PRICE CONTROL FOR
FIRMUS ENERGY (SUPPLY) LIMITED
2023-2026

DRAFT DETERMINATION
CONSULTATION RESPONSE

26 JULY 2022

Contents

Part 1. Introduction

firmus energy welcomes the opportunity to respond to the consultation on the Utility Regulator's Price Control for firmus energy (Supply) Limited, 2023-2026 (SPC23) Draft Determination and looks forward to productive dialogue in advance of the Utility Regulator's Final Determination, due to be published in September 2022.

The following document focuses on the draft determined operating cost allowances for firmus energy in the Ten Towns Network Area and the draft determined retail supply margin.

The SPC23 process to date has been defined by a transparent information sharing process and meaningful engagement between the Utility Regulator and firmus energy, to the benefit of consumers across the Ten Towns Network Area. As a result, we are providing comments for a small number of key areas within the Manpower Costs, Operational Costs and Billing Costs that we believe require further consideration by the Utility Regulator.

It remains firmus energy's intention to provide the Utility Regulator with the necessary clarity and detail to support its forecast of expenditure levels required for the regulated tariff sector in the Ten Towns Network Area for the period 1st January 2023 to 31st December 2026.

Part 2. Supply Operating Costs

2.1 Manpower Costs

Manpower costs include the following cost categories:

- Salaries
- Entertainment
- Training
- Travel and subsistence including fleet
- Recruitment costs and contract staff

As noted in the Utility Regulator's Draft Determination, salaries make up the vast majority (93%) of the manpower cost submission.

A comprehensive and detailed breakdown of all tariff and non-tariff FTEs and salaries was provided for the following four categories:

- Sales, Marketing and Customer Services
- Finance, HR, Billing and IT
- Regulation and Pricing
- Management

We welcome the Utility Regulator's Consultation analysis and proposal to approve the FTE allowances as submitted by firmus energy.

Sustaining and, in some areas, growing our employee base is necessary for meeting the needs of a growing customer base (c.30k tariff customers forecast over the next 4 years). Without the necessary allowances, we will struggle to retain staff, attract new staff and ultimately deliver our outcomes for customers within the Ten Towns area.

To that end, we still believe that an annual salary increase of 1% above inflation is required to attract and retain staff.

The proposed allowances provide an investment of over £1m per annum in staff salaries and continuing to offer competitive, market-driven salaries will ensure we can maintain our excellent levels of customer service, from a local-based workforce.

2.1.1 Health and Social Care Levy

The Health and Social Care Levy was introduced from April 2021 in regard to Employer National Insurance Contributions and will be a permanent fixture from 2023 (i.e. from the beginning of the SPC23 price control period) at 1.25%.

This additional cost was not included in our submission, and we would welcome the Utility Regulator's review of manpower cost allowances to include an uplift for this government levy.

We would estimate that the total cost to firmus energy for this levy is c.£45k per annum with £30k allocated to our Distribution business. The allocation to Ten Towns Supply would be c.£7k per annum.

2.2 Operations Costs

Operations costs include the following cost categories:

- Office Costs including stationery, telephone and postage
- Rates
- Professional and Legal Fees
- Insurance
- Information Technology
- CAPEX
- Licence Fee
- Network Maintenance including safety inspections
- Call Centre
- Advertising, Website and Sales Development
- Supplier of Last Resort

We welcome the Utility Regulator's review and acceptance of our submitted costs for the majority of these cost lines, however, for those items where our submitted costs have not been accepted, we would welcome the Utility Regulator's reassessment, supported by the following commentary.

2.2.1 Professional and Legal Fees

Whilst firmus energy had forecast costs for professional and legal fees in the SPC23 period to be driven by the forecast increase in customer numbers, the Utility Regulator has provided a fixed allowance based on the forecast costs for 2022.

We accept that it is difficult to directly correlate customer numbers and professional and legal fees although as our customer base grows, the likelihood of incurring customer related consultancy costs also grows.

A proportion of these costs will be relatively fixed in nature (e.g. audit and accountancy costs, trading desk consultancy and professional subscriptions) whilst the remaining costs will vary depending on events, e.g. legal advice, Price Control consultancy and regulatory workstreams.

The current environment for an energy supply company is challenging and even since our submission in January 2022 we have seen numerous issues arising because of the more volatile social and economic environment. Many of these new issues have required support and advice from third party experts.

We note in the SPC23: SSE Airtricity Gas Supply (NI) Ltd Draft Determination that an allowance of £178k per annum has been proposed for professional and legal fees. The proposed allowance for firmus energy is less than half of this amount (at £71k per annum).

We would ask the Utility Regulator to review firmus energy's allowances in this area, to ensure we can continue to deliver for our customers and to meet their demands for a high quality, informed service.

2.2.2 Advertising, Website and Sales Development

Within Advertising, Website and Sales Development costs, we included a fixed amount in our submission of £50k for each year from 2023-2026 in anticipation of entry into the Ten Towns market by other domestic gas suppliers. If this entry were to occur, we would have to adopt a new competitive operational strategy.

firmus energy remains of the view that advertising and marketing costs are essential, even for a regulated business, however, we welcome the Utility Regulator's commitment to "*keep this under review as the market develops".*

2.2.3 Supplier of Last Resort (SoLR)

In our submission, annual allowances were requested to allow for costs incurred as a result of a Supplier of Last Resort (SoLR) event. The Utility Regulator's Consultation proposes that any remuneration of costs incurred as a result of a SoLR event would be managed through the SoLR procedures and not included as part of price control considerations.

Whilst the SoLR procedures should capture the costs incurred as a result of a SoLR event, they would not include the costs associated with ensuring that firmus energy are prepared and ready to manage a SoLR event.

In March 2020 the Utility Regulator wrote to firmus energy, stating,
"*Your role as Supplier of Last Resort is important and a necessary part of overall consumer protection. I am writing therefore to ask for your confirmation and assurances that the agreed Supplier of Last Resort (SoLR) arrangements in the retail market are on your priority radar.*"

The letter sought the following assurances:

1. That in the event of supplier default, firmus energy as SoLR, will be able to manage the transfer of the defaulting supplier's portfolio of supply meter points and maintain normal conditions of supply, in line with the Industry arrangements, previously agreed.
2. That the process can be completed with the expedience outlined in the Industry arrangements.

As this letter emphasises, the Utility Regulator is keen to ensure that all Suppliers are "SoLR-Ready" and this is even more relevant for firmus energy as the designated SoLR for the Ten Towns network area.

Furthermore, the backdrop of an increasingly volatile energy retail environment over the last 12 months has materialy increased the requirement of those businesses appointed as Suppliers of Last Resort to be ready to be so.

We believe that our submitted costs are essential to ensuring that firmus energy remains "SoLR-Ready" throughout the SPC23 period.

2.3 Billing Costs

Billing costs include the following cost categories:

- Bad debt
- Paypoint costs incl PAYG cards
- Credit Check Costs
- Bank and Interest Charges
- Meter reading
- Customer Information Bill Processing and Postage

We welcome the Utility Regulator's review and acceptance of our submitted costs for the majority of these cost lines, however, for items where submitted costs have not been allowed we would welcome the Utility Regulators reassessment, supported by the following commentary.

2.3.1 Bad Debt

Following the Utility Regulator's review of historical figures for bad debt and, in particular, the actual levels of bad debt written off, we agree that the average bad debt for tariff customers for 2019 to 2021 was 0.29% of credit revenue.

All things being equal, we would see that as a reasonable benchmark for determining future allowances for tariff bad debt.

We would, however, be apprehensive with applying this figure going forward, given the social and economic events of the past 6 to 12 months. The rising global cost of natural gas, coupled with other cost of living pressures has put significant strain on domestic customers and small businesses. We believe the full extent of these pressures has yet to be realised.

As such, assessing bad debt on retrospective performance alone does not provide a robust allowance for the SPC23 period.

We are currently experiencing a significant uplift in customer engagement, specifically regarding requests to reduce Direct Debit amounts and set up payment plans.

Furthermore, there is an increasing cost to the business for administering these requests and working with our customers.

With increasing gas commodity costs and hence tariffs, and coming into winter 2022, the financial challenges facing our customers will continue to intensify and this will only increase our bad debt levels, or at the least, our cost of funding the escalating time it takes customers to pay.

We note in the SPC23: SSE Airtricity Gas Supply (NI) Ltd Draft Determination that an allowance of 0.6% of credit revenue has been proposed. The proposed allowance for firmus energy is less than half this (0.29%).

As noted above, we anticipate bad debt levels to rise, when compared to historical levels, and increased allowances in this area would allow firmus energy to continue to support those customers who are struggling with making payment.

We would request the Utility Regulator to review their determination in this area and provide an allowance closer to firmus energy's submission of 0.5% of credit revenue.

Part 3. Supply Retail Margin

As part of our SPC23 submission, we included a paper prepared by our consultants, Frontier Economics, supporting an increase to the current supply retail margin of 2%.

The Frontier Economics' calculations, based on the cost of capital approach, resulted in a margin range of 4.1% to 5.2%, i.e. considerably higher than the current 2% margin.

However, Frontier Economics also referenced other regulatory precedents for supply retail margins, namely:

- Power NI's current allowed margin for its supply price control - set at 2.2% of turnover; and
- Ofgem uses an EBIT margin of 1.9% in setting the default tariff cap. This tariff cap also includes a headroom allowance of 1.46% of all costs to take account of risks arising from cost uncertainties that are not included in the assessed efficient costs.

The final range proposed in Frontier Economics' paper, based on both the cost of capital approach and other benchmarks in the energy industry was 2.2% to 3.0% of allowable turnover, placing more weight on the latter given the lack of certainty of certain elements of the cost of capital approach.

Having met with the Utility Regulator and their consultants, First Economics, we acknowledge the differences in approach to deriving a margin based on the methodology of a notional supply business capital base (made up of "core" and "contingent" capital) and the cost of capital.

The main difference within this approach relates to the rate of return applicable to contingent capital, with the issue being that there are no obvious benchmarks to reference what the most appropriate cost of contingent capital should be.

First Economics have relied upon the rates that firmus energy currently pay for contingent capital and we would note that:

- these rates are only achievable as a result of firmus' ownership structure and long term arrangements; and
- the current market situation is very challenging – firmus energy would find it particularly difficult to secure trading collateral at not only the rates we currently have, but also at the quantum we currently have in the current market.

Based on their evidence, First Economics and the Utility Regulator conclude that there is no justification for an increase to the current supply retail margin of 2%.

Whilst we acknowledge the challenges associated with reviewing margin as part of the SPC23 price control review, we would ask that, similar to advertising and marketing costs, the Utility Regulator would continue to keep this under review as the market develops.

firmus energy is the only domestic supplier in the Ten Towns area, with no other supplier entering the domestic market since it opened for competition in April 2015 (over seven years ago). It is our belief that such a low retail margin renders this market an unattractive proposal for retail suppliers, again, demonstrated by the absence of new entrants since its opening in 2015.