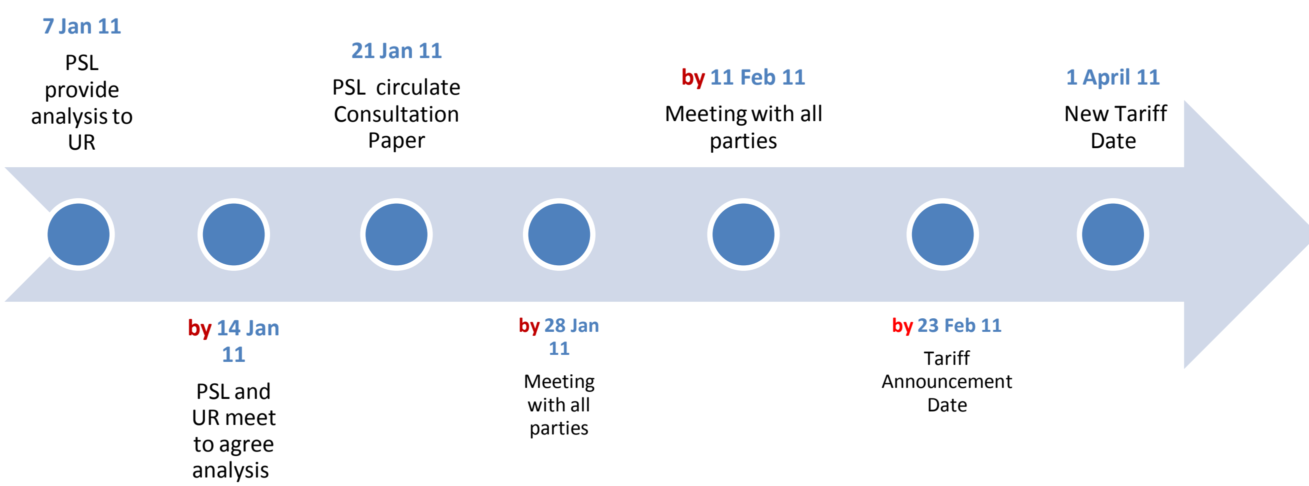
6. Announcement Date

Announcement date will be 35 days before the effective tariff date.

Below is a timeline showing the process. (ETD is effective tariff date)



Below is a worked example of the process where the new tariff date is 1 April 2011.



Appendix 2

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[7]
GB average (Big 6 companies[8])	£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.
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.

[7] Calculated at annual 20,500kWh usage as per Ofgem Decision Letter *Revision of typical domestic consumption values* 5 November 10.
[8] Big 6 companies; British Gas, EDF Energy, Eon, npower, Scottish and Southern Energy and Scottish Power

Control of margin

In November 2010 Ofgem estimated that gas supply companies in GB were achieving an average margin of over 10%[9]. 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

[9] 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?

28 April 2011

Lesley Robinson
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ER

Dear Lesley

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

Thank you for providing firmus energy with this opportunity to respond to the above.

firmus energy has been the protagonist is driving market opening processes and customer switching across the Greater Belfast gas market. Having already switched over 2,500 commercial and residential customers to date, we feel we are well placed to comment on the above consultation.

Our involvement and commitment to competition is demonstrated by the fact that we continue to work closely with the Regulatory Authorities, and the wider industry, to make competition a reality for households and small businesses right across Greater Belfast.

Before commenting on the specific questions associated with the consultation, we would like to note a number of issues relating to the development of competition in this market. Of primary concern to us is the extent to which regulatory controls are in place for the incumbent supply company (and indeed their sister / parent organisations) which can ensure that efficient competition can flourish. In particular is the urgent need for a Code of Practice, as utilised in the Republic of Ireland market, which, amongst other things, prohibits the incumbent commenting on or adversely remarking on the activity of new entrants. In addition, we must have the full support of the incumbent supplier in ensuring that switching systems and processes are sufficiently robust to enable gas users in Greater Belfast the same 'ease of switching' as there is in both the GB and RoI markets.

We understand that the Utility Regulator is of the view that PSL cannot distort prices by charging lower prices now in order to increase gas prices later on. However, we are concerned that the current "maximum tariff" regulatory arrangements do not support this and indeed could distort competition with new entrants, should the incumbent price below the maximum tariff in order to retain/regain business (such as could be the case for 'group' tenders for multiple SME or domestic metered sites). We have a number of examples where this has occurred and would be happy to share this information with the Utility Regulator as requested.

Additionally, we would suggest that, if gas costs and indeed any over/under recovery are deemed “pass though”, full disclosure of same is made public so that new entrants can more effectively and commercially plan for competition.

As an active competing gas supplier, we see no reason for the non-publication of PSL’s hedging strategy. Such information is made publicly available in the RoI gas market to ensure that new entrants, who do not benefit from the economies of scale of the incumbent’s trade book, have a benchmark upon which to commercially aim. The current approach, which utilises an ex-post K factor adjustment, which itself is not open for scrutiny, does not allow new entrants to future proof their commercial market entry plans.

We welcome the fact that the Utility Regulator will closely monitor competition in the domestic market and we understand that the retail unit are now working to develop a roadmap which will consider the future regulatory approach to retail competition. We remain concerned that no roadmap has been published to date for retail competition in the Belfast gas market, which in itself presents significant commercial risk for new entrants. Of particular concern is our understanding that the incumbent is already informing customers that they “will soon be able to compete on price (with the new entrants)”. A roadmap for future deregulation is imperative as soon as possible so that new entrants can plan their activities on an economic basis. We would be keen to be involved in the project to develop a roadmap for the Greater Belfast gas market, to better understand at what level of market share loss/gain the Utility Regulator believes competition will be deemed to have been a success.

In developing a roadmap for gas in the Greater Belfast market, we would be keen to understand the Utility Regulator’s views on why the incumbent is still ‘allocated’ new connections as the default supplier. On the basis of ~8,000 new connections every year in Greater Belfast, new suppliers will need to spend considerable sums of monies switching 8,000 customers per annum, just to maintain the status quo re: customer numbers. We understand the need to ensure an efficient connection process in Greater Belfast, to ensure gas penetration is maximised. However, we would formally ask why the Utility Regulator cannot direct the Network Operator to assign these new connections to new supplier entrant(s), who will undoubtedly offer a cheaper tariff, rather than the incumbent, sister company?

We are also concerned by the continued blurring of the edges between the incumbent gas supply company and the network company as demonstrated in the 2010 advertising campaign in Belfast which are “networks” branded but which referred to “cheaper natural gas……”. Additionally, the *unprecedented* increase in ‘Networks’ advertising activity in early 2011, at a time when a new supplier was entering the market, was, we believe, a blatant attempt to drown out competition. Given these issues, we believe that a significant review of the Network companies advertising and branding activities is required as soon as possible.

Q1. **What are respondents’ views on the scope of this control?**

We understand that over the next few months the Utility Regulator will review the customer sector using more than 25,000 therms. However in the interim, we believe that there are a number of actions that need to be taken within this ‘large user’ sector to ensure that the incumbent does not distort the market going forward.
We have already communicated our concerns about this market and are more than happy to meet to discuss these issues in the interest of moving competition in NI forward.

Q.2. **What do respondents consider to be an appropriate timeframe for this control?**

firmus energy considers that the Utility Regulator proposal for a five year period, with a review at three years is sufficient. We agree that the <25,000 therms p.a. sector of the market should continue to be regulated, in advance of a formal roadmap for deregulation being published. We see this as a means by which to provide certainty for suppliers and new entrants, *so long as there is visibility around costs (as argued elsewhere in this response).*

Q3. **What are the respondents' views on the trigger mechanism?**

We are satisfied with the principle of a trigger mechanism. However, in the interests of avoiding regulatory uncertainty, we would ask that the trigger mechanism is initiated by the Utility Regulator so that tariffs are set for 12 months with the potential for a trigger after 6 months.

Q4. **What are respondents' views on the tariff structure?**

We understand there will be a review of tariff structures to determine whether they are cost reflective, based on annual usage, that no class of customer is paying above the maximum average and that there is a limit on the deviation from the maximum average of lower users. firmus energy welcomes this.

Q5. **What are respondents' views on the K factor?**

We understand that the Utility Regulator is of the opinion that the K factor reduces risk to both the consumer and the company. However, we are of the view that the K factor favours the company more that the consumer, as it is ultimately the consumer who pays these costs as "pass through".
Additionally, without full visibility around the elements and calculation attributed to the K factor, we remain concerned that the K factor works against new entrants. For new entrants to compete effectively, and on a commercially viable basis, full transparency of the K factor is essential.

Q6. **What are respondents' views on bad debt?**

A key element in the management of bad debt is meter reading frequency and billing accuracy. We do not believe that bad debt, which can stem from a suppliers inability, or indeed unwillingness, to read meters more frequently than annually should be "passed through" as a cost. Indeed this could act as a stumbling block for customers wishing to switch. One way of addressing this issue would be to transfer the ownership of meter reading from the supply company(s) to the network company, as is successfully used in the Republic of Ireland. firmus energy would welcome discussions with the Utility Regulator on this issue.

Bill frequency and billing accuracy has been highlighted on numerous occasions by customers, as part of the switching process in Greater Belfast. The fact that the initial meter read by the new supplier, at the time of the switch, may have been the first meter read in over 12 months, has posed significant customer service issues for customers who have received a resultant high final bill from their existing supplier. This issue could become a stumbling block for future switching in the Greater Belfast gas market and we would ask that the Utility Regulator addresses it as soon as practicable.

Given the above factors, we do not feel that full pass through of bad debt costs are appropriate for the incumbent supply company. New entrants, who themselves do not have the safety net of a pass through on bad debt costs, have to invest significantly in meter reading, billing services and debt management processes and must be able to operate on a level playing field with the incumbent.

Q7: **What are respondents' views on efficiency factor?**

We understand that in order to determine an appropriate efficiency factor for the next price control, the Utility Regulator intends to embark on a benchmark exercise. This seems reasonable although we would question whether PSL and NIE energy are comparable entities?

Q8. **What are respondents' views on supply margin?**

We understand the current margin is set at 1.5% on allowable turnover based on working capital allowances, the likely impact of competition and price control cost allowances.

We would concur with the view that the level of risk for the incumbent's business is low given that many of their costs are "pass through". Clearly the headroom available for new entrants is extremely low. However, if sufficient transparency is brought to bear on elements such as K factor and the incumbent's hedging strategy, we do not believe that margins need to be increased in order to facilitate competition. If this clarity is not forthcoming, we would seek further discussion with the Utility Regulator on the allowed supply margin.

I hope you find these comments useful.

Yours sincerely

Michael

Michael Scott
Head of Business Development

PHOENIX SUPPLY LTD

RESPONSE TO CONSULTATION ON
THIRD PRICE CONTROL FOR PHOENIX SUPPLY LTD

APRIL 2011

1.0 Introduction

1.1 This document sets out the response of Phoenix Supply Ltd (**Phoenix Supply**) to the Utility Regulator's consultation on the Third Price Control for Phoenix Supply. It provides our response to the questions raised in the consultation paper.

1.2 Phoenix Supply welcomes the opportunity to provide these comments and is available to further discuss the issues raised in the consultation paper, and others, as the Price Control process progresses.

1.3 As a general point we believe it is worth highlighting that natural gas customers supplied by Phoenix Supply are the most protected energy consumers in the British Isles. Currently, supply operating costs and margins are subject to a Price Control; tariff changes require the approval of the Utility Regulator; and there are licence obligations in respect of consultation regarding consumer issues with the Consumer Council for Northern Ireland.

1.4 The natural gas industry in Northern Ireland is still developing with around 140,000 users connected in the Greater Belfast licence area. This represents around half of those homes and businesses who could potentially connect to natural gas. We consider that this proposed Price Control will be very important for the continued development of the natural gas industry. This Price Control will determine the level of investment to be made in the continued delivery of customer service to the bulk of natural gas users. Phoenix Supply believes the delivery of high-quality customer service, and investment in the same, is vitally important to ensure the number of customers benefiting from the conversion to natural gas is maximized. Phoenix Supply is of strategic importance to the development of the natural gas industry, vital for the support of vulnerable customers and essential for ensuring gas prices can be set at long-term sustainable levels underpinned by the key fundamentals of wholesale gas costs and reliable operations.

1.5 The remaining sections of this paper provide a response to each of the key questions raised throughout the consultation document.

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

2.1 It is stated in the consultation paper that Phoenix Supply continues to supply around 80% market share of those customers who consume greater than

25,000 therms per annum. For clarification, while we do not have access to the total volume of gas supplied during any period, it is our forecast that Phoenix Supply actually supplies around 70% (probably just under 70%) of the total volume in the over 25,000 therm sector. We assume the precise volumes, and therefore market share, could be obtained by the Utility Regulator from Phoenix Natural Gas.

2.2 It is worth noting that at the time of the last Supply Price Control process around 5% (by volume) of the over 25,000 therm sector had switched supplier. Competition in this sector has therefore been active as evidenced by the proportion of customers who have already switched supplier. None of those customers who have transferred supplier have returned to PSL to date.

2.3 Since the date of the last Price Control there is now competition in all market sectors although customer switching in the domestic sector has commenced relatively recently, from 1st November 2010.

2.4 There has been active competition and switching in the small industrial and commercial sector since late 2009. In the period since then around 25% market share (by volume) of the sector between 2,500 therms and 25,000 therms per annum have transferred to an alternative supplier. As a consequence we believe this sector should be deregulated in the very near future during 2011.

2.5 The industrial and commercial sector up to 2,500 therms per annum is also experiencing active competition although this commenced after the between 2,500 therm to 25,00 therm sector. To date, 15% market share have transferred supplier. At current switching rates we expect over 30% of this sector will have transferred supplier by the summer of 2012 and therefore this sector should be deregulated from this date or a clear path to deregulation established.

2.6 Phoenix Supply also requests the Utility Regulator sets out in the Price Control the circumstances in which the remaining market sector (i.e. domestic) should be deregulated. It is our view that deregulation should occur when a market share of 70% is reached. This is essential so that the company and its investors can develop a credible 5-year business plan for future investment and ongoing assessment of the funding required by the company to finance its activities.

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

3.1 Phoenix Supply believes the timeframe for this Price Control should be condition based and not time based. That is, we believe the Price Control should no longer apply once deregulation of the relevant market sector occurs, which we have outlined above should be when a market share of 70% is reached.

3.2 It is our view that a Price Control period of five years is excessive, even with a mid-Price Control review at three years. The proposal for this period of Price Control is out of line with regulatory precedent elsewhere. It would also be an indictment of the Utility Regulator's view on the prospect of the development of competition to set a Price Control for a period of five, or even three, years.

3.3 [redacted]

3.4 Given that there is now competition in all market sectors in the Greater Belfast licence area it is our view that once 30% of each market has transferred supplier that there is a need to remove the Price Control as Phoenix Supply must be permitted to compete with alternative suppliers on a basis which is fair and equitable. Therefore, a Price Control for a period of three years is too long a period since competitors have already entered the domestic retail market. It is also essential that Phoenix Supply can finance its activities and currently a three year window on these requirements is not feasible.

3.5 We also do not believe it is reasonable to expect Phoenix Supply to forecast costs up to six years in advance (forecasts were requested by the Utility Regulator to 2017 as part of the Price Control submission). In particular, gas volumes will vary significantly with temperature variations, acquisition of new customers and as a result of loss of customers to competitors, factors that are outside of Phoenix Supply's control.

3.6 [redacted]

3.7 Given these factors, it is our view that a Price Control period of one year which can be removed during the year once 30% market share has transferred to other suppliers is a more appropriate approach to the length of the Price Control.

4.0 What are respondents' views on the trigger mechanism?

4.1 Phoenix Supply believes that with the advent of competition the Trigger Mechanism is now no longer required. Competitive pressures will ensure that Phoenix Supply reviews tariffs if these are higher than costs. We do recognise there was a rationale for the Trigger Mechanism in the absence of competition as it became the driver for reviewing prices. The Trigger

Mechanism has now served the purpose for which it was intended and is no longer relevant.

4.2 The consultation paper suggests that the application of the Trigger Mechanism will become a "*prescriptive tool*" with a tariff review being initiated when the trigger is breached. Phoenix Supply would urge caution and believes that it is necessary to apply common sense when reviewing tariffs.

4.3 Given the volatility in wholesale energy markets we do not believe that a tariff review should necessarily be automatically initiated once the trigger is reached. Other factors need to be taken into account. For example, length of time since previous tariff review, stage in the gas purchasing cycle, volatility of wholesale costs, etc. Phoenix Supply would be concerned that with the application of a prescriptive Trigger Mechanism, a tariff review would take place each time the trigger is breached, and could lead to changing tariffs on an almost perpetual basis. Apart from the fact that Phoenix Supply's billing system is not designed to handle tariff reviews of this frequency, this is not how the Trigger Mechanism has operated in the previous Price Control period. It is also noteworthy that other energy suppliers across the UK and Ireland normally revise tariffs a maximum of two times per year which is for very good practical and operational reasons.

4.4 Changing tariffs each time the trigger is breached would lead to confusion for customers as tariffs would potentially be changing on a very frequent basis. This is not in the interest of customers nor is the additional cost of this proposal included within our submission (i.e. updated/new billing system, communication and implementation costs, etc.). There are a whole series of actions which follow a tariff review which take weeks to implement and involves extensive communication with customers (e.g. adjusting direct debits, etc.). Customers would conceivably receive contradictory communications within a few weeks of each other and are not conducive to engendering confidence among consumers.

4.5 Normally, Phoenix Supply carries out an annual review of tariffs each April. A mid-year review then usually takes places in October which adjusts tariffs, if necessary. We believe this is in the interest of customers with tariffs being revised if significant factors occur outside these timescales.

4.6 It is also our view that the application of a Trigger Mechanism of 5% is too high and a more appropriate trigger would be at the 2 – 3% level. 5% represents around [redacted] which potentially Phoenix Supply is required to under-recover until the tariff is changed and these costs are recovered from customers. In reality, in a rising wholesale gas cost scenario, the level of under-recovery would be well in excess of [redacted] and given the historic margins for Phoenix Supply clearly the margin has not provided an allowance for funding this level of under-recovery.

4.7 Furthermore, the application of penal interest rates to both under-recovery and over-recovery in the previous Price Control highlight the need to ensure the Trigger Mechanism is as low as possible. Interest rates applicable, as part of the Price Control, should be reflective of the rates which are actually applicable to Phoenix Supply. The use of rates which are not directly related to those applicable to the business create a negative environment of ongoing investment in supply related activity.

5.0 What are respondents' views on the tariff structure?

5.1 Phoenix Supply takes all reasonable steps to ensure that the average price per therm of gas supplied does not exceed the maximum average price and we believe the current tariffs and their structure are appropriate for the size of market in Greater Belfast.

6.0 What are respondents' views on K factor?

6.1 It is our view that cost pass-through must be maintained for Transmission, Distribution and gas costs for the duration of the Price Control.

6.2 Transmission and Distribution charges are currently unknown for the Price Control period but they are subject to scrutiny and approval by the Utility Regulator prior to publication.

6.3 Given that Phoenix Supply is the supplier of last resort, and at a Price Control margin of anything less than 8%, it is not possible to treat gas costs as anything other than pass-through.

6.4 Gas costs have historically been treated as pass-through and we consider this has been to the benefit of consumers in Northern Ireland. During the Price Control period between 2009 and 2011 consumers in Greater Belfast enjoyed among the lowest natural gas prices available anywhere in the British Isles. It also resulted in Phoenix Supply being the first major energy supplier in the UK and Ireland to reduce prices in 2009 following a reduction in wholesale gas costs. These reductions in 2009 totalled 36.9% and were significantly in excess of the reductions passed on by other gas suppliers.

6.5 Phoenix Supply is incentivised to secure natural gas in the wholesale market at the lowest possible cost as the company now faces competition in all market sectors. If it is possible to purchase natural gas at a lower cost than that being incurred by Phoenix Supply then Phoenix Supply can expect to lose market share.

6.6 Furthermore the company also competes with heating oil in order to attract new natural gas customers to connect to the natural gas network and therefore has an additional incentive to purchase gas at the lowest cost possible.

6.7 Phoenix Supply regularly reviews its gas purchasing strategy which is subject to independent external review and is also provided to the Utility Regulator. Wholesale gas prices have increased significantly over the past number of years and wholesale markets are now subject to a much higher degree of volatility than they were even a few years ago.

6.8 It must be remembered that it is not possible for Phoenix Supply to ‘beat the market’ in respect of wholesale gas purchasing costs as the market is entirely outside the control of Phoenix Supply and Phoenix Supply is essentially a ‘price taker’ in respect of wholesale gas costs.

6.9 The mechanism by which wholesale gas costs are treated cannot be considered in isolation. Should the Utility Regulator propose that Phoenix Supply should bear any greater degree of risk in respect of wholesale gas costs the level of allowable margin would need to be reviewed significantly upwards.

6.10 It is our view the current arrangements in respect of treatment of wholesale gas costs provide benefits to all consumers and the current pass-through mechanism should be continued.

7.0 What are respondents' views on bad debt?

7.1 Phoenix Supply is preparing a detailed paper on bad debt to be provided as part of the Price Control process and we would also encourage the Utility Regulator to visit Phoenix Supply to further understand our debt collection procedures.

8.0 What are respondents' views on efficiency factor?

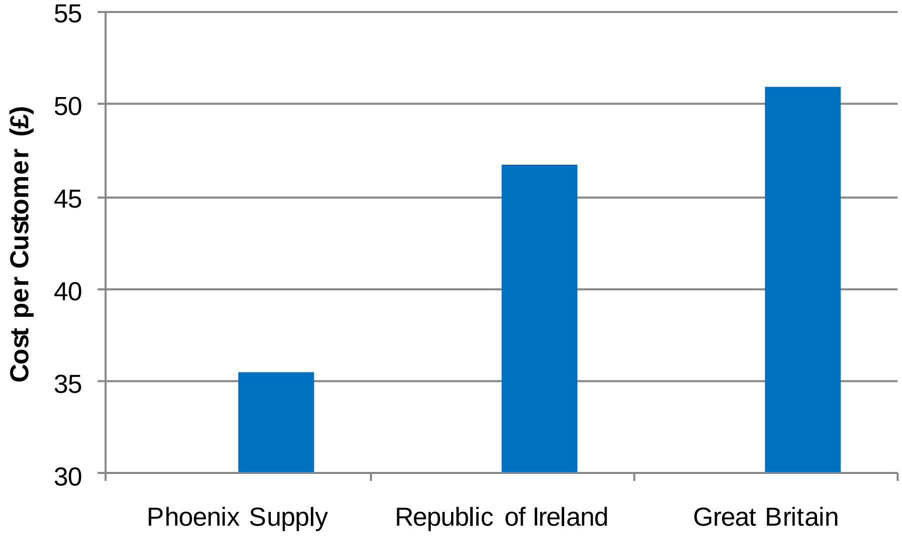
8.1 Phoenix Supply has been built based on a low-cost business model with the need for each additional cost being assessed and market tested for efficiency. The application of an efficiency factor to the relative current efficient nature of the business is irrelevant.

8.2 We note that the Utility Regulator intends to benchmark other supply companies (e.g. NIE Supply) and distribution companies. There is no reason to believe that these comparisons are fair or reflective of the various stages of development of the industries in Northern Ireland where the electricity sector is in a mature state but the natural gas industry is still in a development state. Therefore, the cost base of Phoenix Supply does not reflect an extensive period of investment in IT and other systems as other energy companies may reflect.

8.3 Phoenix Supply has completed benchmarking against supply businesses in Great Britain and also the Republic of Ireland and the results show that

Phoenix Supply has the lowest cost to serve. The graph below shows the cost to serve per customer:

Figure 1
2009 Cost to Serve per Customer[1][2][3]



8.4 It is clear from this data that Phoenix Supply's costs already incorporate significant efficiencies.

8.5 Phoenix Supply is concerned at the suggestion of the application of an efficiency factor on a cost base that is already some 24% lower than the cost to serve in the Republic of Ireland and 30% lower than Great Britain. It would be expected that the cost to serve for Phoenix Supply would be much higher than other regions in the British Isles due to the lack of economies of scale given the relatively small customer base in Northern Ireland. However, despite other suppliers being able to benefit from significant economies of scale in other regions Phoenix Supply's cost to serve customers is significantly less.

8.6 To apply a further efficiency factor to a cost base which has already captured significant efficiencies over other companies and regions will have a direct and detrimental impact on customer service to natural gas customers in Northern Ireland. Phoenix Supply believes that the costs included within its submission for the Price Control period represents the minimum investment required to deliver an acceptable level of customer service.

8.7 Phoenix Supply is already incentivised to operate an efficient business. All market sectors are currently open to competition and all market sectors are

[1] Meter reading costs removed from Phoenix Supply data as Republic of Ireland and Great Britain data do not include meter reading costs.
[2] Republic of Ireland data extracted from Bord Gais Energy Supply presentation made on 10th November 2008 and converted to sterling using current exchange rates.
[3] Great Britain data extracted from NERA Economic Consulting paper dated 7th December 2009 which utilised OFGEM source data. The OFGEM Electricity and Gas Supply Market Report issued on 16th June 2009 indicates the operating cost per gas customer per year is £60.

currently experiencing competition which enables customers to choose their supplier. A key element to ensuring it remains competitive is for Phoenix Supply to operate as efficiently as possible and offer customers value for money.

8.8 Phoenix Supply proposes that the efficiency factor that should be applied by the Utility Regulator is zero. This means that Phoenix Supply would be required to improve efficiency at the same rate as the rest of the economy. To do otherwise would lead to the double-counting of efficiencies as efficiencies have already been determined via a bottom-up analysis of costs in the Price Control submission.

9.0 What are respondents' views on supply margin?

9.1 The margin for supply activities should be one upon which existing and potential investors can make medium and long term investment decisions based on return on capital employed, when considering supply activities as a standalone business in which to invest. To this end clearly a margin of 1.5% is not sufficient to establish a positive medium to long term investment case and steps need to be taken to secure a sustainable margin. In our view this is closer to 5%.

9.2 Furthermore, Phoenix Supply is concerned regarding the Utility Regulator’s proposal to apply a margin of 1.5% for the duration of the Price Control period. Phoenix Supply does not believe that the application of such a margin is consistent with the current costs of financing a business with a risk profile like Phoenix Supply, especially within the financial markets as they now operate. This is further exacerbated by the impact of stranded costs arising from increasing competition and the volatility of gas costs.

9.3 [redacted] and therefore whilst the Utility Regulator’s proposal may result in lower prices for customers in the very short term, we believe that this will be at the expense of stability in the market and higher prices in the future.

9.4 In the rest of this section we outline what the proposals mean in terms of finance for Phoenix Supply and why, this level of margin, is not sustainable.

9.5 The effective margin of Phoenix Supply is less than 1.5%

9.5.1 In the context of the Price Control, it is important to remember that the reported ‘margin’ of 1.5% is actually prior to the cost of financing and completely ignores the level of capital which a business of this type needs to access in order to finance its actual and potential working capital obligations.

9.5.2 The volatile, and higher, nature of commodity costs has clearly increased costs well beyond historic levels. This places a much greater burden on access to capital than was historically the case, for example when a Supply Price Control was in existence in Great Britain. Further, the requirement to operate utility business streams separately and the view of risk taken by the financial markets make it very difficult to get access to any level of credit from suppliers (e.g. distribution operator or upstream gas suppliers), banks or other financial institutions.

9.5.3 [redacted]

9.5.4 The position highlighted above is clearly unsustainable and it has evolved in recent years for the following reasons:

(a) The separation and ring fencing of the distribution asset from that of the supply business [redacted]

(b) Credit arrangements required by distribution operators and gas suppliers to facilitate access to normal credit terms has increased working capital levels employed in the business.

(c) The rising cost of gas and relationship to selling prices has increased the peak working capital requirements of the business.

(d) The volatility of gas cost has increased the potential mark to market gas cost risk for suppliers and thereby impacted on credit arrangements in place with gas traders.

(e) The potential implication of rising gas costs coupled with the funding implications of operating the Trigger Mechanism.

9.5.5 The implication of the above has increased the level of funding which Phoenix Supply needs to have available to it in order to fund its operations. [redacted]

9.5.6 It is also important to be able to differentiate between the historic levels of capital employed by the business from the potential funding implications going forward as this will dictate the line of credit/equity which needs to be retained to support its liquidity. The volatile nature of gas costs and implications of competition in respect to stranded costs have increased the risk profile of supply/trading businesses such as Phoenix Supply and significantly impacted on the level of capital employed therein.

9.5.7 It is to that end that we believe that a profit level of 5%, as a minimum, is required to adequately finance such a business and we believe that the explanation provided in this paper clearly supports such a position.

9.5.8 Further we believe that the Utility Regulator should recognise that margin principally represents a cost of financing activities in much the same manner as the regulatory rate of return in an asset business.

9.5.9 The Utility Regulator has previously suggested that interest costs in respect of the working capital requirements of the business are to be recovered from this allowable margin. However, based on the manner in which such businesses are now financed, principally through equity rather than debt, this can significantly underestimate the impact of financing such businesses.

9.6 Phoenix Supply faces the same risks as any natural gas supplier operating in a competitive environment

9.6.1 We are concerned that the Utility Regulator considers that the level of risk for Phoenix Supply 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 simply not the case.

9.6.2 Phoenix Supply operates in a competitive environment and faces the same risks as other suppliers operating in competitive markets. In particular, it faces the risk associated with the loss of market share and the impact this will have on its ability to recover costs in the future (i.e. stranded costs).

9.6.3 If Phoenix Supply under-recovers in any period there is no certainty that these costs can be recovered in a future period, as Phoenix Supply may not have the customers from which to recover these costs. Increasing tariffs to recover these costs may well result in a significant loss of customers to competitors, which in turn results in tariffs being required to increase even further. The effect is one of a spiral of rising prices and falling market share and demonstrates that it cannot be assumed that Phoenix Supply can recover its costs from customers.

9.6.4 Further the scale and volatility of gas costs in particular is such that a potential risk of under-recovery is significant and thereby places added risk on its recoverability in a falling customer share scenario.

9.6.5 Competition is now active in all market sectors, unlike the last Price Control which was set in 2009. The proposed margin therefore needs to rise to take into account the increased competition in Greater Belfast and the increased risk of under-recovery that Phoenix Supply must consequently face.

9.7 Trigger Mechanism

9.7.1 The level of margin which is proposed also needs to be considered in the context of the Trigger Mechanism which is currently set at a level which places Phoenix Supply at significant financial risk, particularly as competition is introduced. This is because the Trigger Mechanism has both an impact on the working capital requirements of the business (as mentioned previously) and also puts Phoenix Supply at greater risk of non-recovery of revenue due to the impact of competition.

9.7.2 Phoenix Supply is required to have available cash reserves to fund in excess of an ongoing 5% of revenue for under-recovery. While the Trigger Mechanism provides a point from which Phoenix Supply can request the Utility Regulator increase the Maximum Average Tariff, the under-recovery exposure of Phoenix Supply could be well in excess of 5% by the time an increase in tariffs is applied and the under-recovery of costs is recuperated from customers.

9.7.3 Phoenix Supply does not need to access these cash reserves while gas costs are falling against forecast assumptions embedded in its tariff setting assumptions, as they have been during the current control period. This is one of the main reasons Phoenix Supply has avoided incurring a loss during this period despite the 1.5% margin. However, if, as is the case in 2011, gas costs rise in future, these cash reserves will need to be utilised. In any event cash reserves need to be available to fund the contingency of under-recovery of gas costs and the proposed margin of 1.5% is insufficient to attract the level of investment required for a trading business such as Phoenix Supply.

9.7.4 As well as incurring the cost of utilising this cash reserve, there is also no guarantee that Phoenix Supply will be able to recover the higher costs that it will have been funding. This is for the reasons described in 9.6 above, where any attempt to increase prices to recover costs incurred in a previous period will result in a spiral of increasing prices and reducing market share.

9.7.5 These significant issues do not appear to have been taken into account by the Utility Regulator when proposing a margin of 1.5%.

9.8 The proposed margin is significantly below the Return on Capital Employed that would be expected from gas supply activities

9.8.1 The Utility Regulator says "*the margin is determined by the capital risks the company faces and benchmarked against margins applied to similar companies*". However, there is no evidence that it has done either of these assessments in a sufficiently robust manner.

9.8.2 As described above, there is no proper assessment of the capital risks faced by Phoenix Supply. Further, the Utility Regulator needs to take into account the requirements that investors place on Phoenix Supply. As outlined above, in order to provide Letter of Credit facilities and fund the on-going cash requirements of Phoenix Supply, [redacted]

9.8.3 The 1.5% margin proposed by the Utility Regulator [redacted] This is significantly lower than the expected Return on Capital Employed for gas supply activities which should be closer to 15%.

9.8.4 Further, when considering the appropriate Return on Capital Employed for Phoenix Supply, it is necessary to allow a small company premium, given the size of the Greater Belfast natural gas market needs to be taken into account.

9.8.5 There is strong empirical evidence of the existence of a small firm premium on the cost of capital. Many studies have shown there is a strong relationship between firm size and return[4]. This relationship cuts across the entire size spectrum but is most evident among smaller companies which have higher returns, on average, than larger companies.

9.8.6 Including a small company premium is common regulatory practice in Weighted Average Cost of Capital assessments as demonstrated in the table below:

Figure 2
Regulatory Decisions on Small Company Premium[5]

Regulator / date	Reasons given for premium	Premium to the WACC
Competition Commission (Bristol water, 2010)	• Higher cost of debt • To the extent that smaller companies have higher ratios of opex to revenue, they face higher systematic risk • Higher transaction costs for the buying and selling of small companies	0.3% premium on cost of debt (based on Bristol Water's size and other company-specific factors). Increased asset beta by 18%

[4] See for example analysis of the NYSE, AMEX and NASDAQ between 1926-2008, presented in the 2009 Ibbotson Stocks, Bonds, Bills and Inflation Valuation Yearbook.
[5] Regulatory decisions

Ofwat (water only companies, 2009)	• More limited access to debt finance. • More concentration of revenue risk to individual companies	0.3%-0.4% premium on the post-tax WACC
Ofwat (2004)	• Higher equity trading costs • Costs of raising debt and equity capital	0.3% - 0.9% premium on the post-tax WACC
Ofgem (independent gas transporters, 2002)	• IGTs are "relatively small enterprises" • Cross-reference to 2000 Competition Commission decision (reported below)	0.8% premium on pre-tax cost of equity
Oftel (mobile service providers, 2002)	• Oftel suggested a small firm premium for mobile service providers in the range 0.9% to 1.7%	1.35% premium on post-tax cost of equity
Competition Commission (water inquiries, 2000)	• Impact of lower trading liquidity on cost of equity • Market evidence on the impact of company size on the cost of debt	1% premium on post-tax cost of equity Cost of debt 0.9% higher for small companies
Ofwat (1999)	• More limited access to capital markets • Lower liquidity • Higher issue costs	0.4% - 0.75% premium on post-tax WACC

9.8.7 The limited benchmarking that Utility Regulator has done (against RoI and GB) shows the margin to be the lowest of any gas supplier. The Utility Regulator provides no credible justification for why this should be the case.

9.8.8 If the Utility Regulator persists in keeping margins below the competitive level of those in Great Britain and the Republic of Ireland (where the regulated net margin is set at 2%), there may be significant adverse consequences for sustainable competition in Northern Ireland.

9.9 [redacted]

9.10 [redacted] Given the importance of supply margin for the stability and viability of supply companies and the wider impact on the natural gas industry we would expect the Utility Regulator to complete detailed work on the capital requirements of supply companies and the required Return on Capital Employed. This work should be informed by the experience in other energy retail markets which as the Utility Regulator has indicated is in excess of 10% in Great Britain.

Lesley Robinson
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ER

27 April 2011

Dear Lesley,

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

NIE Energy Supply (NIEES) welcomes the opportunity to respond to the recent NIAUR consultation on the proposed principles to be used in determining the PSL price control.

Within the consultation paper NIAUR has sought market feedback regarding 8 key decision areas. Rather than directly respond to each of the questions posed, as a regulated supplier of electricity supplier to circa 780,000 customers within Northern Ireland, NIEES would like to draw upon our experience were relevant and make a series of general comments.

NIEES believes that the scope of the price control should remain consistent with previous years and ensure regulatory certainty exists. It is noteworthy that the deregulation threshold applied within the gas market differs significantly from that applied to electricity. NIEES would welcome the proposed Roadmap as a useful market clarification.

A five year price control period reflects a regulatory norm, providing a degree of certainty while reducing the information burden on PSL. NIEES considers the gas market to be evolutionary in nature and therefore suggests that the proposed review should be brought forward from three years to after two years, therefore taking account of potential market changes.

Notwithstanding that the gas market has substantially greater hedging facilities available and competition is less well developed than the electricity market, the fundamental issues surrounding the k factor are similar. Monopoly suppliers are able to operate with low margins because the correction (k) factor enables them to correct any under-recovery of costs in future years. Retail competition greatly increases the risks to which an incumbent is exposed. Where market entry is possible, any fall in wholesale costs after the incumbent has contracted to supply its customers may result in both a loss of customers and a price level that does not enable cost recovery on the remaining customers. Any significant under-recovery is unlikely to be made good in future years as it would further reduce the competitiveness of the business. Any contracting gain, on the other hand, where prices rise after the contracting round, must be returned to customers. The price controlled incumbent who faces competition is therefore exposed to an asymmetric risk.

NIAUR should be cognisant of the impact that competition and the general market risks have on regulated suppliers and adjust margins appropriately.

Please do not hesitate to contact me should you wish to discuss this response further.

Yours sincerely,

William Steele
NIE Energy (Supply)

The Consumer Council

Lesley Robinson
NIAUR
Queens House
14 Queen Street
Belfast
BT1 6ER

29 April 2011

Dear Lesley,

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

The Consumer Council is a Non-Departmental Public Body set up in legislation to safeguard the interests of all consumers, and particularly the vulnerable and disadvantaged. The Consumer Council is an independent organisation which operates to promote and protect the consumer interest.

We welcome the opportunity to respond to this consultation on the Third Price Control for Phoenix Supply Ltd (PSL).

The Third Price Control for PSL is very significant for the future of the gas market in the Greater Belfast and Larne area. With rising levels of fuel poverty in Northern Ireland, it is increasingly important that consumers know that they are getting a fair deal for the energy they purchase, and that they receive the best possible levels of service. This includes ensuring that bills are correct, meter reading occurs in a timely manner and debt management procedures are put in place.

The competitive landscape has changed since the last Price Control was determined. Firmus have entered the domestic customer market, and although customer switching has yet to take place in significant numbers there is a possibility that with the recent PSL price increase this could change. It is therefore very important that this Price Control provides the gas consumer that chooses to remain on the regulated tariff with the price protection they require.

The consultation refers to ‘effective’ competition. The Consumer Council’s believes that in order for gas competition in Greater Belfast and Larne to be effective it must improve the customer experience for **all** consumers, and it will only do this by:

- Providing lower prices to the consumer;
- Providing better customer service;
- Being available to all types of consumers, and;
- Providing increased and targeted protection to vulnerable consumers;

At present, the Consumer Council believes that there is no comprehensive evidence to suggest that competition will deliver consumers all these benefits. As this consultation document states, “*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*”. It is therefore the Council’s view that competition should not be pursued at any cost. The Consumer Council therefore welcomes the Utility Regulators announcement that it will undertake a project that will consider the future regulatory approach to the retail market and looks forward to working with the Regulator on this.

Consultation questions

1. *What are respondent’s views on the scope of this control?*

The Consumer Council would strongly agree that it is too early in the development of competition in the Greater Belfast area to consider removing the price control mechanism from customers using less than 25,000 therms.

However, we urge the Regulator to monitor this market closely, and set out its vision for a competitive natural gas market in Northern Ireland with a roadmap clearly setting out the milestones on how this will be achieved.

The Consumer Council recognise that if a large number of consumers decide to switch, possibly as result of the recent Phoenix Supply price increase and/or if a new competitor enters the market, it may be necessary to alter the scope of the price control.

Furthermore, we believe that it is prudent to wait until the review of competition in the market for customers using more than 25,000 therms is complete to consider whether a price control is required in this sector.

2. *What do respondents consider to be an appropriate timeframe for this price control?*

The market for domestic and SME gas customers in Greater Belfast is at the early stages of competition. It is too early to say how effective competition in this consumer segment will be. The timeframe for the price control must reflect the competitive conditions, whilst providing certainty to PSL and consumers. A five year period provides a reasonable period of regulatory certainty, but the Price Control must be capable of adapting to meet new market conditions. It would seem prudent to have in place a mechanism to review the price control annually to see if it is continuing to act in the interests of consumers. It would not be in the interests of consumers if in 18 months time the price control was seen to be a barrier to the entry of new competitors.

3. *What are the respondents' views on the trigger mechanism?*

The Consumer Council agree that the figure of five per cent for the trigger to a tariff review is reasonable. We also agree that this figure should work both to increase and decrease the tariff. Whilst the price control remains the Regulator should also retain the flexibility to initiate a review at any time.

4. *What are respondent's views on the tariff structure?*

The Consumer Council welcome the initiative shown by the Regulator to ensure that the tariff structure is cost effective and that no class of customer is paying above the maximum average.

Until the hopeful advent of Social Tariffs, it is the Consumer Council's view that all regulated gas customers should pay the same price irrespective of the amount of gas they use and that there should be no standing charge. PSL gas customers who are in fuel poverty can be best helped by having lower tariffs and other social benefits such as free energy efficiency measures specifically targeted at them.

5. *What are respondents' views on k factor?*

The Consumer Council recognise that the k-factor is incompatible with a fully competitive retail energy market. It distorts a competitive market and reduces the purchasing risk for the incumbent, relative to that of other suppliers.

However, the k-factor, if operated in a closely regulated manner can provide some level of protection to the consumer. The stability it provides for the incumbent supplier allows for a relatively low margin to be set. In addition it provides an element of risk-smoothing for consumers, and is compatible with annual tariff setting. This will involve the Utility Regulator, in partnership with PSL actively monitoring the k-factor to ensure that it does not grow to unwieldy levels.

As competition matures those customers that switch supplier will no longer be paying for an under recovery or receiving the benefit of an over recovery despite having made payments that created it. To some extent this is inevitable in a competitive environment. However, minimising the k-factor that is carried into the next tariff period will help allocate costs and benefits fairly between consumers. Therefore the Consumer Council believe the Utility

Regulator must review the size of the k- factor on a regular basis and take action if and when required to keep it to a minimum.

6. What are respondent's views on bad debt?

The Consumer Council agree that the methods available to PSL to control customer debt do mean that it has a low risk in this area. The consultation states that PSL was given time in the current Price Control to review its policies on reducing customer debt. The Regulator also gave PSL an amount in the 2009-11 Price Control to improve their bad debt processes. To our knowledge PSL have made no improvement in their customer debt processes and we would like to see a report from the Regulator on how PSL have performed in this area.

Increased meter reading will reduce bad debt by improving the accuracy of billing. Despite committing to increase the number of meter reads for Direct Debit customers PSL have failed to do so. This commitment could have been funded from the amount given to PSL in the current Price Control. Therefore, it should not now require additional funding in the new Price Control.

The new Price Control must explicitly insist that PSL increase the number of meter reads for Direct Debit customers, and actively monitor and identify consumers who are struggling with their bills to proactively provide budgeting support to consumers in difficulty.

7. What are respondent's views on efficiency factor?

It is important that the Price Control is used to provide an incentive to PSL to increase the efficiency of the business and reduce the price to the end user.

The end price consumers pay for gas is dependent upon, among other things, the efficiency which PSL exercises when purchasing gas. Currently the Regulator is not prescriptive and only monitors the strategy which PSL uses to purchase gas. While the Consumer Council appreciate PSL seek independent advice when devising their strategy, we believe that it is in the interests of consumers for PSL to be given an incentive to purchase efficiently and for them to incur penalties if they fail to purchase economically.

Incentives can keep costs down, and that is for the benefit of supply companies and consumers. To draw a parallel in the Northern Ireland context, NIE Energy has a licence requirement to purchase electricity economically, (the Economic Purchasing Obligation). Urgent consideration should be given to creating a mechanism that can be enforced against PSL if need be.

Research commissioned by the Utility Regulator and undertaken in 2010, showed that gas suppliers scored less well than the electricity supplier over a range of customer contact indicators, for customers with debt problems[1]. We

[1] Utility Regulator - Social Action Plan Customer Debt Project. May 2010. The research surveyed, PSL, firmus and NIE Energy customers.

believe that the Price Control should include incentives and penalties covering the performance of PSL in its customer service role.

The Energy Act 2011 has introduced standards of performance that includes compensating customers when standards are not reached. The Consumer Council believe that any such payments must come from the profits of the gas suppliers or they will fail to provide an incentive for PSL to improve its performance.

8. What are respondent's views on supply margin?

We agree that the pass though of costs to consumers means that PSL should be able to recover all their costs from consumers and therefore the risk to PSL is assessed by the Regulator as low.

The margin of 1.5 per cent that was determined for the current Price Control included the impact of competition and the risk of working capital. However until regulation and the pass through mechanism is removed, the risk in fact lies with the consumer. If the customer base decreases because of switching to a competitor or the cost of working capital increases, it is the customer that will pay for this. The supply margin should ultimately reflect the risk to the supplier of providing a regulated tariff, in which the costs are passed through to the consumer. We therefore see no reason to increase the margin from its current 1.5 per cent.

Furthermore, it follows that if the total costs increase the final overall cash figure derived from the 1.5 per cent margin will also increase. The Consumer Council believes that steps must also be taken to reduce the overall costs involved as currently there is an incentive to increase costs.

Corporate Social Responsibility

We appreciate that the issue of Corporate Social Responsibility (CSR) was not consulted on as part of the PSL Price Control. However, this is an area which we believe is important for consumers and should be given urgent consideration.

It is the position of the Consumer Council that Energy Companies that make a profit from generating, distributing and selling fuel and power have a corporate social responsibility to their customers to provide support and care schemes to households that are struggling to heat their homes to adequate levels.

It is often argued that the main domestic energy suppliers are tightly regulated and financially have no leeway to invest or develop social tariffs for those in fuel poverty. The Consumer Council believe that there is a real opportunity to examine the whole supply chain within the energy market as a whole, which would include suppliers, importers, generators and transmission and distribution companies.

EU Third Internal Energy Package (IME3)

The provisions of the IME3 contain a range of measures that will increase consumer protection. The Consumer Council welcome these enhanced measures. It is important in preparing the new Price Control that consideration be given now to the resources that may be required by PSL to implement these measures. It is important to identify and take account of these measures as early as possible so that costs are not required unnecessarily and to ensure the maximum benefit to the consumer.

Conclusion

The Consumer Council believes that we need to ensure that regulation works in consumers' best interests in both the long and short term, and with growing levels of fuel poverty provides adequate protection for the most vulnerable consumers in our society.

Therefore we believe this process should be conducted in a manner that will focus on the final consumers needs and ensure that the pass through risks that the consumer faces are accurately reflected in energy companies margins, purchasing decisions, and levels of service provided.

Yours Sincerely,

Richard Williams
Senior Consumer affairs Officer