Phoenix Supply Ltd. Price Control from 2009 – High Level Options

Introduction

The Northern Ireland Authority for Utility Regulation (the Utility Regulator) seeks responses to its' consultation on the high level options for a price control on Phoenix Supply Limited (PSL) from 1st January 2009. This is the second price control for PSL, the previous price control was for the period from 1st January 2007 to 31st December 2008.

The following section in the PSL licence confers on the Utility Regulator ("the Authority" in the licence) the power to control charges if deemed necessary:

"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"

A price control is the mechanism that the Utility Regulator uses to determine the costs, both operating expenditure and gas costs, which are used to establish the maximum average price per therm that PSL can charge in the subsequent tariff year.

The options in terms of having a price control are either:

- to continue to have a price control from 1st January 2009, or
- to remove the price control

In March 2008 the National Audit Office (NAO) in Great Britain (GB) issued some guidelines and comments in consideration of the removal of a price control[1] including the following:

[1] National Audit Office report "Protecting consumers? Removing retail price controls" 28 March 2008 http://www.nao.org.uk/publications/nao_reports/07-08/0708342.pdf

- To determine whether a price control can be removed a regulator needs to evaluate the prospect for future effective competition using both qualitative and quantitative data.
- Ofcom, Ofgem and Postcomm need to ensure that in removing further price controls they continue to assess the impact on, and provide the necessary protection for, vulnerable consumers.
- As competition develops further in those sectors where retail price controls have been removed, all three regulators will increasingly rely on their competition powers.

Energywatch raised concerns in February 2008 about the lack of effective competition in the energy sector in GB. Ofgem subsequently launched a “market probe” to investigate certain aspects of the functioning of the energy supply market. Ofgem expects to complete its’ study by the end of September 2008. It was noted that retail price increases in GB have coincided with increases in some firms’ reported profits.

The supply market in Northern Ireland (NI), specifically in the Greater Belfast area, is more highly concentrated than in GB with 100% of customers who consume less than 25,000 therms per annum, known as tariff customers, being supplied by Phoenix Supply Ltd.

Effective competition should in theory keep margins under control, encourage reduced costs and innovation, and improve customer service. In the absence of effective competition a price control can serve as a proxy for effective competition in terms of controlling costs and margins. A carefully constructed price control should ensure that customers are not at risk from inflated margins whilst still allowing new suppliers to enter the market. It is difficult to see how competition powers alone would be enough protection for consumers in the Northern Ireland market.

By controlling costs and determining the allowed margin a price control can reduce the exposure of NI consumers (including vulnerable customers) to the risk of inflated prices resulting from any potential abuse of the market. A price control also affords transparency over PSL’s activities.

The current view of the Utility Regulator is that a supply price control is still necessary in the current gas supply market in the Greater Belfast area.

The previous price control was selective in that larger Industrial and Commercial consumers (I&Cs) with a usage of greater than 25,000 therms per annum, known as contract customers, were not part of the price control. The consultation will examine if this arrangement should be continued and, if so, what the threshold should be.

This consultation will examine the options in relation to the price control. There is a regulatory precedent for incentive regulation with the revenue being subject to RPI-X, and this will be the approach adopted. However, some aspects in the previous price control were retrospectively adjusted and these aspects will form part of this consultation.

Scope of the Price Control

The price control for 2007 and 2008 applies to domestic and I&C consumers with an annual gas consumption of less than 25,000 therms, which represents 56% of gas consumed by volume. The remaining 44% of gas is used by contract customers above the 25,000 therms per annum usage. These contract customers are considered to be operating in a competitive market with competition available both from other fuel sources (primarily oil) and from other gas supply companies. There are three gas supply companies currently competing in the market for contract customers, although PSL has the main share of this section of the market at approximately 95% by volume.

The Utility Regulator will continue to monitor the development of this section of the market and the market as a whole as supply companies compete with the incumbent.

Question 1 – Is there a rationale for increasing the scope of the price control to cover all customers and if not what should the threshold be?

Duration

As mentioned previously a price control is deemed to be unnecessary when there is effective competition in the market. The last gas supply price control in GB ended in April 2002. At this stage the incumbent British Gas Trading (BGT) had a steadily reducing share of the market as other suppliers penetrated the market.

Table 1. BGT's share of domestic gas supply by customers supplied[2]

Date	Market share (%)
September 1998	84
September 1999	75
September 2000	71
September 2001	67

Given that there is currently only one company in the market for tariff customers (those using less than 25,000 therms per annum) in Greater Belfast it is unlikely that there will be effective competition before the end of 2011. The Utility Regulator therefore proposes that the price control should be for a period of three years for 2009, 2010 and 2011.

The Utility Regulator welcomes views on how the market will develop going forward and the proposal to set the price control for a period of three years.

[2] Ofgem November 2001, Review of domestic gas and electricity competition and supply price regulation http://ofgem2.ulcc.ac.uk/temp/ofgem/cache/cmsattach/149_26nov01_pub.pdf?wtfrom=/ofgem/whats-new/archive.jsp

Question 2 – Do respondents agree with the proposal to set the price control for a period of three years? If not how long should the price control run for?

How the Price Control Timetable fits in with the Tariff Timetable

The Price Control period runs from the 1st January to the 31st December. Under Condition 2.4.1 of their licence PSL request the Utility Regulator's consent to a maximum average price per therm which PSL can charge in the tariff. The maximum average price is comprised of gas costs, transmission and distribution tariffs, supply operating expenditure and supply margin. The tariff for 2008 was set on the 1st May however PSL can request a tariff review during the year if gas costs increase sufficiently to cause a 5% uplift in the tariff.

Supply Operating Expenditure

Gas Costs

Wholesale gas costs represent a significant proportion of PSL's costs. All gas costs are passed through to the customer with any over or under recoveries being recovered the following year. Currently PSL produces an annual gas purchasing strategy which it uses to purchase gas. The Utility Regulator has visibility of PSL's gas purchasing policy and monitors PSL's actual gas purchasing. However, there is currently no economic purchasing obligation on PSL under the terms of their licence and the Utility Regulator is not prescriptive about how gas is purchased.

The Utility Regulator would welcome comments on whether or not there should be an economic purchasing obligation and what the benefits would be.

Question 3 – Should there be an economic purchasing obligation on PSL and if so what would the benefits be?

Retrospectively Adjusted Items

Within the 2007 and 2008 price control the Utility regulator determined that there would be a retrospective adjustment for those costs that PSL had no control over. This allows Phoenix to capture any over or under recoveries in the following year. The following costs are passed through to the customer:

- Gas costs
- Apportionment between tariff and contract costs (based on relative volume changes)
- Transmission and Distribution tariff changes
- Licence fee
- Inflation

For the following costs the Utility Regulator has set a unit cost but allows a retrospective adjustment based on a change in the cost driver:

- Transactions Costs – these will be adjusted for the actual number of transactions
- Meter Reading – adjusted for the actual number of meters read
- Bad Debt – adjusted for actual credit revenue

There is a currently a trigger mechanism for gas costs which reduces under-recovery in the tariff in that a tariff review can be initiated in year if wholesale gas costs increase sufficiently to result in a 5% increase in the tariff.

A correction mechanism for volumes is employed such that there is a an incentive for PSL to neither over or under recover as a result of actual volumes differing widely from forecast volumes. This works by applying different interest rates to over/under recovery as follows:

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

The Utility Regulator invites comments on the treatment of these items as retrospectively adjustable in the next price control. Additionally comments are welcomed on the trigger mechanism for gas costs and the correction mechanism for volumes.

Question 4 – Do respondents agree with the items that are retrospectively adjusted and the retrospective mechanism employed?

Treatment of Other Items

A price control should be designed to incentivise PSL to create efficiencies within their business. The methodology employed by Ofgem to generate an efficiency factor during the recent Gas Distribution

Price Control Review (December 2007) produced an efficiency factor of 2.5%. This assumed that the companies were already efficient but should be able to make efficiency improvements over time. An efficiency factor of 2.5% was used for the PSL price control for 2007 and 2008 and it is the intention of the Utility Regulator to apply the efficiency factor of 2.5% in this price control.

Supply operating expenditure items (eg billing, manpower, office costs, IT, professional and legal, etc.), other than those subject to the retrospective mechanism, will be subject to determined allowances and the applied efficiency factor x.

Question 5 – What are the views of respondents on the application of the efficiency factor?

Supply Margin

In GB the last Supply price control was set in 2000 (for the period up to April 2002). After this point Ofgem deemed that there was sufficient competition in the market to remove the need for a price control. In this price control the margin on turnover was set at 1.5%. In the Republic of Ireland the CER (Commission for Energy Regulation) set a gas margin of 1.3% on turnover for the three years prior to 2007/2008 when there was no competition and then increased it to 2% in the context of gas market opening.

The Utility Regulator applies a cash flow methodology in determining the allowable business costs, which permits PSL to earn a margin on turnover, in addition to operating and capital costs being financed on a pay as you go basis.

In the previous price control the Utility Regulator assessed the business risks faced by PSL including capital at risk and working capital, the likely impact of competition and other aspects of the price control such as the pass through of gas costs. The margin was determined to be 1.3% for 2007 and increased to 1.5% in 2008, on the assumption that competitors may enter the market. The Utility Regulator proposes to continue with a margin of 1.5% for the duration of this price control.

Question 6 - What are the benefits for customers in the long run of the proposed margin?

Responding to the Consultation

The Utility Regulator welcomes responses to the specific questions posed in this consultation and any additional comments respondents may wish to make in respect of the proposed price control. Please send comments by 22nd August 2008 to:

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Summary of Questions for the High Level Consultation

Question 1 – Is there a rationale for increasing the scope of the price control to cover all customers and if not what should the threshold be?

Question 2 – Do respondents agree with the proposal to set the price control for a period of three years? If not how long should the price control run for?

Question 3 – Should there be an economic purchasing obligation on PSL and if so what would the benefits be?

Question 4 – Do respondents agree with the items that are retrospectively adjusted and the retrospective mechanism employed?

Question 5 – What are the views of respondents on the application of the efficiency factor?

Question 6 - What are the benefits for customers in the long run of the proposed margin?