

Phoenix Natural Gas Limited response to the Utility Regulator Consultation on its Overall Approach to Price Controls for Northern Ireland's Gas Distribution Networks (GD14)

Introduction

Phoenix Natural Gas Limited ("**PNGL**") welcomes the opportunity to respond to the Utility Regulator's (**UR**) consultation on its overall approach to the GD14 price control. Following the referral of the previous PNGL12 price control to the Competition Commission ("**the Commission**"), PNGL believes that this GD14 price control will be vital in reinforcing the recommendations of the Commission, and restoring stability, transparency and predictability to the regulatory process.

The Commission's Inquiry involved extremely challenging timescales and required substantial resources of both PNGL and UR. It is noteworthy that the GD14 price control review has commenced within a few weeks of the Commission issuing its final determination. PNGL is therefore disappointed that UR has attempted to hold PNGL responsible for the challenging timing of the GD14 price control review (see paragraph 6.1). UR called upon the Commission to re-determine PNGL's PNGL12 price control and it is this process that has ultimately "delayed" commencement of the GD14 price control review. In the absence of a price control determination for PNGL12, there was no licence requirement for PNGL to provide UR with a detailed submission in September 2012 when its resources were already fully committed to the Commission's Inquiry. PNGL has been very timely in making its GD14 price control submission given the Commission's eight-month Inquiry which was only presented to UR at the end of November 2012.

At the time of writing, UR has yet to provide PNGL with the appropriate licence modifications to implement the Commission's findings. It is imperative that PNGL12 is fully implemented and prioritised by UR ahead of its detailed scrutiny of the GD14 submissions.

PNGL understands it will have the opportunity to fully engage with UR on an ongoing basis as part of the GD14 review. This response raises our high level concerns with the initial consultation.

Form of control

UR has suggested implementing a roll over and delaying the full price controls for a period of time in paragraph 3.11. PNGL agrees with UR that this is not appropriate. PNGL believes it is now imperative that longer-term stability and predictability is bedded in to the regulatory process as soon as possible. This is reflected in remarks made by Chairman of the Phoenix Inquiry Group and Commission Deputy Chairman, Professor Martin Cave:

*'We think that the long-term public interest is best served by a stable environment that encourages confidence and investment.'*¹

PNGL believes that the timely completion of the GD14 review in line with the principles of the Commission's determination will help the development of the natural gas network in Northern Ireland and the move to a period of longer term regulatory stability. A one-year roll over would be counterproductive to this primary objective. This is reinforced by the fact that PNGL12 was a two-year "mini" price control, and that PNGL has already operated without a price control determination for almost half of the PNGL12 review period. There has therefore already been an extended period of regulatory uncertainty which would only be exacerbated in the event of a rollover.

The need for greater stability and predictability also applies to the use of "re-openers" referred to in paragraphs 4.5, 4.8, 4.20 and 6.3. In line with the principles of the Commission's determination, PNGL understands that these re-openers will only apply on a forward-looking basis and they will not have a retrospective effect. Similarly, given the principles established by the Commission, re-openers should only be introduced where a delay to implementation can reasonably be expected to have a material net benefit (given the costs of introducing re-openers in increased uncertainty), and the number of re-openers should be limited. If substantial elements of the price control are subject to re-openers (as suggested in paragraph 6.3), this is likely to undermine any efforts to ensure long-term stability and predictability, and to reduce regulatory uncertainty. Put another way, there would be little point in implementing a 5 year control were there to be a substantial number of re-openers.

Annual Cost Reporting

PNGL must be able to communicate its cost forecasts to UR in a clear and effective manner which accurately reflects the operation of its business. This will facilitate transparent discussion with UR and its consultants throughout the GD14 review and ultimately facilitate its timely completion.

UR's statement in paragraph 4.5 that price control submissions "*should be in line with cost reporting templates previously set out*" is therefore concerning. As UR is aware, PNGL and UR have not discussed the cost reporting template submitted by PNGL to UR almost two years ago. In PNGL's opinion the cost reporting template is not fit-for-purpose; it does not reflect the operation of PNGL's business, it does not allow PNGL to communicate its cost forecasts to UR in a clear and effective manner and it does not provide UR with the level of detail and transparency which PNGL has provided to UR as part of the PNGL12 and GD14 price control submissions. If UR wishes to maintain continuity and simplicity, UR must consider the role of the annual cost reporting template in price control reviews. PNGL would suggest that the annual cost reporting template is reviewed by UR following completion of the GD14 review when UR will have a better understanding of the operational differences between GB and NI GDNs and indeed between the two GDNs in NI. The current annual cost reporting template does not allow UR to undertake any meaningful analysis and does not provide sufficient detail to allow UR to make an informed determination.

¹ Competition Commission, News Release, 19 December 2012

Recommendations by the Commission

PNGL notes UR's comment in paragraph 4.19 that it is proposing "to consider the implications of the Competition Commission Final Decision of PNGL12 including how historic outperformance should be treated beyond 2013". PNGL agrees that the Commission made some recommendations in Section 10 of its report and accepts that these will be given due consideration as part of the GD14 review. However, the consultation fails to reference a number of the Commission's most important findings. For example, the treatment of historic outperformance is an issue that must now be considered closed (see paragraph 9.109 of the Commission's report).

Another example relates to UR's Statutory Duties. PNGL notes UR's interpretation of its statutory duties in paragraphs 1.3 and 1.4 and trusts that UR will conduct its GD14 review in the manner which gives proper weight to its principal objective, that being the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland.

PNGL trusts that UR will not elevate its duty to protect the interests of consumers of gas above all other duties to which it is subject. PNGL would highlight that the Energy (Northern Ireland) Order 2003 defines consumers as "including both existing consumers and future consumers". In Northern Ireland, a significant proportion of future consumers are outside PNGL's and firmus's licensed areas. The interests of such consumers must be considered by UR as part of the GD14 review to ensure that prices/costs are as low as possible over longer time horizons than the GD14 price control period.

Another important omission is the reference to PNGL's rate of return being fixed until 2016 in paragraph 4.15.

PNGL trusts that UR will implement each of the Commission's findings as set out in its November 2012 determination.

Benchmarking

UR makes a number of statements about its intentions to use benchmarks as part of the GD14 review e.g. external benchmarking of cost and rate of return. If done properly, such comparisons may be useful: PNGL believes it runs a lean and efficient business in line with industry-leading standards. Consideration must however be given to relevant specific factors, both for comparing PNGL to firmus, and when comparing the NI GDNs to those in GB or other "relevant" regimes. Regarding the latter, as the Commission noted: "*making meaningful comparisons is not easy. Direct comparisons of distribution prices between Northern Ireland and, for example, Great Britain are likely to be misleading because PNGL's network is newly developed, its customers are only gradually switching to gas, the costs of its initial investments are still being repaid, and its revenues have been deferred. In addition, the geography, density of the network and so on will vary between PNGL's Licensed Area and comparator areas. Given that there are so many differences that need to be controlled for (but where measures of these differences may be difficult or uncertain), we did not*

*think that direct comparisons of prices would be meaningful.*²² Given these challenges, PNGL will welcome the opportunity to engage with UR on its benchmarking proposals so as to ensure that meaningful comparisons can be made.

Regarding the former, PNGL and firmus are still very different companies at different stages in development and this must be taken into account in any decisions to further align the controls. The regulatory models may be different for good reason, and UR should continue to ensure that the regulatory framework applied is relevant for the circumstances in which the companies operate.

Publication

PNGL notes UR's proposal to publish PNGL's financial models in paragraph 4.16. PNGL is happy to discuss publication of data with UR during the GD14 review to ensure that this is presented in an appropriate format and any confidentiality issues are considered e.g. PNGL's price control submission and supporting data must not be disclosed however it may be appropriate to publish a condensed version of the "Pis model" based on high level total opex and total capex cost lines.

Outputs

PNGL notes UR's proposal to keep to the principle that capex allowances must deliver certain outputs in paragraph 4.11. PNGL understands that this comment means that such outputs will continue to form part of the retrospective mechanism and that PNGL will only receive an allowance if, for example, the pipe is laid or a connection made. PNGL believes that this aspect of its regulatory framework currently functions effectively, and should not require significant alteration at GD14.

Designated Parameters

UR's intentions in paragraph 4.18 are unclear. UR may simply intend updating PNGL's designated parameters in line with current licence conditions. However it may be that UR intends reviewing the form of PNGL's control. UR should therefore clarify its intentions and allow PNGL to engage with UR at the earliest opportunity.

Profile Adjustment

PNGL would clarify that PNGL's regulatory model does not specifically capitalise opex, however the profile adjustment does work in a way whereby unrecovered allowed costs are capitalised, at least until the profile adjustment has peaked. PNGL understands that this is what is meant by UR in paragraph 4.21. PNGL has indicated as part of the Commission's Inquiry that it is happy to consider mechanisms to accelerate the recovery of the profile adjustment and is happy to engage with UR at the earliest opportunity if this is UR's concern.

²² Competition Commission, Phoenix Natural Gas Limited price determination, paragraph 9.88