Gas Retail Supply Price Controls 2023 (SPC23)

UR Information Note

25 November 2021

About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs, Markets and Networks. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our mission

To protect the short- and long-term interests of consumers of electricity, gas and water.

Our vision

To ensure value and sustainability in energy and water.

Our values

- Be a best practice regulator: transparent, consistent, proportionate, accountable and targeted.
- Be professional – listening, explaining and acting with integrity.
- Be a collaborative, co-operative and learning team.
- Be motivated and empowered to make a difference.

Abstract

This information paper sets out the Utility Regulator's (UR) approach to the supply price controls for both price regulated gas companies. The next price controls for the gas supply companies, firmus energy (supply) Ltd (FES) and SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) are due to begin 1 January 2023 and 1 April 2023 respectively.

This is the first of a series of documents which the UR will publish relating to the price controls under this SPC23 project. This paper outlines the UR's proposed approach in relation to examining the main areas within the controls: structure and form; scope and coverage of regulated tariffs; duration of control; operating costs levels and allocations; and allowed margin.

Audience

Consumers and consumer groups; industry; and statutory bodies.

Consumer impact

This paper sets out the UR's intended approach for the gas supply price controls from 2023 onwards. The price controls establish the permitted costs and profit margin for each regulated company for the duration of the control period. Subsequent regulated tariffs will have to operate within these limits.

The price control decisions will therefore impact on the bills of price regulated customers

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1. CONTEXT

Background

1.1 In relation to gas the principal objective of the UR is "to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland" whilst having regard to "the need to ensure a high level of protection of the interests of consumers of gas".

1.2 In Northern Ireland (NI) there are three distinct distribution network areas for natural gas. These are the 'Greater Belfast area', the 'Ten Towns' area and the 'West'. The Greater Belfast area is served by Phoenix Natural Gas Ltd, the Ten Towns area is served by Firmus Energy (Distribution) Ltd and the West is served by SGN Natural Gas Ltd.

1.3 There are two price regulated gas supply companies in NI:

- SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) in the gas supply sector in 'Greater Belfast' and the 'West'; and
- firmus energy (supply) Ltd (FES) in the gas supply sector in the 'Ten Towns area'.

1.4 The Greater Belfast market has been open to competition since 2007, and at present there are approximately 235,000 customers in the market[1]. Currently, there are six active suppliers in the market; however, only two companies offer supply to domestic consumers. SSE Airtricity is the incumbent supplier in this area and holds a market share of 78% for domestic and small business customers. Their current price control lasts for a period of three years from 1 April 2020 to 31 March 2023.

1.5 The 'West' area has less than 2,000 customers in the market, and SSE Airtricity remains the sole supplier to domestic customers.

1.6 The 'Ten Towns' gas market has approximately 58,000 gas customers. The market for I&C customers using less than 732,000 kWh per annum has been open to competition since April 2015 and there are currently six suppliers. However, FES is currently the only supplier for domestic customers. Their current price control lasts for a period of three years from 1 January 2020 to 31 December 2022.

UR strategic approach to NI energy gas retail markets

1.7 Where competition is not sufficiently developed or effective, the UR protects

[1] https://www.uregni.gov.uk/files/uregni/documents/2021-09/q2-2021-qremm_1.pdf

customers by regulation and this applies to the relevant areas of the electricity and gas supply markets as much as to other sectors of the energy industry. In both gas markets, the UR retains price controls on those supply companies with dominant market positions in relation to household and small business customers.

1.8 At this time, we envisage that the controls will remain in place for both price regulated gas suppliers beyond 2023, given their market dominance especially in the household sectors, and thus we need to prepare the controls via SPC23. Other issues relating to the scope/coverage of the planned controls are discussed further below.

About this document

1.9 The purpose of this document is to outline the approach and timetable the UR is taking in relation to setting the next price controls for the gas supply companies.

1.10 This paper marks the start of the process within which the new controls will be set. It is anticipated that the work will be completed by the end of 2022 with the view to having the controls in place for the relevant start dates.

1.11 We intend for this process to be transparent and structured. To that end this paper highlights the main issues likely to affect the control, as well as our initial thoughts on how those issues may be addressed or looked at further. We also present the timetable for the process. **Given the need for timely delivery to meet licence requirements, we intend to stick closely to that timetable and the milestones set out therein.**

1.12 Following on from this Information Paper, and in light of subsequent interactions with the companies and with relevant stakeholders, the UR then plans to issue a consultation by the end of May 2022. That paper will include our proposals in relation to the supply businesses' operating costs and profit margin as well as the scope of the controls and their durations. These will be fully consulted upon prior to final decisions being made in the late autumn

2. STRUCTURE AND FORM

2.1 The details of the operation of FES and SSE Airtricity's supply price control are set out in each Licence. At present, the maximum allowed unit price of gas (Pst) for customers subject to price control is made up of a number of components:

Pst = Gt + Ut + St + Mt + Et - Kst

2.2 In any given year t:

- **Gt** refers to the cost of the "wholesale" gas which the supply company purchases and will be passed directly through to customers via the regulated tariff.
- **Ut** covers the costs of using the gas distribution network; these costs are regulated for all Suppliers through the Gas Transmission and Distribution (T&D) price controls.
- **St** means the allowed operating charge in pence per unit of gas supplied by the Licensee to Regulated Premises in Relevant Year t
- **Mt** means the applicable margin to be applied to each unit of gas supplied by the Licensee to Regulated Premises in Relevant Year t
- **Kst** is a correction facility whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).
- **Et** is associated with costs which are uncontrollable and are passed through to customers via the regulated tariff on a 100% basis. These costs include licence fees; IT projects required in order to put in place the systems and processes to comply with licence obligations and some other costs. The Et element of the control is reviewed and amended in the licence as part of each price control setting process.

2.3 Operating costs and profit margin are discussed later in this paper.

2.4 A price control is the mechanism that we use to determine the allowed costs which make up the maximum average price per therm that a regulated gas supply company can charge.

2.5 In granting consent to the maximum average price we review the tariff to ensure that it is constructed in line with the provisions within the price control.

2.6 The price control sets out the treatment of each cost element which makes up the tariff. The elements which make up the maximum average price are:

- Network Costs
- Wholesale Gas Costs
- Supply Operating Costs
- Margin
- Et costs

2.7 In both current gas supply price controls the cost elements of the tariff are the same and the treatment of these costs are the same for the two regulated gas supply companies.

2.8 The current controls set network costs and wholesale gas costs as pass through costs, meaning that the companies are allowed to recover the actual level of these costs.

2.9 Operating costs are set at a fixed amount, with the exception of some billing costs which are adjusted on the basis of actual customer numbers and various other drivers. Et costs are generally also operating costs.

2.10 Margin is set within the control at a percentage of allowed revenue, that being 2%. This was set at this level after in-depth consideration during SPC17.

UR Approach

2.11 We do not propose to make any changes to the current structure and form of the two price controls.

3. SCOPE AND COVERAGE

3.1 This section of the paper covers the scope and coverage for both gas price controls – in other words, the customer types who are covered under the Price Control regime.

SSE Airtricity

3.2 Currently SSE Airtricity are subject to price control in the market for those consumers using less than 73,200kWh per annum (known as "EUC1" tariff), this includes all domestic consumers and small industrial and commercial consumers (I&C).

3.3 FES are the only supplier competing with SSE Airtricity in the domestic market in Greater Belfast; and SSE Airtricity hold 78% domestic market share. In addition, the latest quarterly transparency report published[2] by the UR shows that SSE Airtricity currently also hold 62% market share in the small I&C market in Belfast.

3.4 There are currently no competing suppliers in the domestic market in the West area, and therefore SSE Airtricity hold 100% market share in that area.

Firmus Energy

3.5 Currently FES are subject to price control in the market for those consumers using less than 73,200kWh per annum (EUC1 tariff), this includes all domestic consumers and small I&C consumers.

3.6 There are currently no competing suppliers in the domestic market in the Ten Towns, and therefore FES hold 100% market share. In addition, the latest quarterly transparency report published by the UR shows that FES currently hold 68% market share in the small I&C market.

UR Approach

3.7 Given the dominant market shares of both SSE Airtricity and FES in the domestic and small business markets, our initial view is that we propose no change to the scope / customer coverage of the current price controls.

[2] https://www.uregni.gov.uk/files/uregni/documents/2021-09/q2-2021-qremm_1.pdf

4. DURATION

4.1 The existing price control for both FES and SSE Airtricity have durations of three years. Below we outline our views on duration options for SPC23.

4.2 **One to Two Years** - We are of the view that anything less than three years is too short. This is based on the rationale that any efficiencies which are achieved by the company during that one year will be taken back when setting the next control. This short period in which the companies can retain the out-performance reduces the incentive on the companies to make efficiencies, which are ultimately passed back to customers in subsequent price controls. This goes against the principle of incentive regulation.

4.3 There are also negative resource implications for both the company and the UR.

4.4 **Three to Four years** - The market conditions have not changed significantly since the last price controls were set, and therefore proceeding with a further three year control for each company is a viable option.

4.5 However, a three year duration limits the UR's ability to assess the supplier's performance under existing controls when preparing for the following control. This is because when the control in is under review, the UR will only have one year's actual outturn performance from the existing control (for year 1) to baseline expenditure; as well as latest best estimates (LBEs) (for year 2), and forecasts (for year 3). A longer control would provide additional years actual outturn costs to assess the appropriateness of the supplier's allowances.

4.6 A longer control will also incentivise the companies to make efficiencies, as the supplier can benefit more in a longer control. The UR can then ultimately recoup these potentially greater efficiencies in the following control through a reduction in allowance, which benefits consumers in the long-term.

4.7 A longer control also reflects the relatively stable market conditions, where there has been nominal change in market shares and competition since SPC20 was set.

4.8 **Five years** – These are common in network controls as these are stable and fairly 'steady state' businesses; however, the presence of competition (or the threat of new entrant competitors) in the retail markets and the resultant potential movement in market shares can cause difficulty in forecasting of costs and volumes in the longer term.

4.9 However a five year control has been set for supply businesses in the past and it would increase further the incentive for efficiency.

UR Proposed Approach

4.10 Our initial view is that we consider a four year duration for SPC23 is most the appropriate time period for the new controls to last. However, we will invite stakeholders to share their views on this during the SPC23 consultation.

5. TREATMENT OF COSTS

5.1 This section of the document will discuss the proposed approach to the treatment of costs within the gas supply price controls.

5.2 The gas supply price control determines the treatment of each of the costs which make up the maximum average price. These costs are:

- Network Costs
- Wholesale Gas Costs
- Supply Operating Costs

Network Costs

5.3 Network costs cover the charges for the use of the NI gas transmission and distribution systems. These charges are reviewed and approved by UR under the price control frameworks with the relevant gas network companies.

5.4 The costs for the transmission system are those costs involved in bringing gas from Scotland to Northern Ireland, via the Scotland to NI Pipeline (SNIP), and all the transmission pipelines within NI.

5.5 The costs for the distribution system are those costs associated with moving gas throughout the three distribution areas to homes and businesses. Transmission and distribution costs are published by the relevant system operator.

5.6 In previous controls network costs have been treated as pass through which means that the company is allowed to recover the actual costs incurred. We will retain this approach for the forthcoming controls and allow network costs to be recovered on a pass through basis.

Wholesale Gas Costs

5.7 Gas Costs relate to the cost of wholesale gas as well as the costs for transporting gas through Great Britain to the SNIP. These transportation costs are published by National Grid. Previous controls have determined that these costs are pass through which means that the company is allowed to recover the actual cost of gas. Therefore where wholesale gas costs increase or decrease, the additional costs, or resulting saving are passed on to customers.

5.8 We propose to continue to allow wholesale gas costs and the related transportation costs as pass through costs. Wholesale gas costs will be allowed as pass through at the level purchased at the National Balancing Point (NBP). All Wholesale cost inputs are then verified as part of the regulated tariff review exercises every 6 months.

Supply Operating Costs (OPEX)

5.9 We propose to use a bottom up approach for both companies, building up the OPEX on a line by line basis with a detailed review of each cost line (with historical trend analysis). We opt for this approach on the basis that the costs allowances that were set in the last controls were, for many items, new and increased.

5.10 We do not propose to carry out a “top down” approach as both suppliers will likely see new customers being connected to the network and we need to allow for that projected customer growth.

5.11 Actual spend will need to be analysed and compared to current SPC allowances and determinations made on the level of these for the next control period will need to be made. We will focus our analysis on the larger cost areas and those areas which are forecast to increase significantly over the period of the control albeit we will investigate every cost line to some degree.

5.12 For both gas supply companies there are a number of potential OPEX areas which we may examine in further detail. These include, but are not limited to; bad debt, manpower, billing, and IT costs.

5.13 The gas supply companies will submit forecast costs for a minimum of a four year period, along with historical costs evidencing costs to date. This will include the Latest Best Estimate (LBE) for the most recent year if it has not fully closed. The LBE should be based on actual monthly costs up to the point they have been finalised in the management accounts and forecast costs for the remainder of the year. We may ask the suppliers to split the LBE year costs into actual and forecast They will also be required to identify any activity which is to be discontinued and where spending will not reoccur. OPEX allowances will only be given if:

- any net increase in costs is due to exogenous changes in business obligations and are unavoidable and forecast at efficient levels; and
- The company is able to provide compelling evidence for the amounts claimed.

5.14 This means that the burden of proof lies with the company. If the company is not able to justify its claims to the UR’s satisfaction then the costs will not be allowed within the control.

Additional Operating Costs

5.15 It is normal regulatory practice to make separate allowances for any incremental expenditure or any reductions in expenditure that result from changes in the scope and nature of business activities.

5.16 We will set a number of items within the control for which additional allowances may be granted through the control period. These will include items such as changes in legislation, licence changes or European Directives. In order to be granted an additional allowance the companies will need to clearly demonstrate that the change places a financial burden on them that was not considered at the time of the control. Furthermore the company will have to justify any amount of new allowance to the UR's satisfaction.

5.17 Any costs arising outside of those allowed within the control and outside of these additional items will not be allowed.

Cost allocation

5.18 The gas supply companies will be required to apportion their costs between affiliated businesses and between regulated and non-regulated customers in line with the apportionment methodology set out in condition 1.2.5 of the gas supply licence.

Treatment of Variable Costs

5.19 Within this control we propose to review our treatment of variable costs, i.e. those costs which vary by customer numbers or volume. We understand that the nature of a gas supply business is such that some costs are dependent on the number of customers and the volume flowed; and that within the gas supply business both these drivers could rise or fall depending on the level of competition, the growth in the gas industry or external factors such as the weather.

5.20 Within the current gas supply price controls the majority of OPEX costs are set at a fixed allowance. However, there are a number of costs which are retrospectively adjusted. These costs relate to the costs for billing, meter reading, printing and posting bills and transaction costs for prepayment customers. Currently these costs are allowed on the basis of the actual cost drivers (meters read, bills posted etc.).

5.21 We will review these costs to determine if it is appropriate to retain these costs as retrospective costs or to introduce a methodology to determine fixed and variable costs. It is important to note that this methodology may differ between the two companies due to their relative size.

6. MARGIN

6.1 This section of the report discusses the approach to setting a margin for each of the price regulated energy supply companies.

6.2 Both SSE Airtricity and FES currently operate under existing price control provisions with an allowed margin of 2% of revenue.

6.3 SSE Airtricity and FES' current price controls are fixed using the formula as defined in both supply licenses:

$$\mathbf{Mt = ((Gt + Ut + St + Et + Kst)/0.98) - (Gt + Ut + St + Et + Kst)}$$

6.4 During SPC17, the UR—along with external consultants—carried out a complete review of margin. For this we used the framework of analysis developed during the 2013 Power NI price control review to understand what an appropriate margin would need to be in order for the two gas companies to be in a position to earn a profit equivalent to the amount of financial capital in a supply business multiplied by the cost of that capital (i.e. a capital base x cost of capital calculation).

6.5 In the case of the capital base, we assessed the size of requirements of the following: fixed assets, customer acquisition costs, collateral and security deposits, working capital, and standby risk capital.

6.6 In terms of cost of capital, we applied the methods that regulators typically use when calculating the weighted costs of capital (WACCs) of regulated companies more generally. This entails, in particular, the use of the capital asset pricing model (CAPM) to estimate the cost of equity.

6.7 The SPC17 Final Determination approved a margin of 2% of allowable turnover. This was determined to strike an appropriate balance between the calculations of the CMA, UR external consultants and both FES and SSE Airtricity and their advisors, whilst at the same time taking account of other benchmarks in the energy industry. Both companies accepted the same margin in SPC20 given little underlying change to market conditions.

6.8 In GB, the margin set in the Standard Variable Tariff ~3% (Margin is a fixed percentage of 1.9% of turnover; and added headroom set as fixed percentage of costs—excluding network costs—at 1.46%).

6.9 The regulated gas tariffs in NI also importantly include a 'K-Factor' to address under / over recoveries within the tariff. This serves as an important cost / risk mitigation mechanism, therefore reducing the need for added risk premiums within the margin.

UR Proposed Approach

6.10 We do not believe that market conditions have changed sufficiently to warrant any amendment to this level of margin agreed in SPC20. Both suppliers still retain a similarly dominant position in supply to price regulated customers, as well as cost pass through of volatile wholesale costs; plus the freedom to change tariffs at any time of the year in order to collect under recoveries and future increased forecast costs. Therefore, our initial view is that we propose no change to the allowed margin.

7. TIMEFRAME AND NEXT STEPS

7.1 The following timetable highlights the various stages of the price control review process and (approximately) when the UR expects each milestone to be achieved for both regulated suppliers.

Table 1: Price Control Review timetable

Date	Milestone
November 2021	Utility Regulator information/approach note published
November 2021	Utility Regulator to send Business Efficiency Questionnaire (BEQ) to SSE Airtricity and FES.
January 2022	Submission of completed BEQ by price controlled suppliers
February - April 2022	BEQ Analysis and iteration with the price controlled suppliers and consultation proposals developed.
May 2022	Utility Regulator to publish price control proposals consultation paper
July 2022	End of consultation period
September 2022	Utility Regulator to publish final decision
September 2022	Utility Regulator to consult on licence modifications to implement price control decisions.
October/November 2022	End of licence modification consultation period Publish licence modification Decision

7.2 We envisage that the entire process will be an iterative one and we will engage with SSE Airtricity, FES, and other stakeholders throughout.