Utility Regulator Decision on

Phoenix Supply Price Control, 2009 - 2011

March 2009

Contents

Tables

1. Introduction

This paper sets out the final determination of the Northern Ireland Authority for Utility Regulation (the Utility Regulator) on the second price control undertaken for Phoenix Supply Ltd (PSL). This determination is only for PSL and does not apply to any other suppliers currently in the greater Belfast area or to any new entrants. The determination takes into account the views of respondents to the high-level price control consultation issued by the Utility Regulator during July 2008.

2. Summary

This price control will last for three calendar years from 1 January 2009 to 31 December 2011. It is applicable only to those customers using less than 25,000 therms per annum. The price control sets out a level of operating expenditure for PSL for each year of the control, contained within this amount are some costs which will be retrospectively adjusted to account for a movement in the driver. The treatment of these retrospective items will be subject to review during the period of the control and the determination will be subject to a re-opener pending the outcome of this review.

Gas costs are treated as pass through in this determination, however the treatment of gas costs will also be subject to review during the period of the control and the determination will be subject to a re-opener pending the outcome of this review.

The margin remains at 1.5%, this too will be subject to review and a re-opener applied to the determination pending the outcome of the review.

3. Methodology

To initiate the price control process the Utility Regulator issued for consultation a paper examining the high-level issues relating to the price control. These issues included the scope of the price control, the period of the control, the treatment of specific costs and the allowed margin. The responses to this consultation have been used to inform this determination. The consultation can be viewed on the Utility Regulator's website. In all five responses were received to the consultation, three of these responses have been marked confidential the others can be viewed on the Utility Regulator's website.

3.1 The scope of the control

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. 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. Respondents were split on this issue with three stating that there is effective competition in this sector and that a price control should not be applied. The remaining respondents state that some form of regulation may be required due to the low level of customer switching. It is the decision of the Utility Regulator 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.

3.2 Duration of the control

The Utility Regulator proposed in the high level consultation document that this price control should be set for a period of three years for 2009, 2010 and 2011 as we are of the opinion that competition will not be effective in the tariff market (those using under 25,000 therms per annum) before that point. Respondents were again split on this point; two agreed that the proposed three year timescale was appropriate while two believed that annual controls would be more appropriate. The Utility Regulator has decided to set a three year period for the price control.

4. FORM OF REGULATION

According to the terms of the Phoenix Supply licence[1] 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. The tariff is made up of a number of different elements which are outlined below. The price control establishes the principles which determine the maximum average price that PSL can charge to tariff customers for the period of the control (tariff customers are those who use less than 25,000 therms per annum). The Utility Regulator will use these principles to review the costs submitted by PSL in its tariff review and give or withhold consent to the average maximum price. The elements of the tariff and their treatment are detailed below.

Table 4-1 Elements of Tariff

Cost	Treatment of Cost
Transmission	Pass through
Distribution	Pass through
Supply Opex	As detailed in section 5
Gas Costs	As detailed in section 6
Margin	As detailed in section 7

[1] 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.

5. EXPENDITURE ANALYSIS

To derive best estimates of the costs for 2009, 2010 and 2011 the Utility Regulator, in discussion with PSL, has reviewed each element of the forecast supply operating costs and associated information. Operating costs are apportioned between tariff and contract customers with the aim of ensuring a fair allocation of costs.

To derive the annual supply operating figures the Utility Regulator has taken into consideration the historic actual costs to 2007 and forecasted 2008 figures, forecasts for the period of the price control, the submissions provided by Phoenix, any changes in the gas industry, cost drivers and comparisons with GB and RoI. The Utility Regulator has determined for Phoenix Supply Ltd. the allowed level of operating expenditure at £3,516k for 2009, £3,532k for 2010 and £3,616k for 2011 (1996 prices).

The following table sets out Phoenix Supply's submission and the Utility Regulator's Decision (including contract and tariff costs) for the three years 2009, 2010 and 2011.

Table 5-1 PSL Submission v Utility Regulator Decision (£'000 1996 prices)

	2009	2010	2011
PSL Submission	4,762	4,691	4,835
Utility Regulator Decision	3,516	3,532	3,616
Difference	1,246	1,159	1,219

5.1 Efficiency factor

The price control is designed to incentivise Phoenix Supply to create efficiencies within their business.

PSL have requested additional monies for new projects and development of existing systems. It is the opinion of the Utility Regulator that these projects provide a benefit to the company in terms of efficiencies in the cost base and that these projects can be funded through PSL identifying appropriate efficiencies. To this end, it is the decision of the Utility Regulator to disallow funding for these projects and to apply an efficiency factor of zero for the period of this control.

5.2 Recharges

A significant proportion of Phoenix Supply costs are the result of recharges from the Phoenix distribution business; IT, fleet costs, rates, office costs, telephone and postage, stationery and human resources. We have accepted the Phoenix recharging methodology and applied it to the costs set out in our Phoenix Distribution price control determination. The recharged amounts in the supply price control have been taken from the distribution price control. As agreed with Phoenix the recharging methodology will be reviewed to ensure it remains the most appropriate way of recharging the PNG Distribution costs going forward and a re-opener will be considered as appropriate.

5.3 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 at the mid point of the year.

Inflation costs are treated as a pass through and will be retrospectively adjusted for the actual inflation figure. Inflation is assumed at 0.9% for 2009 and this figure has been applied in the derivation of the 2009 supply costs. Going forward inflation is assumed at 2% for 2010 and 2011. Transmission and distribution costs will be treated as a pass through in the correction mechanism. Any over or under recoveries on pass through costs will be charged interest at LIBOR plus 1.5%.

5.4 Retrospective Mechanism

Those costs over which PSL has limited control will be included within a retrospective mechanism. The retrospective mechanism will adjust forecast costs for actual costs when the audited accounts are received. The areas are as follows.

- Billing
    - Bad Debt
    - Bill printing and postage costs
    - Transactions costs (PAYG)
    - Meter Reading Costs
- Licence Fee

The treatment of retrospective amounts is detailed in section 4. These retrospective amounts will be rolled forward at LIBOR plus 1.5%.

Within the high-level consultation document, the Utility Regulator questioned if respondents agreed with the items that are retrospectively adjusted and the retrospective mechanism employed. Three of the respondents stated that retrospective adjustments should not be allowed due to the affect they have on competition of distorting the price of the incumbent supplier.

It is the decision of the Utility Regulator to continue with the treatment of retrospective items as it is of the opinion that PSL should not be unduly penalised on costs over which it has limited control. However, the retrospective mechanism and treatment of any over or under recovery will be subject to review by the Utility Regulator during 2009/10. There will be a re-opener in the price control subject to the outcome of this review.

5.5 Apportionment of Supply Costs

In order to ensure a reasonable allocation of costs between tariff and contract a cost driver has been identified for each element of supply opex as listed in Appendix 1. Where the driver is volume related a reduction of 10% has been applied to contract volumes in each year to account for the impact of competition.

The Utility Regulator is of the opinion that the table in appendix 1 outlines the most appropriate methods of apportioning costs between tariff and contract. When the supply costs are apportioned tariff costs represent 82.8% of total supply operating costs in 2009, 84.5% in 2010 and 86.1% in 2011.

The apportionment of supply costs will be retrospectively adjusted based on outturn volumes, customer numbers, number of bills generated, number of meter reads and revenue where appropriate.

The Utility Regulator will allow PSL to resubmit volumes at the commencement of each tariff period.

5.6 Outcome

The outcome of the price control determination for opex for each year of the price control is to allow a supply operating pence per therm figure of 6.25p for 2009, 6.15p for 2010 and 6.18p for 2011. These figures are nominal for each year and will form part of the final selling price for that year. To calculate the supply cost per therm we divide the tariff element of the supply opex by the load in therms (supplied) for tariff customers.

6. TREATMENT OF GAS COSTS

6.1 Gas cost pass through

This price control will establish the principles upon which gas costs will be based. The gas costs will be set as part of the tariff review which will occur annually as per licence condition 2.4.1, where

'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'

In order to facilitate the establishment of an annual tariff the Utility Regulator will not set gas costs as part of this determination but will instead review the costs put forward as part of each tariff submission and give or withhold consent to the maximum average price. However detailed here are the principles upon which the gas costs will be reviewed.

In the previous price control period the Utility Regulator allowed a gas cost pass through system that took into consideration gas costs and volumes. The high-level consultation questioned respondents on this treatment of gas costs. Three of the respondents stated that gas costs should not be treated as pass through, stating that this will influence competition by distorting prices charged by the incumbent through allowing over or under recoveries.

The Utility Regulator will undertake a review of the treatment of gas costs during 2009/10. A re-opener will apply to this price control subject to the outcome of that review. In the meantime, the Utility Regulator will continue to allow the pass through of gas costs.

6.2 Trigger mechanism

The pass through treatment of gas costs means that the actual gas purchase costs incurred by Phoenix are recoverable within its supply tariffs. To mitigate the risks to PSL of a significant divergence between forecast gas costs and the actual wholesale prices of gas a trigger mechanism will be put in place as per the previous price control period. 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. The trigger mechanism will ensure Phoenix Supply Ltd. can finance its regulated activities while also ensuring a smooth path of prices for customers where possible.

7. SUPPLY MARGIN

In determining the allowable supply business costs the Utility Regulator has applied a cash flow methodology, which allows Phoenix to earn a margin on turnover, in addition to operating and capital costs being financed on a pay as you go basis. In setting the supply margin the Utility Regulator has taken into consideration the range of business risks that Phoenix are expected to encounter including capital at risk, working capital and competition from alternative suppliers (in so far as competition would increase risks should the treatment of costs remains the same).

The supply margin is set at 1.5% in line with the previous price control. The Utility Regulator determines that a change in margin at this stage is not appropriate as the company faces no additional risks from the previous price control and there is no competition in the tariff market. The supply margin will be reviewed in line with the gas cost and over/under recovery review due to take place during 2009/10. There will be a re-opener in the price control to reflect the outcome of this review.

8. APPENDIX 1

Table A-1 Drivers applied in the apportioning of the supply costs

Cost	Driver
Network Maintenance	Avg. no. burning customers (supplied)
Manpower	Load in therms (supplied) and number of bills generated
Fleet Costs	No. of cars
Travel and Subsistence	Direct manpower cost
Rates	Direct manpower cost
Office Costs	Direct manpower cost
Telephone and Postage	Avg. no. burning customers (supplied)
Stationery	Manpower numbers
Advertising Marketing and PR	Avg. no. burning customers (supplied)
Licence Fee	Load in therms (supplied)
Information Technology	Avg. no. burning customers (supplied)
Professional and Legal Fees	Supply Gas Revenue
Billing	
Bank Fees and Charges	Average No Burning customers (supplied)
Bad Debt Provision	Credit Turnover
Quantum	All tariff
Bill Printing	No bills generated
Third Party Debt Recovery	Credit revenue
Compensation for Incorrect Billing	No bills generated
Paypoint	All tariff
Libra	All tariff
Meter Reading	No. meter reads
Entertainment	Manpower numbers
Insurance	
Commercial All Risks - Section A to E	Turnover
Computer Breakdown & Loss	No Employees
Fidelity Guarantee	No Employees
EL PL PL	No Employees
Excess Employers Liability	No Employees
Group Personal Accident & Travel	No Employees
Commercial combined (Marine Pipeline) Includes BII	turnover/customers
Other insurance	No of employees
Directors & Officers	No of Directors
Car	No Cars
Human Resources	Manpower numbers