Conclusion of the Utility Regulator's Review of the Phoenix Supply Ltd Maximum Average Price

April 2011

Approval by the Utility Regulator of the Phoenix Supply Ltd. Maximum Average Price

Summary

On 4 February 2011 the Utility Regulator in conjunction with Phoenix Supply Ltd (PSL), DETI and the Consumer Council began a review of the Phoenix Supply maximum average price for customers using less than 25,000 therms per annum. This price had previously been set on 1 October 2009 until 31 March 2011. Therefore a review was required to establish the new maximum average price going forward.

The decision was made to delay the new maximum average price until 1 May 2011 due to volatility in the wholesale gas market. The Utility Regulator considered it prudent to delay the tariff to gather further information to inform the price review. This review has resulted in our approval of a 39.1% increase in PSL's maximum average price effective from 1 May 2011. This paper sets out the background to and reasoning behind our decision.

Background

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

> *'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'*

The Utility Regulator establishes a price control determination to control PSL costs. A price control determination will set out how each of the costs will be treated in the maximum average price.

PSL can choose to set a price which is below the maximum average price. To date they have always charged the maximum average price.

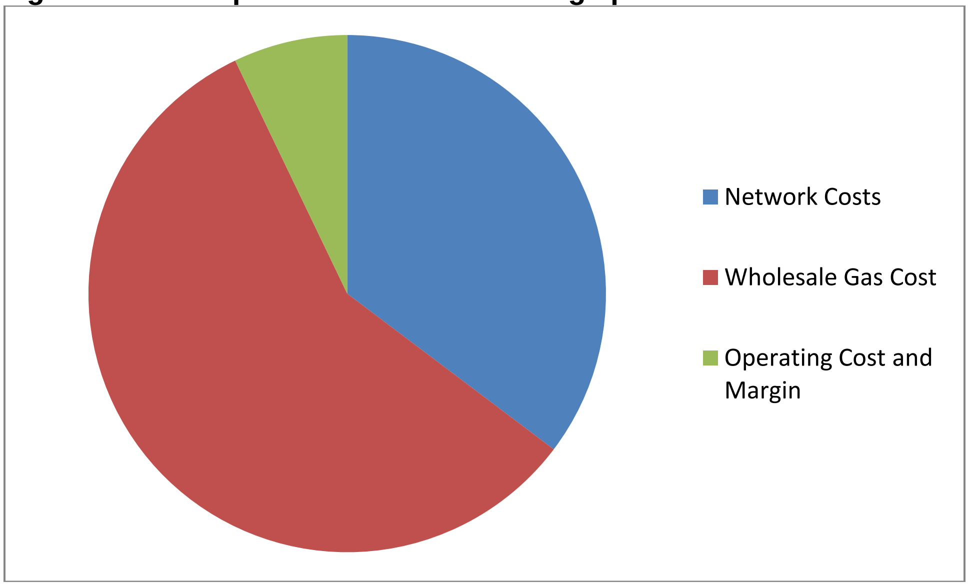
Elements of Maximum Average Price

The maximum average price is made up of a number of costs.

- The wholesale cost of gas
- Network use costs
- The operating expenditure of the supply business and supply margin

The breakdown is shown in figure 1 below.

Figure 1 - Makeup of the maximum average price



Network Costs

Network costs are the charges for the use of the transmission and distribution systems. These charges are reviewed and approved by the Utility Regulator.

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 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/.

Operating Costs and Margin

Operating costs refer to those costs necessary for PSL to run its supply business to tariff customers. For example the costs of billing, meter reading, staff etc. The margin refers to the amount of profit PSL is allowed to make. The margin is currently set at 1.5% of turnover from tariff customers. Both of these elements are determined by the price control carried out by the Utility Regulator. The most recent price control runs from 1 January 2009 to 31 December 2011 and this can be found on our website at http://www.uregni.gov.uk/uploads/publications/Phoenix_Supply_Price_Control_Final_Determination_2009.pdf.

The Utility Regulator is currently consulting on the approach for the next price control to begin on 1 January 2012. This consultation can be found at http://www.uregni.gov.uk/news/view/utility_regulator_consults_on_phoenix_supply_price_control.

Gas Costs

The wholesale cost of gas is the largest element of the tariff comprising over 55% of the total price in May 2011. The price control determines that gas costs are treated as pass through which means that the customer pays for the actual cost of gas. Where wholesale gas costs are above those set in the tariff the company will be able to recharge the difference to customers and where wholesale gas costs are below those set in the tariff the company will refund the difference to customers through the tariff.

This element of recovery is known as the k factor. For this tariff period PSL have a k factor of around £1.5m which needs to be recovered from customers. This works out at 1.87% of the tariff.

The PSL tariff is reviewed biannually in April and October and the price control also contains provision to review the tariff if the price of gas changes significantly.

Table 1 below shows the movement in the PSL tariff from May 2008 to date.

Table 1 - Historic PSL tariff

Effective from date	1 May 2008	1 October 2008	8 January 2009	1 October 2009	1 May 2011
Approved Tariff (per therm)	£1.28	£1.53	£1.19	£0.96	£1.34
% Change	28.0%	19.2%	-22.1%	-19.0%	39.1%

Figure 2 – Breakdown of October 2009 tariff versus May 2011 tariff

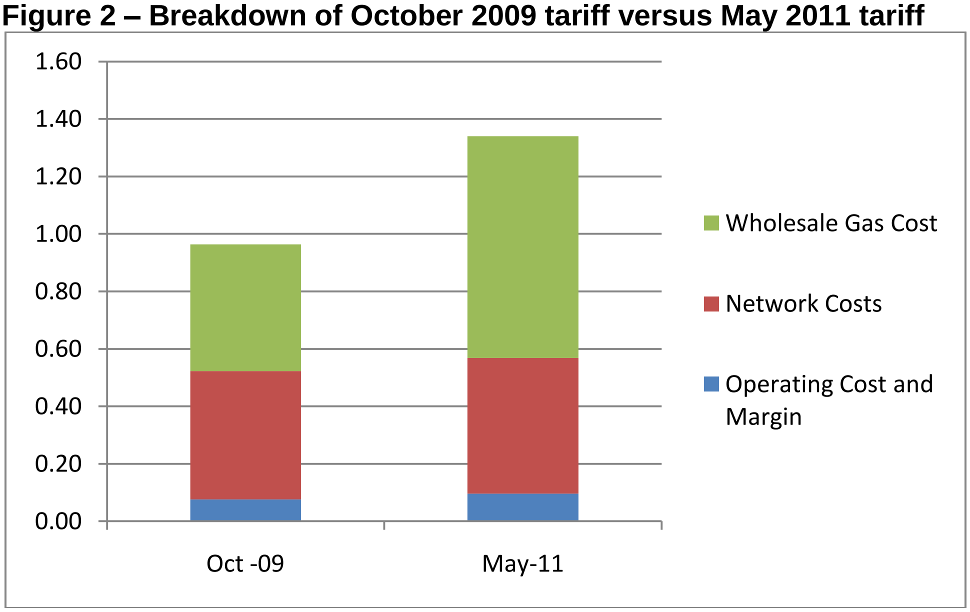
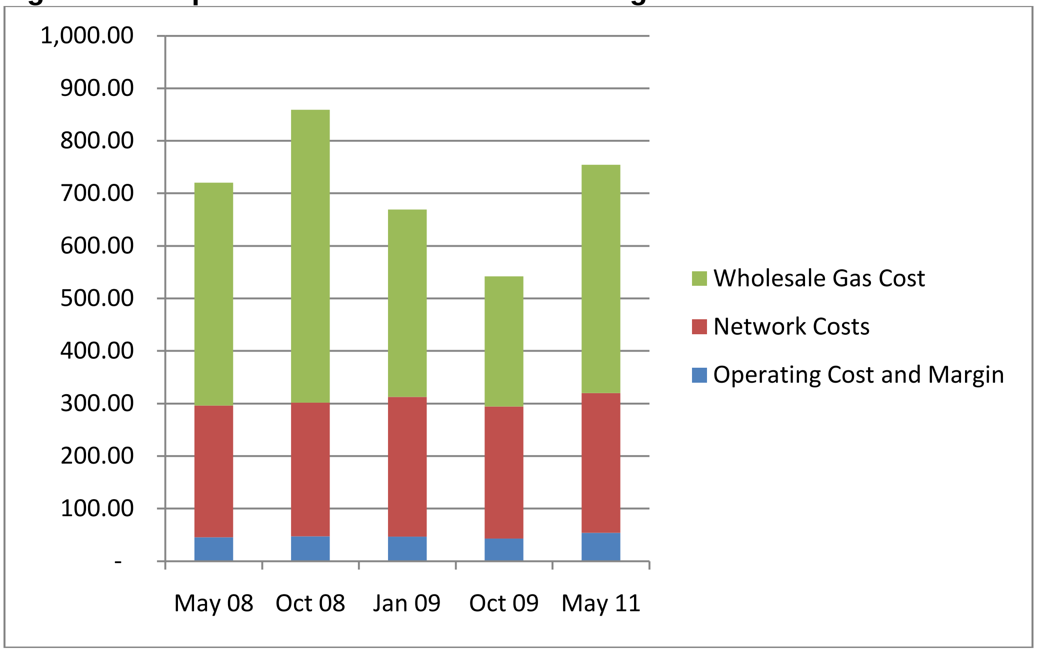


Figure 2 above compares the breakdown of the tariff for the previous tariff and the new tariff bill and demonstrates that network costs and operating costs remain largely the same. However the changing wholesale gas costs make a significant difference to the tariff.

Figure 3 below shows the breakdown in the average annual bill for consumers over the past three years and illustrates again the variation caused by changes in the wholesale price of gas.

Figure 3 - Graph to show breakdown of average annual bill



Why are PSL Tariffs Increasing?

The increase in PSL tariffs is driven by an increase in wholesale gas costs. Prices for Winter 2012 have increased by around 77% over prices for Winter 2011[1]. The majority of this increase has been from February 2011. The wholesale price of gas has been driven up by ongoing instability in the Middle East and North Africa, alongside the current disaster in Japan.

Bord Gais produce a monthly Energy Index. This index is a seasonally adjusted measure of prices in the wholesale energy market. The index tracks movements in oil and gas in addition to other fuels and illustrates the movements in these markets. The energy index can be found at http://www.bordgaisenergy.ie/energyindex/ .

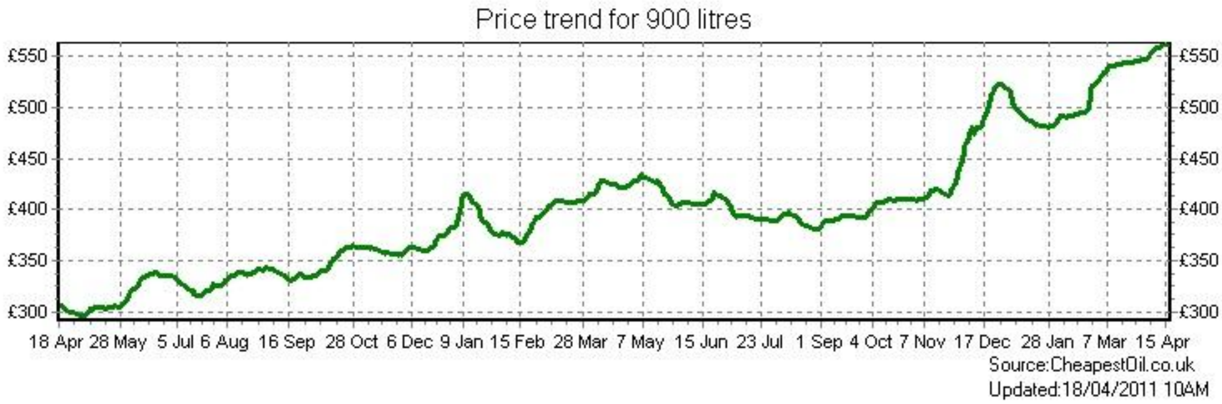
Comparison with Oil

Oil prices have risen steadily, also driven by events in the Middle East and Japan. The price of crude oil is currently at its highest level for the past two and a half years. The impact of this on

[1] This compares the average price for Q1 2012 taken over the past 20 business days (from 18 March to 15 April 2011) compared to the average price for Q1 2011 taken over the same period in 2010.

Northern Ireland consumers can be seen in figure 4 below. This graph shows the average price for 900 litres of oil over a two year period has risen from around £300 to around £550. This represents an increase of over 80% to consumers from April 2009 to April 2011.

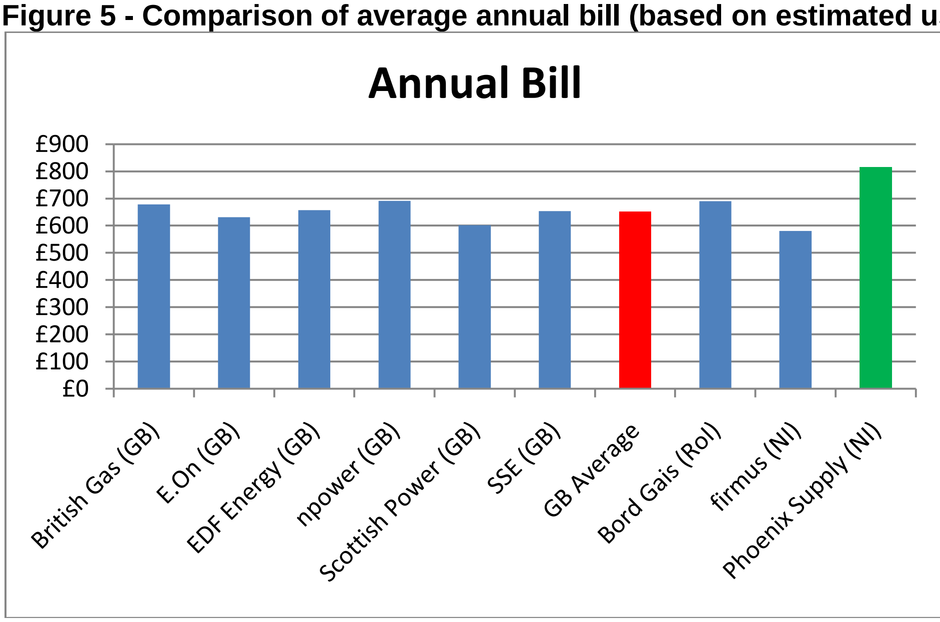
Figure 4 – Price of 900l Home Heating Oil from April 2009 to date



Comparison with GB and RoI

Figure 5, below, shows the average annual bill for PSL compared to the Big 6[2] companies in GB, Bord Gais in Ireland and firmus energy in the Greater Belfast Area. This comparison is based on the standard tariffs of each company.

Figure 5 - Comparison of average annual bill (based on estimated usage 16,500kWh[3] pa)



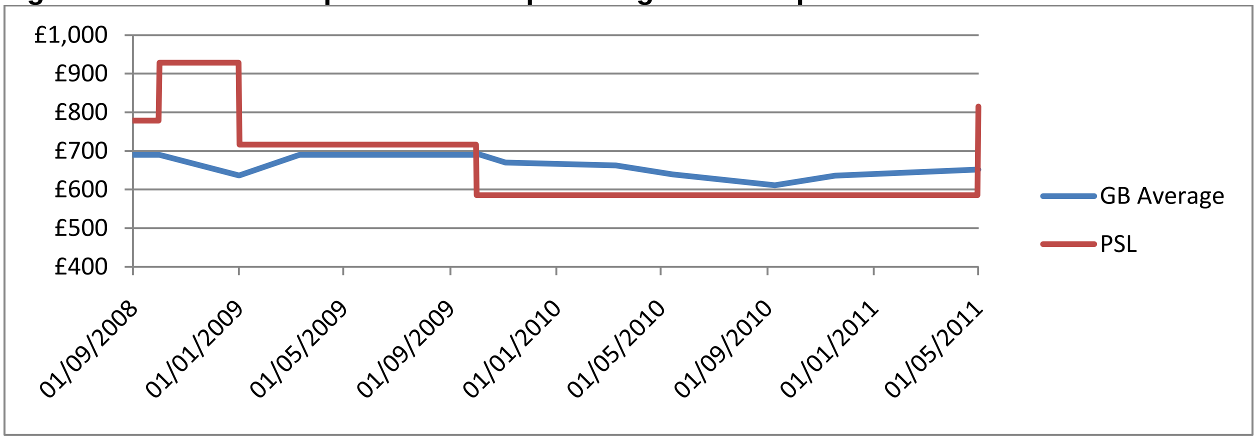
[2] Big 6 companies are British Gas, Scottish and Southern Electric, Scottish Power, npower, EDF and E.on

[3] 16,500kWh annual usage estimate is based on the figure published by Ofgem in their Decision Letter: review of typical domestic consumption levels document published on 5 November 2010. This can be found at http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid= 14&refer= Markets/RetMkts/Compl/Consumption

Figure 5 illustrates that PSL tariffs will be around 25% higher than the GB average standard tariff around 18% higher than tariffs in RoI. PSL tariffs are expected to be higher than those in GB due to the cost of transporting gas from Scotland to Northern Ireland. However, for the last 18 months the PSL tariff has been lower than the GB average, this has been caused by GB firms earning greater margins. These firms are not price regulated and can therefore set their own margins. Evidence suggests that GB firms are currently earning in the region of 8%[4] compared to the regulated PSL margin of 1.5%. GB firms have also been quicker to raise tariffs in response to rising wholesale prices and slower to reduce tariffs when wholesale prices fall.

Figure 6 illustrates the historic comparison of PSL prices against the average standard tariff in GB. It shows that PSL prices have been lower than the average standard GB tariff for the past 18 months.

Figure 6 - Historic Comparison of GB prices against PSL prices



BGE have announced that they are intending to increase prices in October and we anticipate that GB prices will also rise over the forthcoming months to take account of the most recent rises in the wholesale gas market.

Outcome

The Utility Regulator has reviewed the Maximum Average Price Review submission provided by PSL and reviewed the PSL forecasts against its own market analysis. The Utility Regulator is satisfied that this increase is justified and therefore approves the tariff of £1.3397 per therm effective on 1 May 2011, which represents an increase of 39.1% over the previous tariff effective on 1st October 2009 of £0.96 per therm.

However, the Utility Regulator retains the flexibility to have a review of gas prices at any stage if it is considered to be in the interest of customers.

[4] Figure calculated from the March 2011 Ofgem Electricity and Gas Market report which can be found at http://www.ofgem.gov.uk/Markets/RetMkts/rmr/Documents1/Supply_Market_Report_March2011.pdf