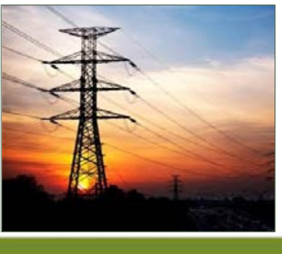
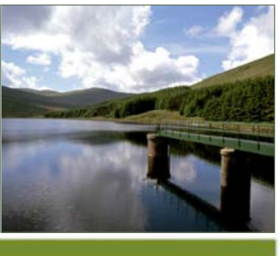
Draft Determination on Price Control for firmus energy (Supply) Ltd

October 2014

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; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission	Value and sustainability in energy and water.
Our Vision	We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

This document sets out for consultation our draft determination for a first price control on firmus energy (Supply) Ltd. The price control will come into effect on 1 April 2015 when the Ten Towns market will open fully to competition. This consultation follows our initial consultation published in June 2014. The draft determination is made on the basis of the responses to the initial consultation, submission from firmus energy (Supply) Ltd and benchmarking with other relevant organisations. We welcome feedback from all interested parties on the proposals set out in this document.

Audience

Industry, consumers and their representative bodies and statutory bodies.

Consumer impact

The price control will protect customers in terms of price by setting a maximum limit on the average price that firmus energy (Supply) Ltd can charge for gas in the Ten Towns area.

Contents

Glossary

Name	Definition
SSE Airtricity	SSE Airtricity Gas Supply (NI) Ltd
CCNI	Consumer Council for Northern Ireland
CMA	Competition and Markets Authority
DETI	Department of Enterprise, Trade and Investment
firmus	firmus energy (Supply)Ltd
firmus distribution	firmus energy (Distribution) Ltd
GB	Great Britain
NI	Northern Ireland
NTS	National Transmission System
PNGL	Phoenix Natural Gas Ltd
TSO	Transmission System Operator

1. Introduction

This consultation sets out for comment by interested stakeholders our draft determination for a price control for firmus energy (Supply) Ltd (firmus) from 1 April 2015. This will be the first supply price control for firmus, previously the supply costs have been part of the distribution price control.

This consultation sets out the basis for the price control and provides background information on the gas markets in Northern Ireland.

This is the second consultation on the price control process for firmus energy.

The 'Initial Consultation on a Price Control for firmus energy' was published in June 2014 and can be found on our website at http://www.uregni.gov.uk/uploads/publications/2014-05-07_Initial_Consultation_fe_supply_price_control.pdf . This consultation set out our high level proposals for the price control. We received two responses to this consultation which we refer to in our proposals. One of these consultations was marked confidential. The other is published in Annex 2 below. Following responses to this draft determination we will publish our final determination in December 2014.

We consider this approach is consistent with the principles of better regulation[1] which the Utility Regulator continues to apply: transparent, consistent, proportionate, accountable, and targeted.

All costs presented are in January 2014 prices.

[1] Department for Business Innovation & Skills, *Principles for Economic Regulation*, published April 2011. A copy of this paper is available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

2. Background

In Northern Ireland there are two distinct distribution areas for natural gas. These are the Greater Belfast area and the Ten Towns area. The Greater Belfast area is served by Phoenix Natural Gas Ltd and the Ten Towns area is served by firmus energy (Distribution) Ltd (firmus distribution).

The Ten Towns area covers a geographical region that includes Londonderry, Limavady, Coleraine (including Portstewart and Bushmills). Ballymoney, Ballymena (Broughshane), Antrim (including Ballyclare and Templepatrick), Craigavon (including Portadown and Lurgan), Banbridge, Newry (Warrenpoint) and Armagh (Tandragee). firmus energy (Supply) Ltd (firmus) holds a licence to supply gas to this Ten Towns area. The licence grants to firmus a period of exclusivity for supplying gas to customers within the Ten Towns area, meaning that firmus is the only company allowed to supply gas during this period. This period of exclusivity ended on 30 September 2012 for customers using more than 25,000 therms per annum, typically large industrial and commercial customers. The period of exclusivity for all customers using less than 25,000 therms per annum will end on 31 March 2015; this will include all domestic customers and small to medium business customers. From 1 April 2015 therefore, the supply market in the Ten Towns area will be open to new entrant suppliers in all sectors.

The Ten Towns Market is a relatively small market, there are currently approximately 22,000 gas customers (comprising of 2,000 small industrial and commercial and 20,000 domestic customers) using less than 25,000 therms per annum, these customers will be eligible to switch from 1 April 2015. There are 238 meter points using more than 25,000 therms per annum who have been eligible to switch since September 2012. To date 29 meter points have switched, all of whom have switched to SSE SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) as the only other active supplier. This equates to around 12% of the market[2].

In the Greater Belfast Market there are approximately 170,000 customers. This market has been open to competition since 2007. Currently there are four active suppliers in the market, only two of these companies supply to domestic customers, SSE Airtricity and firmus. SSE Airtricity, as the incumbent dominant supplier (having purchased Phoenix Supply Limited), is subject to price control. The current SSE Airtricity price control lasts for a period of five years from January 2012 to December 2016. This price control can be found on our website[3].

[2] Retail Market Monitoring Quarterly Transparency Report, published May 2014: http://www.uregni.gov.uk/uploads/publications/TransparencyReport_2014_AUG.pdf

[3] http://www.uregni.gov.uk/publications/utility_regulator_publishes_the_phoenix_supply_ltd_price_control_determinat

The Utility Regulator is currently undertaking a detailed review of the regulated energy supply markets in NI to assess the effectiveness of competition within these markets. A strategy document was published in May which sets out the strategic rationale for this project, and how it links in with other key projects. This document can be found at http://www.uregni.gov.uk/uploads/publications/Strategic_Overarch_Paper.pdf

The aim of this review is to assess the effectiveness of competition in energy markets and the implications for our regulatory framework.

There are two stages to this review.

1. The first is to undertake a formal review of the effectiveness of retail competition in our energy markets, and the factors which might limit that competition. It will consider the information requirements necessary to monitor the effectiveness of competition. This review will broadly follow the structure of the recent Ofgem market assessment;

2. In light of the findings of phase one of the project, phase two of the project is to define the appropriate policy response and regulatory framework to deal with the issues identified and assess if there is any change required to the current regulatory regime. This regulatory policy review will be dependent upon the outcome of phase one and will look at a wide range of regulatory roles in retail markets (price controls, consumer protection licence conditions and requirements from the regulatory framework in different market sectors).

Phase 1 of the project is currently underway with the collation of qualitative and quantitative data to inform the formal review. It is our intention that both phases one and two of the project will be completed before the end of this proposed price control period for firmus. Our decision on how to regulate this market going forward will then be based on the policy decisions that form the conclusions to this review.

3. Basis for Price Control

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

<u>2.4.1 Control over Charges in the absence of competition</u>

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 [75,000 therms] 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 we use to determine the costs which are used to establish the maximum average price per therm that firmus can charge in a twelve month period.

In determining if it is appropriate to apply a price control in this instance we have examined both the tests set out in the licence condition above.

(a) Opportunity to take gas from another supplier

Currently firmus supplies 100% of those consumers within the Ten Towns area who use less than 25,000 therms per annum and is therefore in a dominant position in this market. As there is no competition in this market we cannot determine whether the opening of the market to new entrants will safeguard the interests of consumers.

We can examine the experience in the Greater Belfast market; where in the first year of competition around 7% of customers switched to a different supplier. There were a number of factors that promoted this level of switching including a price differential of 35% for a period of time between competitors. If we extrapolate these figures in the Ten Towns market this would indicate that over 20,000 customers may not change supplier and would remain with firmus. There is no indication that consumers in the Ten Towns market will behave in the same way as those in the Greater Belfast market. Additionally we have no indication of how suppliers will seek to compete in the Ten Towns area, or how this will affect the switching levels. Therefore we do not consider that competition, at this stage in the market, will necessarily safeguard the interests of consumers.

(b) Competition from other fuels

We do not consider that these consumers are protected by competition from other fuels. There is a large capital outlay required by consumers to switch fuels, which acts as a significant barrier to switching, and we consider that it would require a significant price shock in the market for consumers to consider changing fuels. This would especially be the case for vulnerable consumers.

In keeping with our statutory duties to protect the interests of consumers therefore, we do not consider that competition in this market will be sufficiently effective to protect consumers and that as a result a price control on firmus is required.

4. Scope and Duration

4.1. Scope

Within our initial consultation we proposed that this price control will apply to customers using less than 25,000 therms per annum (typically domestic properties and small to medium businesses). This is equivalent to the customer coverage of the price control applying in the Greater Belfast market.

The market for those customers using more than 25,000 therms per annum has been open to competition since 1 October 2012. We are carefully monitoring the progress of competition in this market. There is currently only one other supplier active in the Ten Towns market and around 12% of the available meter points have switched. We consider there to be potential for more companies to enter the market in the near future.

The results of the review of competition project will affect our decisions on which markets to regulate in the future, but for now we consider it appropriate to treat this market in line with the Greater Belfast Market. We will consider the issue of the customer scope of the controls again at the time of the next firmus (and SSE Airtricity) price controls.

4.2. Duration

Within our initial consultation we proposed to apply the firmus price control for a period of 21 months from 1 April 2015 to 31 December 2016. This was in order to bring the control into alignment with the price control on SSE Airtricity – both controls would then commence next time on 1st January 2017. This will allow synergies in the development of the two price controls, as well as effective benchmarking.

In addition, by the end of 2016 we will have completed our work on the effectiveness of competition in the market and used the results of this project to set out our policies for dealing with price controls in the future. This will allow us to treat both price controls in the same manner and in line with the established policies of the Utility Regulator on supply price controls. Therefore we propose a 21 month price control period.

4.3. Responses to Initial Consultation

Both respondents supported the proposed scope for this price control. In relation to duration, one respondent expressed concern around the short timeframe of the control, stating the need for a stable and predictable policy and regulatory regime.

In principle we would normally refrain from short-duration price controls, however in this circumstance we consider that the benefits of the outcomes from the review of the market and the subsequent alignment of price controls on the basis of this review will outweigh any negatives of an initial short price control period.

One respondent stated that the price control should be in place until the incumbent supplier's share of the market falls to below 50%. The review of the effectiveness of competition as set out in Section 2 above will set out our decisions on regulatory policy beyond 2017 on the basis of a well developed understanding of the particular market in Northern Ireland.

Additionally this respondent noted the restriction of the number of tariffs available in GB and commented that this was not a sensible approach for the NI market to support customer choice. We continue to monitor closely developments in the GB market. However policy decisions which affect the Northern Ireland energy markets will be on the basis of a careful understanding of the Northern Ireland market and the needs of the Northern Ireland consumer.

5. The Regulated Tariff for firmus

The firmus licence condition 2.4.1 states that firmus

...shall take all reasonable steps to secure that in any period of 12 months the average price per them of gas supplied to such consumers shall not exceed a maximum price to which the Authority has consented...

In order to approve this maximum average price the Utility Regulator will review the proposed tariff of firmus to ensure that it is constructed in line with the provisions set out in the price control.

5.1. firmus Tariff

The tariff is the price that firmus charges its customers for gas. This can be set at or below the maximum average price. The tariff is made up of a number of elements.

- Transmission costs
- Distribution costs
- Supply operating costs
- Gas costs
- Margin

Within the initial consultation we set out our proposals for how each of these costs would be treated. These costs are discussed further in sections six to nine of this consultation.

5.2. K Factor

Within the initial consultation we proposed that a number of costs were treated as pass through. The k factor is the term for the difference between actual allowed costs and forecasts for those costs. It is our intention to maintain the k factor at a minimum level though the use of regular tariff reviews and a trigger mechanism to monitor the tariff closely and thus minimise the impact of k factor on the tariff.

5.3. Tariff Review

A tariff review is the process of analysis and discussion of the tariff to consider if a change to the tariff is needed, and to decide the magnitude and timing of any change. We propose to review the firmus tariff on a bi annual basis; additionally we will be able to initiate a tariff review under the trigger mechanism as discussed below. This follows the process established within the SSE Airtricity price control. Our experience with SSE Airtricity demonstrates that regular reviews minimise the impact of k factor on the tariff.

We have established a process in consultation with firmus, CCNI and DETI which will establish the timescales and information required in setting the tariff. The tariff review process is a consultative one where all parties bring their expertise and opinion in relation to the needs of firmus, the needs of the consumer and the wider impact on the economy. It is important, therefore, that all parties are aware of and in agreement with a formal process.

This process will provide a robust procedure, which is in line with the requirements of the licence to ensure that all parties are consulted in a timely, prescribed and comprehensive manner for both anticipated and unanticipated tariff reviews. The process is published in Annex 2.

5.4. Trigger Mechanism

In addition to the bi annual tariff review we propose to create a trigger mechanism within the price control. The aim of this trigger mechanism is to initiate a tariff review should the cost of wholesale gas purchased by the regulated Supplier vary significantly from the cost forecast within the tariff.

We propose that the trigger mechanism will operate to allow the Utility Regulator to initiate a tariff review should the wholesale cost of gas change, either increase or decrease, so as to change the tariff by 5%. This is the same mechanism that applies to SSE Airtricity in the Greater Belfast market. We consider the 5% level to be an appropriate level, any level under this and volatility in the wholesale market could necessitate a number of tariff reviews in a year. Tariff reviews can be costly and complex for the company. Where a review is initiated by the trigger mechanism the tariff review group will look at not only the wholesale cost of gas but a number of factors including

- Volatility in the wholesale gas market
- Time since last tariff review
- Level of k factor
- Amount of gas purchased by firmus

The Utility Regulator retains the flexibility to initiate a review at any stage it believes is in the interest of customers.

5.5. Tariff Structure

The firmus domestic credit tariff is made up of two charges, a higher charge for the first 2,000kWh used per annum and a second charge for any usage above 2,000kWh per annum. Pay as You Go customers pay a flat tariff for each unit used. [4]

[4] firmus domestic tariff: http://www.firmusenergy.co.uk/for_home_10_towns.aspx?dataid=499871

Industrial and commercial customers using less than73,200 kWh (2,500 therms) per annum are charged a tariff with the same structure as the domestic credit tariff. Those customers using between 73,200 and 732,000 (2,500 and 25,000 therms) per annum are charged a three tiered tariff, with different charges for usage up to 2,000kWh per annum, between 2,001kWh and 73,200kWh per annum and above 73,200kWh per annum.[5]

At each tariff review we will require firmus to demonstrate the assumptions used to create the tariff structure to ensure that the average weighted price charged to customers is equal to or less than the maximum average tariff.

5.6. Responses to Initial Consultation

Only one respondent commented on our proposals for the regulated tariff to state that they were in support of them.

[5] firmus business tariff: http://www.firmusenergy.co.uk/for_business_10_towns_content.aspx?dataid=500983

6. Network Costs

Network costs are the charges for the use of the transmission and distribution systems.

The costs for the transmission system are those costs involved in bringing gas from Scotland to Northern Ireland, via the Scotland to Northern Ireland Pipeline. They also include the costs for bringing gas to the distribution network areas through the transmission pipeline systems. The tariff for using the transmission pipelines are published on an annual basis on the Transmission System Operator's (TSO) websites. We propose to treat transmission charges as pass through costs.

The costs for the distribution system are those costs associated with moving gas throughout the firmus distribution network area to homes and businesses. These can be found on the firmus distribution website. Distribution costs are also subject to price control by the Utility Regulator. The latest price control GD14[6] came into force on 1 January 2014 and will last for a period of three years. We propose to treat distribution charges as pass through costs.

6.1. Responses to Initial Consultation

Only one respondent commented on our proposals for the regulated tariff to state that they were in support of them.

6 [6]GD14 Price Control for Northern Ireland's Gas Distribution Networks for 2014-2016 Final Determination, 20 December 2013: http://www.uregni.gov.uk/uploads/publications/2013-12-20_GD14_Price_Control_for_NI_GDNs_2014-2016_Final_Determination.pdf

7. Supply Operating Costs

7.1. Supply Business Costs

The supply operating costs of the firmus Ten Towns supply business are those costs that relate directly to supplying gas to customers within the Ten Towns area, with the exception of the costs related to wholesale gas.

Following information requests, firmus submitted a comprehensive breakdown of their cost base, detailing the breakdown of the supply operating costs on a line by line basis. We have analysed the costs submitted by firmus, on both a historical and forecast basis. We have carefully analysed the split of these costs between the firmus distribution and supply businesses. We have benchmarked these costs with other relevant organisations where appropriate. For clarity, in benchmarking the costs of firmus with other organisations we have taken into consideration the relative size of the Ten Towns business. We have considered the impact on firmus' submission of changes in the market and the impact of any forthcoming EU Directives on the company.

We consider it is appropriate, for ease of description, to summarise these costs into three areas as can be seen in Table 1 below; manpower, operations and billing.

- Manpower costs are those costs related to staffing the Ten Towns supply business including salaries, training and travel costs.
- Operations costs refer to the costs of operating the supply business including office costs, insurance, professional fees, IT and call centre costs
- Billing costs include meter reading, paypoint transaction costs and bad debt.

By summarising these costs and setting an overall allowed level of costs, it is not our intention to set a cost for firmus for each cost line of their business, but rather to set an overall allowance for manpower and operations which we consider an appropriate efficient level for firmus to finance their regulated activities in the Ten Towns area. This allowance is built up on the submission that firmus made, and for clarity we set out in Annex 1 a fuller breakdown of this allowance. However, this detailed allowance is not a prescriptive budget for firmus to follow. Our intention is that firmus will decide how to most efficiently spend this proposed allowance in conducting its regulated activities and meeting its Supply licence requirements.

Costs relating to billing are treated differently. These costs are driven by actual volumes of gas burned and actual customer numbers and can therefore be affected by factors outside of the control of firmus (e.g. weather).

For this reason we treat these costs as retrospective costs, meaning that final costs will be adjusted for actual cost drivers.

The costs affected are

- Bad debt – adjusted for actual credit revenue
- Paypoint costs – adjusted for actual customer numbers and number of transactions
- Bill processing– adjusted for actual number of bills
- Meter reading – adjusted for actual number of meters read

The retrospective mechanism is detailed in section10.2 below.

The table below shows the firmus submission against our draft allowance.

Table 1 – firmus Submission v Draft Determination (2014 prices)

	2015		2016	
Overall Allowance	firmus submission	Draft determination	firmus submission	Draft determination
	£'000	£'000	£'000	£'000
Manpower	471	370	504	370
Operations	276	137	287	135
Billing	565	455	580	466
	1,312	961	1,370	970

As the table shows our proposed allowance is significantly reduced from the firmus submission in each area. As a result of the analysis completed on the firmus submission we considered that in each of these cost areas the firmus submission for Supply-related costs were high. In calculating our proposed allowance the two areas which have led to the most significant variance in costs are

- Apportionment of costs between the firmus businesses
- Benchmarking of costs with other appropriate companies such as SSE Airtricity and Power NI

This is demonstrated in the table in Annex 1 which shows the actual costs for 2013 along with the latest best estimate for 2014. These costs are apportioned on the firmus basis for apportionment. We consider that the movement in costs is caused by the apportionment methods used by the business. As a result we have carried out a robust analysis of the apportionment methods as detailed in section 7.4. The actual costs cannot be compared to our allowances as the apportionment methods used to apportion between the various businesses and customer groups vary significantly from those applied by firmus.

In particular, in relation to manpower, we have reduced costs relating to manpower as we consider the submitted manpower levels to be high for a supply business of this size. We have removed costs relating to meter tampering as we consider that these costs should be collected from the relevant customer and, where they cannot be, they form part of bad debt. We have proposed a bad debt allowance of 0.2% of credit revenue based on the historic performance to date and on the high percentage of prepayment meters installed in the Ten Towns area.

7.2. Retrospective Adjustment of Costs

As stated above we consider that it is appropriate to treat billing costs as retrospective costs as these costs are dependent on the actual volume of gas burned and the actual number of customers. These retrospective costs are:

- Bad debt – adjusted for actual credit revenue
- Paypoint costs – adjusted for actual customer numbers and number of transactions
- Bill processing – adjusted for actual number of bills
- Meter reading – adjusted for actual number of meters read

In each case we will set a unit rate per transaction and set an allowance based on the forecast cost driver. This will then be reconciled to adjust the forecast costs based on the actual cost driver. For example bad debt is set at 0.2% of credit revenue. An allowance is set at 0.2% multiplied by the forecast credit revenue based on forecasted volumes. This allowance will be adjusted for the actual credit revenue received multiplied by 0.2%.

7.3. Efficiency Factor

Within our initial consultation we proposed setting an efficiency factor on the supply operating costs of firmus if we deemed it appropriate.

In setting our proposed allowance for operating costs we have proposed an allowance which we consider is efficient for firmus to carry out its regulated activities. We have benchmarked this allowance with other appropriate companies. In addition we are mindful of the relatively short time period proposed for this control of 21 months. We consider that achieving this proposed cost level within the relatively short control period will provide sufficient challenge to firmus and therefore for this control propose an efficiency factor of 0%.

7.4. Apportionment of Costs

As firmus is an integrated business, that is to say that its distribution and supply activities all form part of the same business, it is accepted that some of the costs will apply to the business as a whole, costs such as office costs, insurance, rates etc. In analysing the costs of the Ten Towns business we have considered the apportionment of these costs between the distribution and supply businesses, between the various supply businesses (Ten Towns, Greater Belfast and electricity) and between the regulated and non regulated business within the Ten Towns.

For those costs which relate to the whole business we have examined the treatment of these costs in the distribution price control (GD14) set in December 2013.[7] We have applied a consistent methodology to the setting of these costs and their apportionment between the Ten Towns supply business and the distribution and other supply businesses. Additionally we have examined those costs which are apportioned between supply businesses including manpower, call centre costs and professional fees and apportioned these costs on the basis of manpower and customer numbers where appropriate.

Finally we have allocated costs between regulated customers (those using less than 25,000 therms per annum) and non regulated customers on the basis of customer numbers, volume and manpower to ensure only appropriate costs are allocated to the regulated sector.

7.5. Reconciliation

On an annual basis we will reconcile the costs allowed in the price control with the actual costs incurred by firmus and determine a reconciliation amount. This amount will then form part of the k factor.

The reconciliation will take into account

- Retrospective items
- Rate of Interest Applicable

7.6. Rate of Interest

We propose that any reconciled amounts, whether under or over recovered, including gas costs, will be rolled forward at an interest of LIBOR plus 1.5%. This is in line with the treatment of these costs in the SSE Airtricity price control. The proposed rate of interest is set to reflect the cost to firmus of financing the under recovery or the benefits to them of holding any over recovery.

7 http://www.uregni.gov.uk/publications/gd14_price_control_for_gas_distribution_networks_final_determination

7.7. Responses to Initial Consultation

In relation to operating costs one respondent commented on the cost of meter reading to the supply business and stated that they considered that this was an activity that the distribution company should undertake and this would result in savings due to economies of scale. This is a significant issue, which would apply also potentially in the gas markets elsewhere in NI. Therefore, we will consider this matter in the future when resource permits.

In relation to efficiency factors respondents commented that applying an efficiency factor in addition to setting efficient costs can result in double counting potential cost savings. Another respondent commented that an efficiency factor was unrealistic. As indicated above, we have chosen not to apply a separate efficiency factor in this short Control.

8. Gas Costs

The wholesale cost of gas and the associated costs of purchasing gas make up more than half of the final price to gas customers. This section details our proposals for dealing with each element of gas costs. We consulted on these proposals within the initial consultation.

8.1. Wholesale Costs

The wholesale costs of gas make up the largest single element of the gas tariff. It is these costs that also provide the greatest risk to changes in the tariff. The Committee on Climate Change demonstrated that over the past number of years (2004 to 2011) gas prices in Great Britain have risen by 121%, of this rise 80% is due to increasing wholesale costs[8]. Over the past two years the wholesale gas forward curve has remained relatively stable, however this is not an indication that prices will remain at this level. Ofgem has stated that wholesale prices are likely to rise over the next number of years as Great Britain relies more on gas imports from Europe and further afield and therefore prices are increasingly influenced by global events[9].

We consider that in the wholesale gas market firmus is a price taker; it has no control over the price of wholesale gas. As a result we propose to allow gas costs as pass through costs for the duration of the control. This is in line with the treatment of gas costs in the SSE Airtricity price control. In our initial consultation we stated that the pass through arrangements would require following information from firmus;

- The purchasing strategy of firmus
- The apportionment of costs among customer groups and firmus businesses (Ten Towns/Greater Belfast)
- On a monthly basis details of gas purchases on an ex ante and ex post basis for both tariff and non tariff customers.
- Full details of any over/under recoveries

firmus has confirmed in its submission that it will continue to provide this information to us. We propose to closely monitor the build up of over/under recoveries and will act to ensure these remain at a low level so as not to distort prices.

8 Household energy bills – impacts of meeting carbon budgets Committee o n Climate Change, December 2011

9 https://www.ofgem.gov.uk/gas/retail-market/monitoring-data-and-statistics/understanding-energy-prices-great-britain

8.2. Network Costs

firmus is also responsible for paying national transmission system (NTS) transportation charges in order to transport gas through the transmission system in Great Britain. These costs are set and published by National Grid. We propose to allow these costs as pass through costs at the published rate. Additionally we propose that charges for removing gas from the NTS, known as Moffat exit charges will also be treated as pass through costs.

firmus will also be required to purchase additional gas in order to meet the Shrinkage Factor set by firmus distribution. We propose that this cost is treated as a pass through cost.

8.3. Credit Support

firmus has submitted credit costs on the basis of forecasts as these costs were not previously incurred by the business. We have reviewed the forecast to ensure that it falls within industry requirements for credit arrangements. We propose an allowance credit support of 0.51ppt and 0.52ppt for 2015 and 2016 respectively. This will form part of the tariff costs.

8.4. Responses to Initial Consultation

One respondent stated that new entrants to the market should have visibility of the gas procurement strategy of the incumbent supplier. We consider that this is not appropriate, a company's gas purchasing strategy is confidential and can be a competitive edge for a company. We will seek to ensure that there is no cross subsidisation of gas costs between supply businesses or customer groups. We do not consider that new entrants should seek to be price followers in the market but instead should aim to compete on their own merits.

9. Margin

During the Power NI price control (of the regulated dominant supplier in the electricity market) in 2013, the Utility Regulator carried out a robust and comprehensive analysis of the retail margin, taking into account theoretical and evidence based perspectives and engaging consultants in order to establish an appropriate margin for Power NI. This resulted in a margin of 2.2% (historically at 1.7%) for Power NI.

For the purposes of this price control we have engaged consultants to carry out a similar analysis to the Power NI analysis. This analysis uses the Power NI margin as a basis for comparison and considers whether it is appropriate for the margin for firmus to be the same or different from the Power NI margin of 2.2%.

We consider that these principles will result in an appropriate margin for firmus based on the capital requirements faced by the Supplier and the risks they face, balancing our statutory duties to protect customers while ensuring that regulated companies can finance their efficient licensed activities.

We consider it appropriate to use the Power NI margin as a basis for comparison due to the similarities between the companies. Power NI and firmus are broadly similar in a number of respects; they hold dominant positions in their respective markets, their customer base overlaps and they retail similar products. However there are a number of differences between the companies and it is these differences which play a key part in determining the final margin.

The key aspect of the differences is that they lead to higher capital requirements for Power NI than for the regulated gas suppliers. In relation to energy purchasing Power NI buys most of its electricity from the Single Energy Market (SEM). The rules of SEM impose high collateral requirements on electricity supply companies which are not replicated in the gas market. Additionally the SEM is a dual currency market and as such Power NI considers it necessary to hedge against currency risk which increases collateral costs.

As Power NI has a higher working capital requirement, this suggests that the margin for firmus should be less than the 2.2% Power NI margin. In fact, after re-working the Power NI-type methodology on the basis of the reduced working capital requirements of a gas supplier results in a suggested margin for firmus of no more than 1.5%. In addition, we note that the margin within the current SSE Airtricity price control (as accepted by that company at their recent Control for the Greater Belfast gas supply market, is also 1.5%.

We propose therefore to apply a supply margin of 1.5% on allowed costs for firmus in line with the margin applied to SSE Airtricity. These businesses offer identical products and hold dominant positions in their respective markets. They are under similar regulatory controls so we consider it appropriate that they achieve the same margin.

Based on the outcome of the review of the effectiveness of competition in the market, we intend to carry out a robust analysis of appropriate margins in the gas supply business for both SSE Airtricity and for firmus at the time of the next price Controls.

9.1. Responses to Initial Consultation

Both respondents commented on margin. One respondent proposed that the margin should be set at 2.2% rather than the 1.5%.

The other respondent agreed that analysis of the margin was appropriate and requested that we consider the differences in scale between Power NI, SSE Airtricity and firmus.

10. Next Steps

The table below sets out our proposed timescale for the price control process. We will further review these timescales following responses to this consultation. Achieving these timescales will require close cooperation between firmus and ourselves and the provision of timely and quality information.

Date	Action
November 2014	Responses to consultation
December 2014	Final Determination for firmus supply price control
April 2015	Ten Towns market opens to competition

11. Responding to the consultation

As a public body and non-ministerial government department, the Utility Regulator is bound by the Freedom of Information Act which came into effect on 1 January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in responses can be put into the public domain. Hence it is possible that all responses made to consultations will be discoverable under Freedom of Information Act, even if respondents asked the Utility Regulator to treat responses as "confidential".

It is therefore important that respondents note these developments and in particular, when marking responses as "confidential" or asking the Utility Regulator to treat responses as confidential should specify why they consider the information in question to be confidential. Confidentiality disclaimers created automatically by your company's email system will not normally be treated as sufficient in terms of a confidentiality request.

This is an open consultation. We have not posed any specific questions in this paper. Instead we invite stakeholders to express a view on any particular aspect of the paper.

Responses should be received by 5 pm on 17 November 2014 and should be addressed to:

Lesley Robinson
Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED
E-mail: Lesley.robinson@uregni.gov.uk

Annex 1

The table below shows the breakdown of the firmus submission and the proposed allowance as referred to in section 7.1. This table is for information purposes only to show the build up of the proposed cost allowances.

	firmus submission				Draft Determination	
Operating Expenditure Totals	2013 (£)	2014 (£)	2015 (£)	2016 (£)	2015 (£)	2016 (£)
Manpower costs						
Manpower	505	388	439	470	359	359
Training	10	5	6	7	1	1
Labour Recharge	27	7	7	7	7	7
Travel and subsistence including Fleet Costs	22	17	19	20	3	3
Total Manpower Costs	**564**	**416**	**471**	**504**	**370**	**370**
Operations Costs						
Office Costs including stationery, telephone and postage	76	60	66	69	43	39
Rates	5	3	3	3	2	2
Professional and Legal Fees	36	4	7	7	4	4
Insurance	24	18	21	22	8	8
Information Technology	86	15	15	15	10	10
CAPEX	-	-	-	-	-	-
Licence Fee	- 9	0	0	0	0	0
Network Maintenance	27	118	135	140	39	41
Call centre	-	-	30	31	30	31
Total Operations Costs	**245**	**218**	**276**	**287**	**136**	**135**
Billing Costs						
Bad debt	136	102	113	118	27	28
Agency fees	105	211	237	247	230	240
Bank and Interest Charges	9	2	2	2	2	2
Meter reading	102	92	126	127	126	127
Bill Processing	9	102	87	87	70	69
Total Billing Costs	**361**	**509**	**565**	**580**	**455**	**466**
Total	**1,171**	**1,144**	**1,312**	**1,370**	**961**	**970**

Annex 2

Gas Tariff Review Process

Introduction

The aim of this document is to outline the process for tariff reviews for the incumbent gas suppliers in Northern Ireland, currently SSE Airtricity Gas Supply Ltd (AGS) in the Greater Belfast Area and firmus energy (Supply) Ltd in the Ten Towns area. The tariff review process is a consultative one which involves the supply company, Utility Regulator, Department of Energy, Trade and Investment (DETI) and Consumer Council for Northern Ireland (CCNI). All parties bring their expertise and opinion in relation to the needs of the company, the needs of the consumer and the wider impact on the economy. It is important, therefore, that all parties are aware of and in agreement with a formal process.

Under the terms of the price control supply companies set a tariff in April each year, followed by a mid-year tariff review in October. There have also been occasions where the cost of gas has changed significantly so as to make a review at other times of the year necessary. This process will provide a robust procedure to ensure that all parties are consulted in a timely, prescribed and comprehensive manner for both anticipated and unanticipated tariff reviews. A tariff review is the process of analysis and discussion of the tariff to consider if a change to the tariff is needed, and to decide the magnitude and timing of any change.

This process is set out within the AGS price control (PC03)[10], which covers 2012-2016. It is currently proposed to apply to firmus from 1 April 2015.[11]

Requirement for process

According to the terms of the gas supply licence[12], the supply company must apply to the Utility Regulator for consent to a maximum average price which it can charge for gas supply over a 12 month period. Within the AGS price control (PC03) which covers 2012-2016, there is also a trigger mechanism which allows the Utility Regulator to initiate a further tariff review; this trigger mechanism is also proposed in the firmus supply price control

> *'In addition to the bi annual tariff review there will be a trigger mechanism in line with previous price controls. The aim of this trigger mechanism is to initiate a tariff review should the cost of gas vary significantly from the cost forecast within the tariff…The trigger mechanism will operate to allow the Utility Regulator to initiate a tariff review should the wholesale cost of gas change, either increase or decrease, so as to change the tariff by*

10 Utility Regulator Determination on Phoenix Supply Price Control 2012 - 2016, November 2011: http://www.uregni.gov.uk/publications/utility_regulator_publishes_the_phoenix_supply_ltd_price_control_determinat

11 Initial Consultation on Price Control for firmus energy (Supply) Ltd, June 2014: http://www.uregni.gov.uk/uploads/publications/2014-05-07_Initial_Consultation_fe_supply_price_control.pdf

12 Condition 2.4.1: 'Control over Charges in the absence of competition'.

5%. Where a review is initiated by the trigger mechanism the tariff review group will look at not only the wholesale cost of gas but a number of factors including

- *Volatility in the wholesale gas market*
- *Time since last tariff review*
- *Level of k factor*
- *Amount of gas purchased by [supply company]*

The Utility Regulator retains the flexibility to initiate a review at any stage it believes in is the interest of customers'[13]

Elements of the tariff

The following table shows the makeup of the gas supply tariff and the treatment of these items in the AGS price control. We have proposed to treat these costs in the same manner in the firmus price control.

Element of Tariff	**Treatment of Cost**
Transmission	Pass through - analysed as part of tariff review
Distribution	Pass through - analysed as part of tariff review
Gas Costs	Pass through – based on forward purchases made to date and the weighted average taken on prescribed five days
Over/under recovery	Analysed as part of tariff review
Supply Opex	Set in price control
Margin	Set in price control

Process

The supply licence condition 2.18.11 states that

'*Where the Licensee proposes to vary any of the terms and conditions of a Contract it has with a domestic customer, it shall....notify each such domestic consumer of the proposed variation...at least 21 days in advance of the date the variation is due to take effect.'*

The process will start eight weeks before the intended tariff announcement date for formalised reviews. Where the trigger mechanism is activated the tariff review process will start. To start the process the supply company and the Utility Regulator will agree the analysis of the tariff. This analysis will be based on the principals set out in the price control, including elements such as gas costs, over/under recovery, transmission and distribution costs.

The supply company will provide analysis for the tariff over the timescales requested by the Utility Regulator. These will vary depending on the timing of the review and the rationale for the review. The Utility Regulator considers it essential to be flexible in this

13 Utility Regulator Determination on Phoenix Supply Price Control 2012 - 2016, November 2011. This flexibility is also proposed to be included in the firmus supply price control.

analysis so as to best show the impact of the forward gas curve on the tariff and the impact of over/under recovery.

The weighted average cost of gas (WACOG) in the final tariff will be calculated based on

- gas already purchased by supplier;
- volumes still to be purchased at a price taken as an average of five working days on the forward curve.

The five working days will commence seven working days before the tariff announcement date. For example for a new tariff on 1 April 2015 the tariff announcement date will be 11 March at the latest and based on this announcement date the five working days will be 2 to 6 March 2015.

	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday
March 15	23	24	25	26	27	28	1
	2	3	4	5	6	7	8
	9	10	11	12	13	14	15
	16	17	18	19	20	21	22
	23	24	25	26	27	28	29
April 15	30	31	1	2	3	4	5

The Utility Regulator considers that flexibility is essential when considering the data set to use for setting the tariff. Where the market is highly volatile the Utility Regulator may consider it appropriate to use a different set of dates or change the basis for setting the tariff.

Meetings

During the process there will be at least one meeting for all parties. The supply company and the Utility Regulator will present the result of the analysis of the tariff. The parties will discuss the consultation paper, comment on preferred options, agree the way forward and arrange subsequent meeting(s) in line with dates for the final tariff decision. The parties will also discuss media issues, timings of announcements and related issues. These meetings will be minuted with a record of the meeting forwarded to all parties.

Timing of Tariff Reviews

All other things being equal there will be a tariff review in:

- February/March (for an April tariff change)
- August/September (for an October tariff change)
- Any occasion where trigger mechanism is activated

The Utility Regulator retains the flexibility to initiate a review where it considers it to be necessary.

If, as a result of analysis, the supply company and the Utility Regulator propose that there should be no change to the tariff, the process will still be followed. All parties will meet to discuss the results of the analysis and to discuss the media and related issues associated with the announcement.

Once the tariff decision has been announced the Utility Regulator will publish a review of the tariff decision, including comparisons with other suppliers and regions.

Tariff Review Process

1. **Analysis**

   11 weeks before a new tariff date the supply company to provide Utility Regulator with

   - Draft consultation paper
   - Detailed tariff analysis for timescales requested by Utility Regulator
   - Over/under recovery analysis
   - Analysis of transmission and distribution charges

   The Utility Regulator will inform all parties that this information has been received from the supply company

2. **Meeting with Utility Regulator and Supplier**

   Within two weeks of analysis being received the Utility Regulator and the supply company meet to discuss analysis and consultation paper. Final analysis will use gas figures for five workings days commencing seven working days before the tariff announcement date. These dates will remain flexible particularly where the market is volatile.

3. **Tariff Analysis Consultation Paper**

   8 weeks before a new tariff date supply company to circulate consultation paper to all parties with information on

   - Elements of tariff
   - Analysis
   - Over/under recovery
   - Supplier preferred option

4. **Meeting with Supplier, CCNI, DETI and Utility Regulator**

   Within one week of receipt of paper all parties to meet to discuss consultation paper, comment on preferred options, agree way forward and arrange subsequent meeting in line with dates for final tariff decision. This meeting will be minuted with a record of the meeting forwarded to all parties.

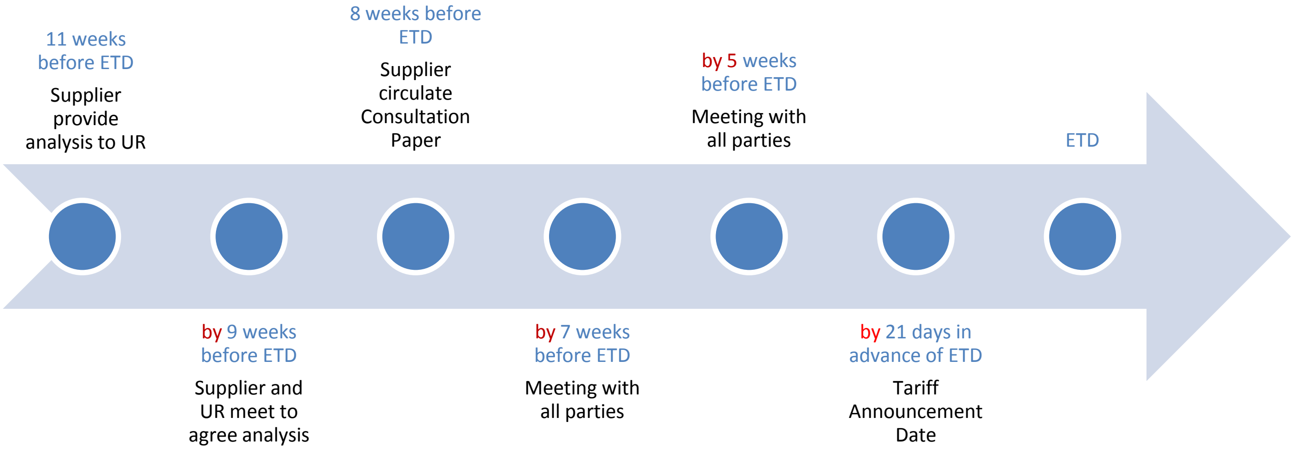
5. **Meeting with Supplier, CCNI, DETI and Utility Regulator**

   At least five weeks before the new tariff date all parties meet to discuss the tariff and timings of press releases and statements from all relevant parties.

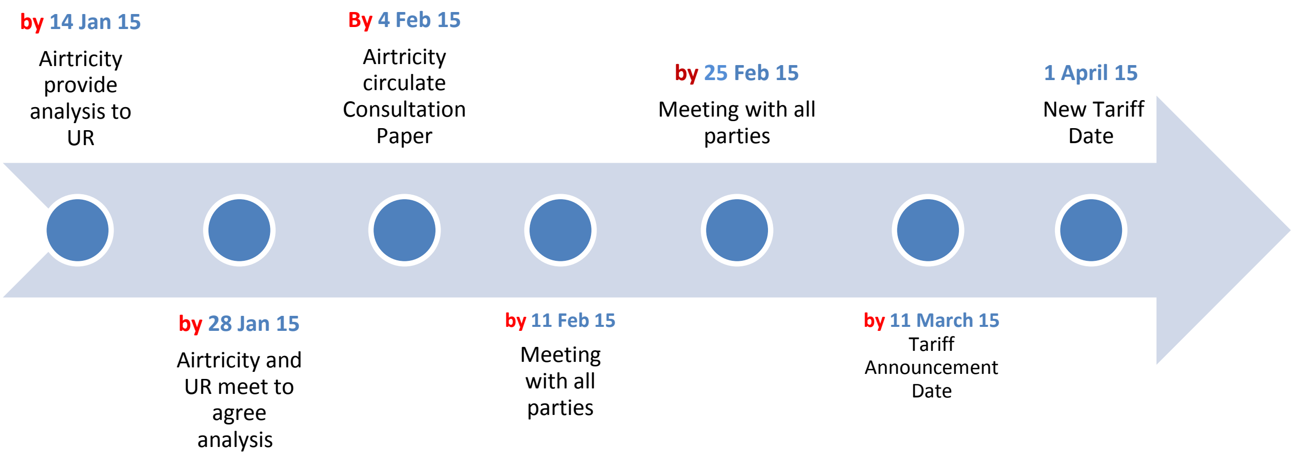
6. **Announcement Date**

   Announcement date will be at least 21 days before the effective tariff date.

Below is a timeline showing the process. (ETD is effective tariff date)



Below is a worked example of the process where the new tariff date is 1 April 2015.



Annex 3

Airport Road West
Belfast Harbour Estate
Belfast BT3 9ED

t. 028 9073 2611
f. 028 9073 2020
e. info@flogasni.com

www.flogasni.com

Lesley Robinson

Utility Regulator

14 Queen Street

Belfast

BT1 6ED

29th July 2014

<u>RE: Consultation on Firmus Price Consultation</u>

Dear Lesley,

Please find a response from Flogas Natural Gas Ltd. in relation to the Initial Consultation on Price Control for Firmus Energy (supply) Ltd.

<u>Basis for Price Control</u>

We understand the basis for the price control and we believe that the price control should remain in place until the incumbent supplier's share of the market falls below 50%.

<u>Review of the Effectiveness of Competition</u>

I note your comment on the practices that Ofgem have adopted regarding restricting the number of tariffs that suppliers have in the UK. I don't think this is a sensible approach when trying to promote competition in the market place and would not advise this for the NI market because it's important that we are supporting customer choice.

<u>Scope and Duration</u>

We agree with the duration of the price control and are happy that there will be a price review every 6 months. We all know how volatile the market can be and this gives us assurance that we can recover any rise in gas prices above 5%, should the situation present itself.

<u>Efficiency Factor</u>

We agree with the concept of rolling the costs forward at an inflation rate but we would feel that the efficiency factor seems a bit unrealistic.

Correction Mechanism

While it is important that Firmus forecast their volumes correctly we feel that the two tier mechanism proposed is a bit excessive.

Wholesale costs

As part of the pass through arrangement, Firmus will provide the Utility Regulator with details of their purchasing strategy and apportionment of costs. It is reasonable that new entrants should have some visibility on the gas procurement strategy underlying the regulated price.

Margin

We are proposing that the margin % be set at 2.2%, not 1.5% as is currently set for the Airtricity price control.

Pricing Structure

We have noted that there is no reference to the recovery of any Cap Ex costs in their overall cost structure? Is this fully recovered in the Distribution costs?

Meter Reading

Currently all suppliers are responsible for collecting and reporting the meter readings for their own customers. This cost is obviously built into the sales commodity tariff we set internally for our customers. We feel that this is something that the Distributor should do and this should result in economies of scale if only one company is looking after the whole meter reading process. This economy of scale would result in a lower price to the end customer. I understand that the Distribution price would increase but the increase in the Distribution price should be lower than the cost to the individual supplier for doing their own readings.

We trust you will take into account the above points made by Flogas when formulating your decision on the Price Control.

If you have any queries in relation to any of the above please don't hesitate to contact us.

Yours sincerely,

____

Hazel Byrne

Flogas Natural Gas Ltd