Submission to the Competition Commission’s inquiry into the Phoenix Natural Gas Ltd Price Control determination

Date: May 2012
Contact: Richard Williams
Our reference: RW/PNGL12
About the Consumer Council

The Consumer Council is an independent consumer organisation, working to bring about change to benefit Northern Ireland (NI) consumers. Our aim is to make the consumer voice heard and make it count.

We have a statutory remit to promote and safeguard the interests of consumers in NI and we have specific functions in relation to energy, water, transport and food (the Consumer Council and the Food Standards Agency (FSA) have a memorandum of understanding and the Council's strategic focus on food is primarily in relation to food prices and customer experience). These include considering consumer complaints and enquiries, carrying out research and educating and informing consumers.

The Consumer Council is also a designated body for the purposes of supercomplaints, which means that we can refer any consumer affairs goods and services issue to the Office of Fair Trading, where we feel that the market may be harming consumers’ best interests.

In taking forward our broad statutory remit we are informed by and representative of consumers in NI. We work to bring about change to benefit consumers by making their voice heard and making it count. To represent consumers in the best way we can, we listen to them and produce robust evidence to put their priorities at the heart of all we do.

Summary

- The Northern Ireland consumer pays more for their energy than consumers anywhere else in the UK and NI has the highest level of fuel poverty in the UK. The price of natural gas in the Phoenix Natural Gas (PNG) licence area has risen by 87 per cent\(^1\) since October 2003;

\(^1\) See Table 3, page 6.
• In our view, the overarching public interest in the PNG Price Control is the impact that lower gas prices will have on existing gas using NI households, particularly those in fuel poverty and the potential groundswell of demand it could create for new connections to gas;

• Consumers in Northern Ireland will benefit from using natural gas so long as the price is kept as low as possible and they are able to connect to the network;

• The outcome of the PNG Price Control represents 25 per cent of the overall price of natural gas to consumers in the Greater Belfast and Larne areas;

• Consumers were not consulted in 2006/07 on the issues of outperformance and deferred capex which has resulted in them being expected to pay an estimated £240m over 40 years;

• The Regulatory principles employed by the Regulator in relation to outperformance and deferred capex are sound;

• The Rate of Return PNG is allowed is too high when assessed against GB comparables and does not reflect the risk the company faces going forward;

• The allowances on Marketing, Network Maintenance and IT are more than is required to run the business and the consumer is losing out;

• It is not clear whether there are any defined service standard outputs in the Price Control;

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2 Phoenix Natural Gas Limited Price Control review 2012-2013. An introduction to the Reference to the Competition Commission, March 2012, paragraph 1.15. (Utility Regulator
The argument that the Price Control determination threatens the financing of future NI utility infrastructure projects is not supported by evidence but would benefit from further investigation by the Competition Commission.

The Consumer Council’s role in regulated price controls

Under the terms of the Energy (Northern Ireland) Order 2003 the Consumer Council may ‘represent the views of consumers on such matters, to public authorities… and other persons whose activities may affect the interests of consumers’.

The Northern Ireland consumer environment

It is important to understand the context for NI consumers against which this review of the Utility Regulators (the Regulator) decision on the determination of the PNG Price Control is taking place. Northern Ireland consumers, along with those living in other areas of the UK have seen their overall spending power diminished in recent years. A recent report from the Joseph Rowntree Foundation\(^3\) has examined the impact of the economic downturn on households in Northern Ireland since 2009.

The report found that 22% of people in Northern Ireland were living in poverty and that the number of retired households living in poverty had increased from 55,000 to 70,000. It also confirmed a higher percentage (21%) of pensioners live in poverty in Northern Ireland compared to their counterparts in the rest of the UK where the figure is 16%.

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\(^3\) Monitoring poverty and social exclusion in Northern Ireland 2012, Joseph Rowntree Foundation
The Consumer Council’s own research\(^4\) shows that half of the adult population here is worried about making ends meet and over half are worried about making ends meet in the future. Furthermore, only half are managing to keep up with bills and credit without difficulties and more than one in four stated that they are worried that they, or someone in their household, will lose their job within the next year.

The Consumer Council acknowledges that reliance on home heating oil, as a key energy source for NI homes, is a major contributor to high energy bills. Nonetheless, the cost of energy in Northern Ireland is a crucial issue as consumers already face the highest energy bills in the UK, (see Table 1).

**Table 1 Heating Fuel Bills NI and GB**

<table>
<thead>
<tr>
<th></th>
<th>Average bill 2001</th>
<th>Average bill 2011</th>
<th>% increase 2001 - 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Ireland</td>
<td>£768.55</td>
<td>£2,368.71</td>
<td>208%</td>
</tr>
<tr>
<td>Great Britain</td>
<td>£541.33</td>
<td>£1,258.09</td>
<td>132%</td>
</tr>
<tr>
<td>Difference</td>
<td>£227.22</td>
<td>£1,110.62</td>
<td>389%</td>
</tr>
</tbody>
</table>

*Source: DECC, CCNI, Sutherland tables, Consumer Focus, Power NI, Phoenix Supply Limited, firmus energy*

The increasing cost of energy is affecting nearly everyone in our society. Around 302,000 households in Northern Ireland are struggling to heat their homes to an adequate level and NI’s level of fuel poverty is by far the worst in any part of Great Britain and Ireland, (see Table 2).

**Table 2 - Proportion of households in fuel poverty 2009**

<table>
<thead>
<tr>
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<th>2009</th>
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<tbody>
<tr>
<td>England</td>
<td>13%</td>
</tr>
<tr>
<td>Wales</td>
<td>26%</td>
</tr>
<tr>
<td>Scotland</td>
<td>33%</td>
</tr>
<tr>
<td>Republic of Ireland</td>
<td>19%</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>44%</td>
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*Source: DECC, NI House Condition Survey 2009, RoI Energy Statistics*

Set against a context of increasing energy prices the Competition Commission's consideration of the PNG Price Control determination can be seen as extremely important to Greater Belfast and Larne natural gas customers. Its outcome dictates a quarter of the overall price they will pay for using gas for the duration of the Price Control. Furthermore, the Price Control has the potential to influence the reliability and safety of the network, customer service standards and future investment to improve the network.

The price of natural gas in Greater Belfast and Larne

PNG distributes gas to around 136,000 homes and businesses in the Greater Belfast and Larne areas. According to a recent report by Lord Whitty, the former UK Government Minister with responsibility for energy efficiency and fuel poverty, natural gas ought to provide NI households and businesses with a fuel that is cheaper, cleaner, more fuel efficient, safer and less carbon intensive than the heating oil alternative. As a heating fuel it is also cheaper than electricity.

Natural Gas has the potential to, alongside energy efficiency measures, help tackle NI’s fuel poverty problem. Yet gas is a minority fuel in NI. In GB around 95 per cent of properties are connected to the gas network; in NI the figure is still only about 15 per cent.

When natural gas was first introduced into Belfast in 1996, gas customers were promised an efficient and clean fuel that would reduce their energy costs for years to come. Whilst Phoenix froze its’ prices until 2000 and promised below inflation price rises up to 2003, from that time on the price of natural gas has risen considerably. The cumulative increase in the price of Phoenix natural gas between October 2003 and April 2012 is 87 per cent.

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5 Utility Regulator, Energy Retail report 2011
Table 3 Phoenix tariff changes since 2003

<table>
<thead>
<tr>
<th>Phoenix tariff changes (PNG and PSL after Jan 2007) (%)</th>
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<tr>
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<tr>
<td>11</td>
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</tbody>
</table>

All natural gas customers in the Greater Belfast and Larne areas pay a conveyance charge within the overall tariff that represents around 25 per cent of the tariff. It is self evident that the higher that charge the greater the impact will be on consumers bills.

In order to increase the take up of natural gas in the Greater Belfast and Larne areas and to give the maximum benefit to those consumers who have made the upfront investment in a new heating system (estimated at £3000) the cost of gas must be as low as possible. To achieve this every single element of the price of gas to the end user must be scrutinised in detail by the Regulator and all unjustifiable costs removed.

In our view, the overarching public interest in the PNG Price Control is the impact that lower gas prices will have on existing gas using NI households, particularly those in fuel poverty and the potential groundswell of demand it could create for new connections to gas.

**The Consumer Council role so far in the current Price Control Determination**


In our response we commented on a number of points made in the draft proposals and raised some new issues. We wish to reiterate these points as they relate to the Terms of Reference for this referral which requires the
Commission to investigate whether the Price Control Determination operates against the public interest and if so whether and how this could be remedied.

1. Advertising, Marketing and PR

In our consultation response we stated that:

‘We recognise the introduction of a results based allowance that provides an incentive for PNG to make new connections as an improvement on the previous system.

However, the gas market is sufficiently mature that we question why it is necessary for the consumer to pay for the advertising etc that will enable PNG to grow both its business and asset base. We believe that with a Rate of Return of 7.5 per cent, PNG is a profitable business and therefore can finance its own advertising, marketing and PR. In Great Britain, Ofgem does not allow network companies to charge customers for advertising, marketing and PR.

The cost of natural gas is considerably less than home heating oil and therefore it can play a significant role in helping to reduce the levels of fuel poverty here. It is the view of the Consumer Council that any incentives should be aimed at encouraging those households who use home heating oil and are in fuel poverty in the PNG licence area to connect to gas.’

We recognise that when PNG first entered the Northern Ireland market it was required to set up a gas network and customer base from a zero base. The original regulatory model reflected this in allowances provided to PNG for marketing. However, the network in Greater Belfast and Larne, whilst far from satisfactory, (see our comments on infill) has been established.

The Licence Modifications of 2007 created an Opening Asset Value (OAV). Aside from dealing with the financial instability that PNG was experiencing,
this began the move to regulating PNG in a manner more akin to the methodology applied to network utilities that already have an established asset base. In our view this shows that the natural gas industry in Greater Belfast and Larne is a mature business and should be treated by the Regulator as such. In this respect we note the comments of the Utility Regulator that, ‘PNG now looks like a mature gas network business like you would see in GB’. As we have stated, Ofgem provides no allowances to GB gas network companies for marketing.

Question

The Consumer Council would ask the Competition Commission to review the Utility Regulator’s decision to provide allowances to PNG against advertising, marketing and PR.

2. Network Maintenance

In our consultation response we stated that:

‘We are concerned that PNG currently do not operate an Asset Risk Register and that they are asking for an allowance to do so in the future. The consultation states that having a system such as PAS55 is best industry practice and in Great Britain customers are not expected to pay for such a system. The fact that PNG are asking for an allowance to introduce a system that could have saved the consumer money throughout the period of the previous two price controls is unsatisfactory.

The PAS55 would also provide a benefit to PNG, and we would strongly encourage the company to adopt it. However, consumers should not be paying the cost of it.

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7 Shane Lynch, (Utility Regulator) giving evidence to the Enterprise, Trade and Investment Committee, 6 May 2012
The consultation implies that the ten per cent reduction being applied to the PNG submission is a warning and does not represent the total savings that could have been made had an Asset Risk Register been in place. It appears that the consumer has lost out, and will continue to do so, throughout the period of this Price Control because of PNG’s unwillingness to adopt PAS55. We would therefore expect the Utility Regulator to enforce PAS55, or ensure that the reduction in the current proposed allowance reflects as accurately as possible the ongoing loss to the consumer. The wasted costs should not be picked up by the consumer.

We would wish to add that the Ofgem approach to asset replacement is that:

‘we [Ofgem] do not advocate age based replacement in practice – companies are incentivised to out-perform (and model includes replacement based on forecast time to replace not nominal design lives)”8.

PNG was advised in the previous Price Control to adopt an Asset Risk Register. In ignoring this PNG appears to eschew best practice in asset management, and the NI consumer should not be paying the cost of this.

Question

The Consumer Council would ask the Competition Commission to consider if and how the Regulator could assess the cost to the consumer of PNG’s failure to implement PAS55, and how this could be returned to the consumer.

3. Information Technology

In our consultation response we stated that:

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8Presentation by Martin Crouch, Director Electricity Distribution, Ofgem, March 2006.
'It is normal regulatory practice that when efficiencies are achieved within a price control period, the benefit is captured for the consumer and applied as the starting point for the following price control.

The Regulator has not done this in relation to IT. By granting the full request from PNG, the IT costs have increased from the last two outturn figures to the proposed allowance, by 60 per cent. The increase is part explained by the possible costs of the Common Arrangements for Gas (CAG) project, but the costs of CAG are currently unknown. The costs of CAG should only be applied when they are known and agreed, as otherwise the consumer is paying for costs that may never appear. Once the costs are known they should be recovered in instalments throughout the period of this and future price controls.'

We note that the approach advocated by the Consumer Council is being applied by the Regulator in relation to renewable energy projects in the current NIE Price Control (RP5).9

Question

The Consumer Council would ask the Competition Commission to consider whether by granting PNG its full IT request on a continuing basis, the Utility Regulator has borne down on costs as much as possible.

4. Infill of current network

In our consultation response we stated that:

9 http://www.uregni.gov.uk/news/regulator_launches_consultation_on_nie_td_price_control_proposals
‘With rising fuel poverty levels, and an increasing cost difference between home heating oil and gas, the Consumer Council believes that more needs to be done to maximise the take up of gas within the PNG licence area. We believe that the Utility Regulator should require PNG to strategically plan how it will infill the areas and streets within its licence area, within the period of this and the next Price Control. PNG should also be obliged to commit to telling a customer when they will be able to connect them. This may require a licence modification.

Incentives for infill should be targeted at those households in fuel poverty and not by tenure.’

Question

The Consumer Council would ask the Competition Commission to consider whether the NI public would benefit from measures being placed within the PNG Price Control that would require PNG to strategically plan the infill of its existing network.

5. Standards of Service

In our consultation response we stated that:

‘The Consumer Council recently responded to the Regulator’s consultation on Guaranteed Standards of Service (GSS) in Gas. We recommended that consumer facing issues such as customer service standards and timescales on connections should be subject to penalties and incentives within the price control. GSS are an effective method of acknowledging and addressing individual consumer complaints within the scope of the wider price control mechanism.’

The Consumer Council is concerned that the Utility Regulator’s determination contains no reference to service standards. In December
2007, Ofgem dedicated 14 pages to discussion of its Service Standard requirements\textsuperscript{10}. Meanwhile Energywatch, in its response to Ofgem’s original 2007 Gas Distribution Price Control proposals, discussed in detail the need for service standards\textsuperscript{11}.

Consumer Council research shows that in 2011, 53 per cent of natural gas customers surveyed were dissatisfied with the way that their complaint both before and after installation was dealt with\textsuperscript{12}. Using evidence we have gathered through surveys and consumer panels undertaken in 2011, the Consumer Council will be making a series of recommendations to the natural gas industry on how it can improve the experience of gas users in NI.

**Question**

**The Consumer Council would ask the Competition Commission to consider whether the public interest would be served by the PNG Price Control being more explicit in linking customer service standards with outputs in the Price Control.**

6. **Rate of Return**

In our consultation response the Consumer Council stated:

‘According to the Regulator’s analysis PNG has been significantly de-risked and the company requires no further growth to recover its investment by 2046. We believe that the Regulator should therefore

\textsuperscript{10} Gas Distribution Price Control Review Final Proposals- Ofgem. December 2007
\textsuperscript{11}http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=249&refer=Networks/GasDist r/GDPCR7-13
\textsuperscript{12} Customers Experience of natural Gas in Northern Ireland. Consumer Council, due to be published in May 2012.
examine the Rate of Return it allows PNG and consider it against the rate Ofgem allows of 5.86 per cent\textsuperscript{13}.

The Rate of Return a regulated company is allowed within the Price Control has a direct correlation with the price that it charges its customers. The higher the allowance, the higher the price to customers. It is therefore important that the Rate of Return applied by the Regulator is not inflated as this will result in the consumer paying more than is necessary.

The company will benefit when its actual cost of capital is lower than its allowed Regulatory Rate of Return. The higher the Regulatory Rate of Return the more it will benefit at the expense of the consumer.

The Regulator has stated that PNG is rewarded with the highest Rate of Return of any comparable regulated utility in the UK\textsuperscript{14}. PNG has a Regulatory Rate of Return of 7.5 per cent against that of GB Gas Distribution companies of 5.8 per cent. The cost this allowed Rate of Return generates when applied to the Total Regulatory Value (TRV) is one that must be paid by consumers. As we already outlined, these are the same NI consumers who currently have the highest energy costs in the UK and are more likely to be in fuel poverty.

Meanwhile PNG’s actual cost of capital is 5.5% fixed\textsuperscript{15}. The difference between this and the 7.5 per cent (plus inflation) Regulatory Rate of Return represents pre tax profit to PNG.

The Consumer Council would prefer to see PNG have a Regulated Rate of Return that reflects its actual cost of capital and that PNG earn its profit through a scheme of efficiency and service output incentives that also benefit consumers. However, even in the absence of such incentives, the Consumer Council believes that the PNG’s Regulatory Rate of Return is

\textsuperscript{13} Ofgem- Gas Distribution Price Control Review Final Proposals. 3 December 2007
\textsuperscript{14} Table 23- Phoenix Natural Gas limited Price Control Review 2012-13, Final Decisions
\textsuperscript{15} Issue of £275m of Bonds due 2017 at rate of 5.5% by Phoenix Natural Gas Finance plc. Kellen Group annual Reports and Accounts
excessive. It is higher than GB comparables and over estimates the business risk that PNG faces going forward. It is the Consumer Council’s view that the Rate of Return should be reviewed and reduced.

Looking forward to potential network extension and development, we would prefer to see a cost reflective Regulatory Rate of Return, combined with efficiency and service output incentives model, adopted.

**Question**

*The Consumer Council would ask the Competition Commission to review PNG’s Regulatory Rate of Return allowance in the Price Control.*

**7. Total Regulatory Value**

The Total Regulatory Value (TRV) is an important building block of the Price Control determination and impacts directly on the cost of gas for consumers. As with the Regulatory Rate of Return, the greater the TRV the greater the level of charges the company will be able to pass onto the consumers. It is therefore important that the TRV is calculated as accurately as possible. The company will want to ensure that it is receiving the correct level of return on assets and consumers want assurance that they are not paying for an asset that is inflated or does not exist.

The calculation of the TRV is at the centre of the referral of the Price Control determination to the Competition Commission. At the heart of the argument are the discussions in 2006 between the Regulator and PNG and the final modifications made to the PNG licence in 2007.

We understand that both the Regulator and PNG are putting forward arguments for consideration by the Competition Commission. In considering those arguments we believe that the Competition Commission
should consider the following points that we regard as key regulatory principles:

1. The consumer (public) interest is paramount;
2. Where there is uncertainty, principle 1 applies;
3. Balance of risk should not lie with the consumer;
4. Established regulatory principles should apply where there is a lack of clarity; and
5. All and any loss to consumers should be returned to them in full.

8. Outperformance

The Consumer Council appreciates that this is a complex issue and that the Competition Commission will consider detailed legal argument from both the Regulator and PNG.

However, we would ask the Competition Commission to keep in mind the consumers’ position in this aspect of the Price Control Determination, both in its outcome and the expectation they had from the 2007 Licence Modifications.

The Consumer Council, as the consumer representative, understood the situation in 2006/07 to be as follows:

- The PNG business model was not working as effectively as PNG envisaged and therefore PNG was considering large increases to its distribution charge to manage this. The Consumer Council has received briefings from the Regulator on this situation since 2004, when it was suggested by the Regulator that a 30 per cent increase could be added to the 14 per cent increase already made in April 2004.
Furthermore in its document ‘Draft Licence Modifications to implement Agreement April 2007’, the Regulator states, ‘if Phoenix was to achieve the original rate of return of 8.5 per cent (pre-real tax) it would have to increase the distribution charge substantially above current levels’;

In November 2006 the Consumer Council issued a press release welcoming the prospect of a ‘settlement’ between the Regulator and PNG. However, the Consumer Council’s comments were cautious as there was limited detail on the discussions which had taken place, (attached as appendix 2);

In June 2007, the Consumer Council responded to the Regulator’s consultation on the ‘Draft Licence Modifications to implement Agreement April 2007’, (attached as appendix 3). In our response we asked a number of questions for clarification; notably how the stated amount of £25m of benefit to consumers was arrived at and over what period it would accrue.

There was a lack of clarity about the outcome of the Licence Modifications discussions and unfortunately this remains the case today. The clear expectation that the Consumer Council had in 2007 is that Licence Modifications then being proposed would provide price stability for consumers and would save consumers £25m.

In June 2007, the Consumer Council was not made aware that the Licence Modifications that were under discussion would mean consumers paying an extra £240m over a 40 year period\(^\text{16}\) that would be to the benefit of PNG, for assets that do not exist.

Where a natural monopoly exists, it is the role of the Regulator to act as a proxy for competition. We believe that in a competitive environment the need to keep the cost to the customer as low as possible would have driven the

\(^\text{16}\) Phoenix Natural Gas Limited Price Control review 2012-2013. An introduction to the Reference to the Competition Commission, March 2012, paragraph 1.15. (Utility Regulator)
value of these nonexistent assets out of the TRV and PNG would not have been able to retain the value over the 40 year period now envisaged.

- In retrospect it appears the Regulators office agreed to Licence Modifications that provided a long term benefit to PNG, to the detriment of consumers.

- It is in the interests of consumers that this inequitable situation is rectified.

- The lack of information and clarity within the Licence Modifications and accompanying consultation would suggest a weakness in the Regulatory process at that time. Consequently, the consumer was not consulted over the matter of paying £240m over 40 years.

The Consumer Council understands that the Competition Commission will want to examine in detail the documentation produced at the time of the Licence Modifications in 2006/07. We would urge that if the documentation available does not give a clear view of the party’s intentions, then established and comparable regulatory practice should be followed. It is a sound and consistent regulatory principle that efficiency savings should be shared between the company and the consumer.

If it is established that the NI consumer has ‘lost out’ through the application of the 2007 Licence Modifications, then this loss should be quantified and returned to consumers in full. This should not be achieved by only looking forward from the present, as the adjustment to the TRV proposes. If necessary consumers should receive back any overpayments they have made to PNG.
9. Deferred Capex

We support the Regulator’s approach on this matter and believe that it is in the consumer’s interest. It is an established principle that consumers should not pay for something that does not exist and from which they derive no benefit.

10. The financeability of PNG

Whilst we support the Regulator’s Price Control Determination where it delivers identifiable benefits to consumers, we also recognise that it is in the consumer’s interests that PNG is financially robust and able to finance its current business and future development.

We believe that PNG is financially robust and able to finance its current and future business. We base this view on the following:

1. The detailed analysis of the financeability of PNG contained in the Regulator’s, ‘Phoenix Natural gas limited Price Control Review 2012-2013, Final Decisions’ paper¹⁷;
2. The allowed Rate of Return is above the industry standard and provides sufficient profit within the company to ensure that the Regulator’s proposals present no threat to PNG’s ability to raise finance in the future;
3. The Fitch ratings release of 2 May 2012¹⁸, which comments positively on the gearing and cash flow of PNG based on the Final Price Control decision of the Regulator.

¹⁷ January 2012
¹⁸ Fitch Ratings 02 May 2012
The Consumer Council would ask the Competition Commission on behalf of consumers to consider if the Regulator’s Price Determination undermines the financeability of PNG.

11. Strategic Issues

In September 2010 the Department of Enterprise, Trade and Investment published its ‘Strategic Energy Framework for Northern Ireland’. It contained plans for a number of major energy infrastructure projects within NI. These include:

- Extending the gas network;
- Gas storage;
- Reinforcing the electricity network to enable the increased use of renewable energy;
- Renewable Heat; and
- The Tyrone to Cavan Interconnector.

On 12 October 2011 Fitch Ratings issued a Press Release that put PNG on Ratings Watch Negative and stated ‘that the retrospective clawing back of value for the benefit of consumers is inconsistent with PNG’s existing licence dated 26 June 2009 and represents a unexpected change in Ureg’s communicated regulatory approach, The Regulator’s move to propose a retrospective TRV adjustment relating to outperformance dating from the years 1996-2006 is not considered by the agency to be good regulatory practice’.

PNG has raised the prospect of the Regulator’s proposals on adjusting the TRV as representing a threat to future utility infrastructure investment in NI\textsuperscript{19}.

\textsuperscript{19}‘Gas levy plans could hit business in long term’, The Newsletter, 30 March 2012.
If this is a fact then it will be a concern to consumers, although we do note that the Fitch release in October 2011 was commenting only on the NI natural gas industry.

Fitch Ratings issued a further Press Release on 2 May 2012, which removed PNG from Ratings Watch Negative.

In the absence of clear evidence, the Consumer Council is not in a position to assess the risk for consumers and we would ask that the Competition Commission considers this matter in detail.

If it is possible to do so, consumers in NI would benefit from firm assurance that the decisions made within the PNG Price Control will not raise the level of risk to all regulated utilities in NI to a level that on balance creates extra costs for them.

**Question**

The Consumer Council would like to suggest that the following issues are considered by the Competition Commission:

1. To what extent (if any) is the Regulator’s decision on outperformance creating regulatory uncertainty;
2. To what extent will this Regulatory uncertainty, (if any exists) impact on the confidence of investors in Northern Ireland;
3. What impact, if any will this have on future investment in regulated utility infrastructure in NI?
21 October 2011

Dear Carl,


Introduction

The Consumer Council welcomes the opportunity to respond to this consultation.

The Consumer Council is an independent consumer organisation set up in legislation to safeguard the interests of Northern Ireland consumers, particularly the vulnerable and disadvantaged. We work to promote and protect consumer interest and bring about change to benefit consumers. Our aim is to make the consumer voice heard and make it count.

We represent consumers in the areas of transport, water and energy. We also have responsibility to educate consumers on their rights and responsibilities and to equip them with the skills they need to make good decisions about their money and manage it wisely.

Overview

With rising energy prices and growing levels of fuel poverty in Northern Ireland, it is essential that energy policy and regulation work to give consumers the best possible price.

Natural gas has an important role to play within Northern Ireland’s energy infrastructure. Recent research from the Consumer Council has shown that it can play a role in reducing fuel poverty as its cost is
considerably less than home heating oil. Our research shows that currently a natural gas customer in Northern Ireland will pay £925 per year less for their household energy bill compared to a household that uses home heating oil\textsuperscript{20}.

This Price Control is important, as it is an opportunity to review costs and look at means of further developing the uptake of gas within the PNG licence area.

We welcome the proposals that the Regulator has made and recognise that these could provide a real benefit to the consumer. However, we are concerned about the ratings release of 12 October from Fitch Ratings which states that some aspects of this consultation are ‘not considered to be good regulatory practice’. We would ask the Regulator to provide the Consumer Council with further reassurance that these comments will not raise the level of risk to all regulated utilities in Northern Ireland to a level that creates extra costs for consumers here.

**Regulatory Model**

**Cost of Capital**

According to the Regulators analysis PNG has been significantly de-risked\textsuperscript{2} and the company requires no further growth to recover its investment by 2046. We believe that the Regulator should therefore examine the Rate of Return it allows PNG and consider it against the rate Ofgem allows of 5.86 per cent\textsuperscript{21}.

**Deferred Capex**

The Consumer Council support the Regulator on its approach to dealing with deferred capex. This approach is in the consumers’ interest and is based on a sound principle that consumers should only pay for assets for which they receive a tangible benefit.

\begin{table}[h]
\begin{tabular}{|l|c|c|c|}
\hline
Heating source & Heating cost & Electricity (3,300kWh pa) & Total Fuel Bill \\
\hline
Gas (Ave consumption 12,232kWh) & £601.21 & £588.00 & £1,189.21 \\
\hline
Oil (Ave 500L x 5.25) & £1,526.37 & £588.00 & £2,114.37 \\
\hline
Difference & £925.16 & - & £925.16 \\
\hline
\end{tabular}
\end{table}

Source: Power NI, Phoenix Natural Gas, firmus energy, Sutherland tables and Consumer Council

Note: Gas heating cost based on average between suppliers in Greater Belfast and Larne

\textsuperscript{20} Ofgem- Gas Distribution Price Control Review Final Proposals. 3 December 2007
**Outperformance**

We believe that the approach of the Regulator on outperformance is in the consumers’ interests, as it provides a cost saving on bills to all consumers. It is also a sound and consistent regulatory principle that efficiency savings should be shared between the company and the consumer.

We are aware of the rating warning given by the credit agency, Fitch Ratings, which will remove one notch from the PNG credit rating. However, we consider that the benefit that PNG has received from the ‘outperformance’ sum has been earned on a Rate of Return that is above the industry standard. Furthermore, we believe that a review of the current PNG Rate of Return is necessary as there is sufficient profit within the company to ensure that there will be no threat to PNG’s ability to raise finance in the future.

We also note the further comment of Fitch that the Regulators proposal is ‘not considered by the agency to be good regulatory practice’. Such a view could arguably impact on the financing of regulated utilities in Northern Ireland. We would ask the Regulator to provide consumers with an assurance that its proposals will not compromise its purpose to protect the short and long term interests of consumers.

**Opex**

*Advertising, Marketing and PR*

We recognise the introduction of a results based allowance that provides an incentive for PNG to make new connections as an improvement on the previous system.

However, the gas market is sufficiently mature that we question why it is necessary for the consumer to pay for the advertising etc that will enable PNG to grow both its business and asset base. We believe that with a Rate of Return of 7.5 per cent, PNG is a profitable business and therefore can finance its own advertising, marketing and PR. In Great Britain, Ofgem does not allow network companies to charge customers for advertising, marketing and PR.

The cost of natural gas is considerably less than home heating oil and therefore it can play a significant role in helping to reduce the levels of fuel poverty here. It is the view of the Consumer Council that any incentives should be aimed at encouraging those households who use home heating oil and are in fuel poverty in the PNG licence area.
Network Maintenance

We are concerned that PNG currently do not operate an Asset Risk Register and that they are asking for an allowance to do so in the future. The consultation states that having a system such as PAS55 is best industry practice and in Great Britain customers are not expected to pay for such a system. The fact that PNG are asking for an allowance to introduce a system that could have saved the consumer money throughout the period of the previous two price controls is unsatisfactory.

The PAS55 would also provide a benefit to PNG, and we would strongly encourage the company to adopt it. However, consumers should not be paying the cost of it.

The consultation implies that the ten per cent reduction being applied to the PNG submission is a warning and does not represent the total savings that could have been made had an Asset Risk Register been in place. It appears that the consumer has lost out, and will continue to do so, throughout the period of this Price Control because of PNG’s unwillingness to adopt PAS55. We would therefore expect the Utility Regulator to enforce PAS55, or ensure that the reduction in the current proposed allowance reflects as accurately as possible the ongoing loss to the consumer. The wasted costs should not be picked up by the consumer.

Entertainment

At a time when increasing numbers of consumers are struggling to pay their energy bills, the Consumer Council believes that it is inappropriate for consumers to be paying for entertainment such as seasonal events for PNG staff.

Entertainment is not the same as staff training and development which helps staff to individually and collectively run the business more efficiently.

IT

It is normal regulatory practice that when efficiencies are achieved within a price control period, the benefit is captured for the consumer and applied as the starting point for the following price control.

The Regulator has not done this in relation to IT. By granting the full request from PNG, the IT costs have increased from the last two outturn figures to the proposed allowance, by 60 per cent. The increase is part explained by the possible costs of CAG, but the costs of CAG are currently unknown. The costs of CAG should only be applied when they are known and agreed, as otherwise the consumer
is paying for costs that may never appear. Once the costs are known they should be recovered in instalments throughout the period of this and future price controls.

\textit{Infill}

With rising fuel poverty levels, and an increasing cost difference between home heating oil and gas, the Consumer Council believes that more needs to be done to maximise the take up of gas within the PNG licence area. We believe that the Utility Regulator should require PNG to strategically plan how it will infill the areas and streets within its licence area, within the period of this and the next Price Control. PNG should also be obliged to commit to telling a customer when they will be able to connect them. This may require a licence modification.

Incentives for infill should be targeted at those households in fuel poverty and not by tenure.

\textbf{Other issues}

\textit{Acting in the consumers’ interests}

The PC12 Price Control proposals give significant and welcome cost savings to consumers.

The current average domestic energy bill in Northern Ireland for customers using natural gas is £1189\textsuperscript{22}. The saving to customers of £25 per year that the Regulators proposals on returning the ‘outperformance’ will provide, represents two per cent of that bill. As energy prices continue to increase this percentage figure will decrease.

Whilst this saving on the bill is very welcome, we believe that the Utility Regulator should also consider if this money can be used to increase the use and accessibility of the gas network in the PNG licence area to reduce fuel poverty. It could do this by enabling and encouraging fuel poor households to move from the more expensive home heating oil to natural gas. For example the money could be used:

- As an incentive to help fuel poor households to convert to gas;
- To extend the network within the Phoenix Licence area to allow more homes to connect;
- To subsidise energy efficiency measures for fuel poor households.

The Consumer Council would be keen to discuss with the Utility Regulator how this could be taken forward.

\textsuperscript{22} Power NI and a weighted average of Phoenix Natural Gas and firmus energy customers.
Guaranteed Standards of Service

The Consumer Council recently responded to the Regulator’s consultation on Guaranteed Standards of Service (GSS) in Gas. We recommended that consumer facing issues such as customer service standards and timescales on connections should be subject to penalties’ and incentives within the price control. GSS are an effective method of acknowledging and addressing individual consumer complaints within the scope of the wider price control mechanism. We are disappointed that this has not been addressed and we ask for the Utility Regulator to implement them within this price control.

If you wish to discuss the attached in more detail, please do not hesitate to contact Richard Williams on 028 9067 4895 or by emailing rwilliams@consumercouncil.org.uk.

Yours sincerely

Richard Williams
Senior Consumer Affairs Officer
Appendix 2

Agreement On Gas Is Vital For Consumers

Tuesday 28 November 2006

Welcoming the prospect of a settlement of this longstanding dispute, Wesley Henderson, Director of Energy at the Consumer Council said:

"Agreement is vital in order to provide stability for consumers and to allow the process of market opening and competition to develop. We are pleased that this deal appears to deliver on some of the issues we considered to be important and we will want to discuss it in further detail with the Regulator. We also welcome the commitment to consultation before the new licence is put in place.

"If this new deal incorporates the necessary consumer protection and benefits it will help ensure a positive and stable outcome for both Northern Ireland gas customers and the gas industry itself."

Consumer Council media contact: Susie Brown, telephone, 028 9067 4807 or e-mail, sbrown@consumercouncil.org.uk.

The Consumer Council is an independent consumer organisation, working to bring about change to benefit Northern Ireland's consumers. The Council campaigns for high standards of service and protection and a fair deal for all. It also carries out research, gives advice and publishes reports and other publications. It deals with individual complaints about electricity, natural gas, coal and passenger transpor

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Appendix 3

*Draft Licence Modifications to implement Agreement April 07* Page 29 of 30 Consumer
Council Response
Mr Mike Lowry
NIAUR
Queens House
10-14 Queen Street
BELFAST
BT1 6ER
7 June 2007
Dear Mike

Re: Consultation on Proposed Phoenix Natural Gas Licence Restructuring; Proposed Price Control Licence Modifications

The Consumer Council welcomes the opportunity to respond to the above consultation.

In November we issued a press statement welcoming the agreement on a new regulatory structure for the distribution and transmission networks. We believed it vital in order to provide stability for consumers and to allow the process of market opening and competition to develop. However we consider that there is insufficient detail provided in this consultation on a few key areas. These changes will have far-reaching implications for consumers and we need therefore to have a fully informed understanding of the implications for consumers. As such we are unable to give our full support for the proposals until we receive the following specific information:

- Can further information be provided on how the OAV of £316 m was arrived at?

We welcome the fact that consumers will benefit from the agreement to the tune of £25 million. Can further information be provided on the basis of the £25 million benefit to consumers and over what period it will accrue and in what form?

Given the increases that Phoenix Natural Gas have put up costs by over the last 3 years, a cumulative total of 83%, we consider that consumers need stability to renew their confidence in the Greater Belfast gas market. The decrease of 14.6% announced in March this year will certainly go some way towards achieving that however we would be keen to
understand to what extent the proposals as outlined in the consultation document will contribute towards price stability (excluding gas costs)?

With these proposals how significant is the risk of an increase in prices around 2016 if the £100 million current underspend has not been recovered by then? Are there any other implications for consumers if this is the case?

In answer to your questions we have the following comments to make:

1. How Capex in excess of agreed forecasts is dealt with

The Consumer Council considers that any Capex overspend should be scrutinised in their totality in terms of the justification for the overspend, specifically the benefits to consumers of the overspend and whether any relevant efficiency targets have been met. Capex overspends should not be automatically passed through to consumers and potentially be disallowed if the criteria outlined above have not been met. If this is not the case there is no incentive for the company to keep costs as low as possible and operate their business in the most efficient way they can.

2. How Working Capital should be dealt with

Working capital should be treated in such a way as to ensure that Phoenix is incentivised to manage and more importantly prevent customer debt. In addition it should force suppliers to provide a robust billing capability that delivers better cash flow control and a stronger overall commercial operation. A better approach to billing means a shorter time to recover revenue. It also means better customer service, a satisfied customer and one who is less likely to switch supplier. In dealing with working capital we consider the Regulator should put in place a mechanism to pass through some of the benefits to consumers whilst incentivising the company to manage its revenue flow, billing and debt effectively.

Yours sincerely

JOANNE GAMBLE
Head of Energy
Making the consumer voice heard and making it count

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