Phoenix Supply Ltd

Utility Regulator Minded To Position on
Phoenix Supply Price Control, 2012 - 2016

August 2011

We have engaged with the Utility Regulator in a series of meetings since the publication of the Minded To Position consultation paper on the Phoenix Supply Price Control and also provided additional information.

Efficiency Factor

The consultation paper proposes to apply an efficiency factor of 2.5% to total allowable operating expenditure for each year of the Price Control period. This is a completely unrealistic target that would require Phoenix Supply to significantly outperform the rate of productivity achieved across the economy as a whole in every year of the control.

The application of this efficiency factor in the manner outlined in the minded to paper has the effect of reducing the total allowable expenditure by £0.56 million over the course of the Price Control period. The table below shows the impact of the proposed efficiency factor each year:

Table 1
Annual Effect of Proposed Efficiency Factor

	2012 £'000	**2013 £'000**	**2014 £'000**	**2015 £'000**	**2016 £'000**	**Total £'000**
Efficiency Factor	117	111	108	110	111	557

There are a number of inconsistencies and issues associated with the Utility Regulator's proposal to apply an efficiency factor of 2.5% which are outlined below:

- It is argued in the minded to paper that Phoenix Supply have requested additional monies for information technology projects and as these are being allowed then an efficiency factor should be included. The only project which PSL have requested additional monies for is the costs associated with a PAYG switching system in 2012 all of which has been disallowed by the Utility Regulator. The costs included within information technology costs represent the on-going costs of operating existing Phoenix Supply systems. Therefore, we do not understand why the Utility Regulator is claiming that Phoenix Supply have claimed additional monies for information technology projects which have been allowed when this is not the case;

- The proposal to apply an efficiency factor to Phoenix Supply is inconsistent with the Utility Regulator's proposed treatment of NIE Energy[1] which does not propose the application of an efficiency factor;

- The Utility Regulator has had no discussion with Phoenix Supply in respect of the application of an efficiency factor nor has it conducted an assessment of the efficiency of our business operations. Prior to the proposed application of such a penal efficiency factor we would have expected the Utility Regulator to have completed an in-depth assessment of the relative efficiency of Phoenix Supply's operations and processes;

- Phoenix Supply is not a state-owned or public sector organisation nor is it a privatised company which previously operated in the public sector. There is no “post-privatisation” inefficiency to be taken out. All costs have had to be justified prior to being incurred and as a consequence the company already operates efficiently;

- The Utility Regulator is proposing the double-counting of efficiencies as it is proposing the application of a 2.5% efficiency factor on top of the sweeping cuts proposed to forecast operating expenditure. The level of proposed cuts to forecast operating expenditure are so significant that the company will struggle to meet these cost reductions (which are the subject of separate papers) even before a further efficiency factor is applied;

- The company operates competitive tendering processes for every significant expenditure incurred in the business, ensuring the company already achieves value for money in services received from external service providers;

- Also it should be borne in mind that the advent of competition is likely to result in Phoenix Supply having a smaller customer base and therefore there is little or no scope for the company to generate further economies of scale. This coupled with the additional costs associated with managing customers to/from suppliers, and other obligations brought about by competition, are likely to significantly impact our business.

The Utility Regulator justifies the application of a 2.5% efficiency factor on the basis that this was the efficiency factor used by Ofgem in the Gas Distribution Price Controls from 2008 to 2013. The application of an efficiency factor applied to a distribution business in Great Britain is not relevant to Phoenix Supply for the following reasons:

- The Utility Regulator states that an “efficiency factor is appropriate for this price control given…that inflation is a pass through”. This shows a lack of understanding about indexation to the RPI. What the RPI measures is the change in input prices across the economy less the change in productivity as a whole. By holding operating costs constant in real terms through indexing costs to RPI, the Utility Regulator is already making the assumption that

[1] NIE Energy Supply Price Control 2011 - 2013, Proposals for Consultation, 20th May 2011

Phoenix Supply will make efficiency savings equal to the average of the efficiency savings achieved in the economy as a whole. By way of an example, average Total Factor Productivity for the UK economy has historically been in the region of 1.3% per year[2]. This efficiency assumption is essentially already built in to the RPI;

- An additional efficiency factor is only applied where there is evidence that the regulated company can be expected to make efficiencies that will exceed this average economy-wide productivity growth. To do this, Utility Regulator would need evidence that Phoenix Supply would be able to achieve these greater than average efficiency savings. The Utility Regulator has not provided any such evidence;

- Simply applying an additional efficiency saving that Ofgem specifically calculated for a set of unrelated companies has absolutely no justification. If Ofgem's proposals[3] are examined it can be seen that this figure has been calculated based on the cost base and business model of the GB Gas Distribution Companies and took into account the fact that they had only recently been divested and were formerly state owned assets. Indeed, Ofgem has applied very different efficiency factors in the price controls it has set since this time to reflect the individual circumstances of the companies it is regulating;

- Regulators also make a distinction between the Real Price Effect (RPE) and the ongoing productivity effect when determining the level of efficiency that can be achieved relative to the measure of RPI. This is set out in Ofgem's RIIO methodology[4] and was used by the Competition Commission in its review of Bristol Water;

- These targets have generally fallen since Ofgem set the Gas Distribution price control back in 2007. For example, the Competition Commission recently agreed with Ofwat that the target for Bristol Water should be 0.25% and also struck a note of caution about its use when it said that "there may be a case for erring on the side of caution [in setting this value] given the uncertainty about several components of continuing efficiency calculations."[5] Further, when Ofgem set the last price control for the Electricity Distribution companies the RPE was greater than the productivity assumption, leading to a factor that was added to the RPI index, rather than deducted from it.[6]

Even in the context of the application of an efficiency factor, the efficiency factor proposed by the Utility Regulator is not appropriate for the following reason:

- The proposed efficiency factor has been applied to items which it is proposed will be retrospectively adjusted as part of the Price Control. It would clearly be inconsistent treatment to apply an efficiency factor to a cost which is to be

[2] See, for example, Ofgem – Productivity Improvements in Distribution Network Operators, CEPA
[3] Gas Distribution Price Control Review – Final Proposals, Ofgem, December 2007
[4] Decision on strategy for the next gas distribution price control – RIIO-GD1, Ofgem, March 2011
[5] Bristol Water plc, Competition Commission (2010) para 7.13
[6] Electricity Distribution Price Control Review Final Proposals – Allowed revenue – cost assessment, Ofgem (2010) Chapter 5

retrospectively adjusted for the actual cost incurred, which in itself captures any efficiencies.

The proposed retrospective items are licence fees, bad debt, transaction costs, meter reading and bill printing costs. Together these items equate to a significant proportion of the minded to allowable cost.

Table 2
Retrospective Items Minded To Allowable Cost

	2012 £'000	2013 £'000	2014 £'000	2015 £'000	2016 £'000
Total	1,876	1,711	1,663	1,715	1,763

Clearly these items have to be removed before the application of any efficiency factor. To apply an efficiency factor to retrospective items does not give Phoenix Supply any opportunity to meet the efficiency factor applied (as any efficiency is already captured as part of the retrospective adjustment) which is unjustifiable.

If these costs are not removed, the efficiency factor proposed by the Utility Regulator is effectively over 4%. This would be almost unprecedented.

The application of the efficiency factor is predicated on assumptions which are incorrect and inconsistent and therefore it should be removed from the Price Control.

Margin

The consultation paper states that the Utility Regulator does not consider that the risks to the company have changed so as to warrant an increase in the margin beyond 1.5%.

Clearly there has been a significant change in risks for Phoenix Supply since the date of the last price control, namely, that competition now exists in all market sectors including the domestic sector. This means that costs cannot assumed to be fully recoverable from customers. In the circumstances where Phoenix Supply significantly under-recovers and prices are increased to recover these amounts Phoenix Supply can expect to lose market share. A lower market share from which to recover costs requires a further price increase to recover costs from remaining customers which in turn can be expected to result in an even lower market share.

It is also quoted in this section of the consultation paper that in the last price control for British Gas in 2000 Ofgem applied a 1.5% margin. We do not regard this as an appropriate comparison for the following reasons:

- At the time of the Price Control British Gas had c.20 million customers. Phoenix Supply has around 135,000 customers, making British Gas almost 150 times larger than Phoenix Supply. As a consequence the risks faced by British Gas in respect of loss of market share and therefore incurring unrecoverable (or stranded) costs was much lower than Phoenix Supply.

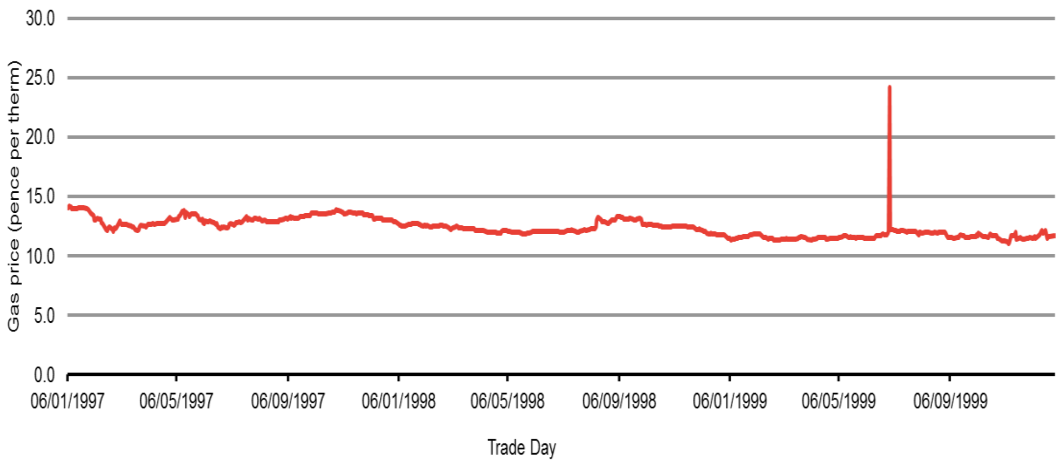
In the Republic of Ireland, Bord Gais Energy (**BGE**), which is more comparable to the size of Phoenix Supply is allowed a regulated margin of 2%. The fact that BGE purchase gas on a ladder mechanism and therefore may incur irrecoverable costs is compensated by the fact that they can also earn a margin well in excess of 2%.

- Financing costs have increased significantly since 2000 which should be adjusted in the regulated margin by the Utility Regulator. These issues were addressed in our response to the previous Supply Price Control consultation.

- The wholesale gas market has fundamentally changed since 2000. Wholesale gas costs have increased significantly since 2000 and therefore working capital requirements are significantly higher than when Ofgem applied a 1.5% margin to British Gas.

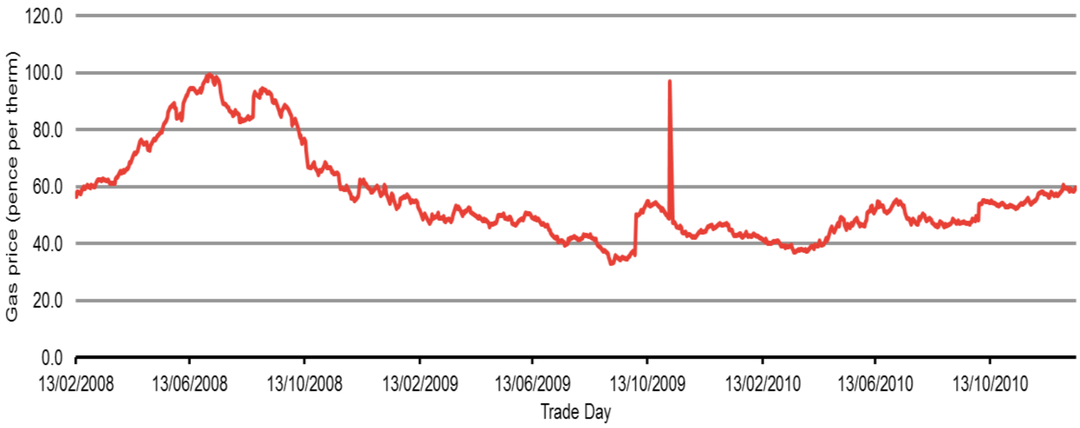
  The step change in the wholesale gas market is demonstrated in the graphs below.

Figure 1
Year Ahead Gas Price Volatility (January 1997 – December 1999)



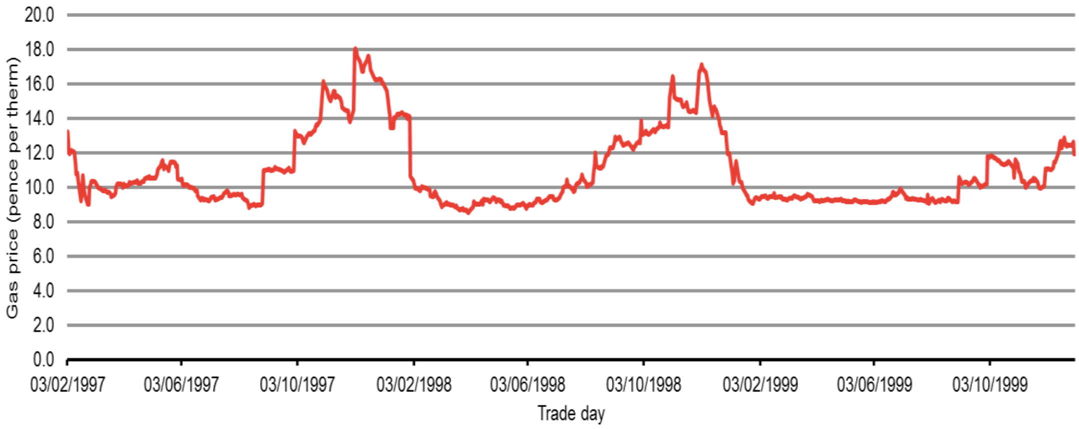
The standard deviation is 0.8 and coefficient of variation is 0.07.

Figure 2
Year Ahead Gas Price Volatility (February 2008 – January 2011)



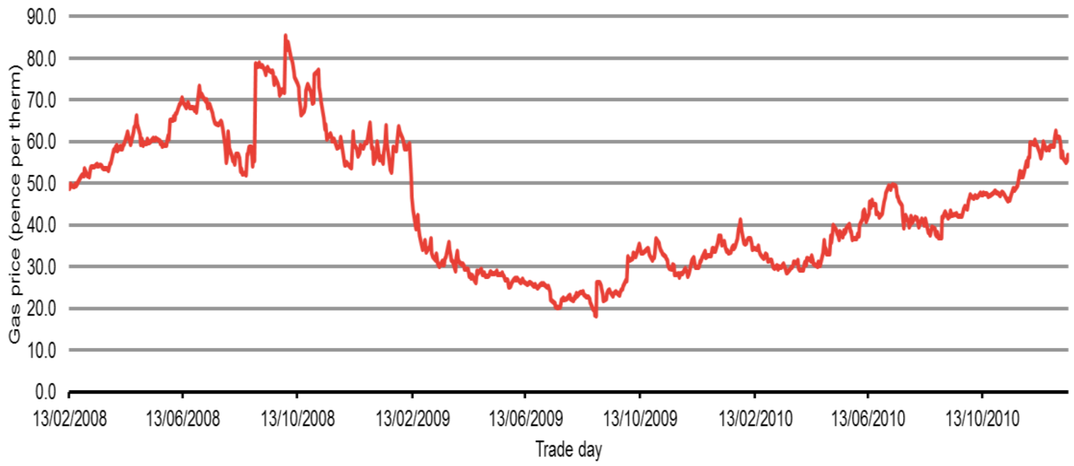
The standard deviation is 15.9 and coefficient of variation is 0.3.

Figure 3
Month Ahead Gas Price Volatility (February 1997 – December 1999)



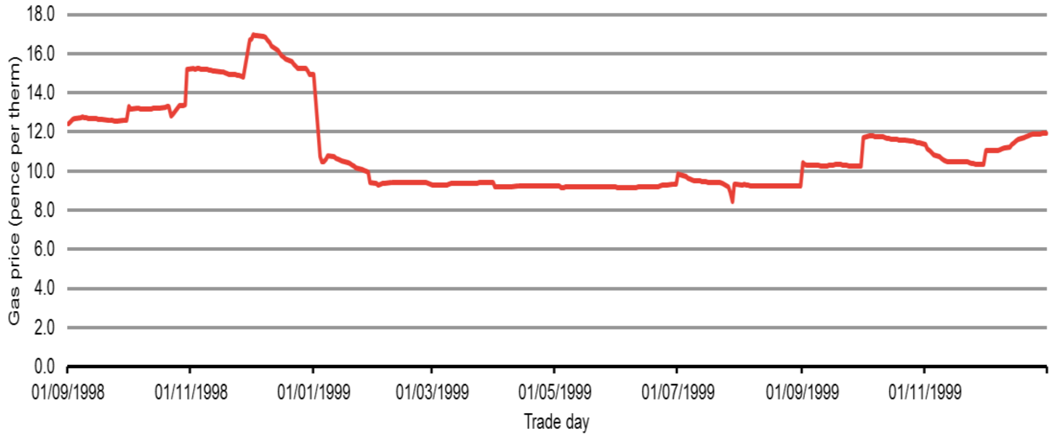
The standard deviation is 2.2 and coefficient of variation is 0.2.

Figure 4
Month Ahead Gas Price Volatility (February 2008 – January 2011)



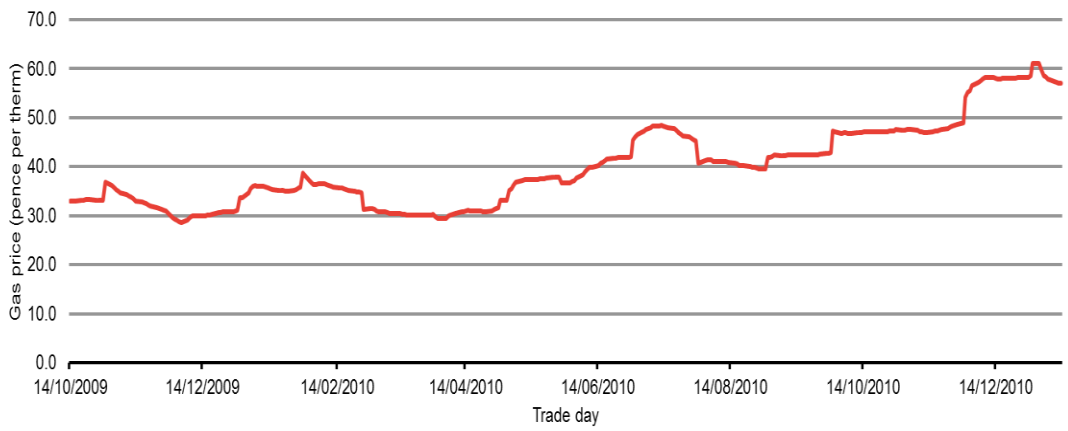
The standard deviation is 15.7 and coefficient of variation is 0.3.

Figure 5
Day Ahead Gas Price Volatility (September 1998 – December 1999)



The standard deviation is 2.2 and coefficient of variation is 0.2.

Figure 6
Day Ahead Gas Price Volatility (October 2009 – January 2011)



The standard deviation is 8.4 and coefficient of variation is 0.2.

It can be clearly seen from comparisons of year ahead, month ahead and day ahead prices that there has been a step increase in volatility and wholesale market prices which directly impacts on the working capital requirements of Phoenix Supply. Therefore, it is not appropriate to use the margin for British Gas set in 2000 as the appropriate margin for Phoenix Supply for the period from 2012 to 2016, which is over a decade after margins were set for British Gas.

In order to ensure sustainable energy retailing in Northern Ireland the Utility Regulator must address the unacceptably low Return on Capital Employed and the wider margin issues which were outlined in our response to the Utility Regulator in April 2011.

Furthermore we are perplexed at why the Utility Regulator has applied a small company discount in respect of the proposed margin for Phoenix Supply which is at direct variance with the principles applied by other regulatory bodies including the Competition Commission, Ofgem, Ofwat and Oftel. All these bodies have accepted the principle of, and need for, a small company premium, yet the Utility Regulator has indicated that one of the reasons for Power NI having a higher margin than Phoenix Supply is "*the comparative size of the markets, as the gas market is smaller.*" This conclusion clearly runs contrary to generally accepted regulatory principles and we ask the Utility Regulator to explain why these generally accepted regulatory principles are being disregarded in this instance.

We would urge the Utility Regulator to allow Phoenix Supply a small company premium in addition to the margin allowed to Power NI of 1.7%. The argument that Phoenix Supply has a lower margin of 1.5% because it is smaller is irrelevant as the fact that a % is applied already takes account of the fact that Phoenix Supply is smaller than Power NI.

Bad Debt

Debt Prevention

The Minded To paper states that "*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 at risk of getting into debt.*" We consider this to be a very unhelpful comment and misleading to readers of the consultation paper. We request that it is removed from the determined to paper.

At Phoenix Supply's request the Utility Regulator visited Phoenix Supply to learn about our debt processes. At this meeting we covered some of the key issues facing Phoenix Supply in collecting and managing debt. However, it was made clear during this meeting that only a proportion of Phoenix Supply's activity in relation to debt was covered as part of this meeting. While the Utility Regulator asked for a number of supporting documents, all of which were provided, we made it clear that if the Utility Regulator had further questions in relation to debt we would welcome further discussions on this issue.

The first occasion Phoenix Supply became aware that the Utility Regulator wished to receive information in relation to measures undertaken to prevent debt was with the publication of the Minded To consultation paper. We consider it would have been more helpful if the Utility Regulator had requested this information from us and we could have engaged in a two-way dialogue specifically on debt prevention issues.

As noted in the presentation made to the Utility Regulator on 6th June 2011 the focus of Phoenix Supply is on debt prevention. Our debt procedures are integrated within our business and endeavour to strike the balance between individual customer needs and our responsibility to help prevent customers getting into debt and also collect debt, where possible, when it arises. We have provided further information in relation to measures undertaken by Phoenix Supply to assist in preventing customers getting into debt.

Measures to Help those in Difficulty Paying their Bill

The consultation paper states that it is the Utility Regulator's view that Phoenix Supply should be focused on helping those customers who have difficulty in paying their bill. We are happy to confirm that this is the focus of our business activities and we have provided information on some of the measures in place designed to help those in difficulty paying their bill.

Comparison with Centrica

In the consultation paper the Utility Regulator states, citing the 2010 Annual Report of Centrica, that Centrica had a combined debt level (domestic and business) of 9.54% of total revenue. This is then compared to a debt level of over 12% for Phoenix Supply. This is quoted as evidence that Phoenix Supply's debt management process requires further investigation.

The figure of 9.54% quoted for Centrica is misleading and the Utility Regulator has clearly misunderstood the financial statements of Centrica. We have provided the relevant analysis below extracted from the Centrica 2010 Annual Report for information:

	Residential £m	**Business £m**	**Total £m**
Revenue	8,355	2,906	11,261
Trade Debtors	2,001	1,643	3,644
Less Provision for losses	(375)	(253)	(628)
Net Trade Debtors	1,626	1,390	3,016
%	19.5%	47.8%	26.8%

Therefore, the 9.54% quoted by the Utility Regulator is actually 26.8%. Centrica did not have a 9.54% combined debt level of total revenue. The table below shows the comparable analysis for Phoenix Supply extracted from information used to derive the 2010 statutory accounts:

	Total £m
Revenue	101.1
Net Trade Debtors	8.0
%	7.9%

This demonstrates, using the methodology adopted by the Utility Regulator, that in fact the performance of Phoenix Supply is actually better than that of Centrica.

It is damaging to Phoenix Supply that the Utility Regulator has chosen to present analysis in the consultation paper which is misleading and we require this to be either removed or the accurate analysis, as above, should be presented together with a note stating that the previous analysis presented by the Utility Regulator was inaccurate.

Comparison with Great Britain

The Utility Regulator cites an Ofgem report which states that just over 5% of gas customers were repaying a debt in June 2009 and compares this to a figure of around 14% for Phoenix Supply.

Firstly, this is not a fair comparison as it is not comparing similar data sets. The debt figures quoted in the Ofgem report relate to either customers who have a prepayment meter set to collect a debt or customers who are on a rescheduled debt repayment programme due to last longer than 91 days (or 13 weeks). The Utility Regulator has then compared this to the total number of accounts in Phoenix Supply in June 2009 which have a debt outstanding greater than 63 days. This type of analysis is unacceptable and very misleading.

In addition it is not appropriate to select one month for comparison of Phoenix Supply and suppliers in Great Britain. The analysis and basis of decisions associated with the Price Control which it is proposed will cover a period of 5 years must be more robust than this type of analysis.

Furthermore, it should be expected that Phoenix Supply has a greater number of accounts which have outstanding debt than similar companies in Great Britain as we have a greater proportion of customers repaying debt through Quantum meters over extended periods of time. It seems perverse that the Utility Regulator on one hand advocates in the consultation paper that Phoenix Supply should do more to help those struggling to pay their energy bills yet at the same time seems to cast dispersions on the company for having a greater proportion of customers in debt than suppliers in Great Britain. The inevitable consequence of helping customers repay their bills over an extended period of time is a greater proportion of customers repaying a debt at any one time. This also leads to a greater likelihood of bad debt.

Gemserv Report on Bad Debt in the GB Energy Market

Phoenix Supply would welcome the publication of the Gemserv report as we believe the limited references in the consultation paper lack transparency. Publication of the Gemserv report will facilitate transparency and allow wider stakeholders to review the findings of the report.

Phoenix Supply has presented actual cost data for bad debt from our audited accounts as part of the Price Control process which shows that bad debt has been in excess of 1% of total revenue since 2008 and has significantly increased, in line with other utility businesses, as a result of the current economic climate.

As part of our Price Control submission we have proposed bad debt in 2012 at 1.25% of total revenue falling to 0.9% by 2014 and remaining at this level to 2017. This in itself will be a significant challenge to deliver given current levels of bad debt. Given Phoenix Supply adopts best practice in relation to debt collection activities the Price Control should allow the costs contained within our submission which more closely reflect the level of actual costs incurred than the unrealistic allowance proposed by the Utility Regulator.