Conclusion of the Utility Regulator's Review of the firmus energy (Supply) Ltd Maximum Average Price in the Ten Towns area

March 2018



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

Protecting customers is at the heart of the Utility Regulator's role and ensuring that customers pay the correct price for energy from the price regulated supplier firmus energy Supply Ltd (feSL) is a core part of our work.

We commenced a review of the maximum average price with feSL in January 2018. We have scrutinised the submission provided by feSL to ensure that the maximum average price approved is not more than the sum of the costs allowed under the price control determination. This ensures that customers pay no more than the costs of purchasing and supplying gas plus a pre-determined allowance for the operating costs of the business and an agreed profit margin.

The maximum average price for feSL's domestic and small business customers in the Ten Towns area will increase to 139.10 pence per therm from 130.27. This equates to an increase of 6.8% to the bills of domestic and small business customers.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

feSL's customers in the Ten Towns area will see an average increase of 6.8% increase in their annual bill. This change will affect all domestic and small business customers using less than 2,500 therms per annum. The change will take effect from 5 April 2018. This follows no change in October 2017.

The impact of the tariff change on a domestic PAYG customer with average consumption of 12,500 kWh per annum will be an increase of approximately £39 per annum (including VAT) on their gas bill.

Approval by the Utility Regulator of the firmus energy (Supply) Limited Maximum Average Price in the Ten Towns area

Summary

On 19th January the Utility Regulator, in consultation with firmus energy (Supply) Limited (**feSL**), the Department for the Economy (**DfE**) and the Consumer Council began a review of the feSL maximum average price for domestic and small business customers using less than 2,500 therms per annum. This covers approximately 36,100 customers within the Ten Towns area.

We carry out formal reviews of the feSL maximum average price on a bi-annual basis (in advance of April and October). The Utility Regulator can also initiate a further review at any stage should the wholesale cost of gas change significantly such that it would result in an increase or decrease of at least 5% to the maximum average price. On an ongoing basis we analyse the cost of wholesale gas on the forward curve, along with the forward purchases that feSL has made to date.

We initiated the formal review to establish the new maximum average price to become effective from 5 April 2018. The review is a formal process agreed by the UR, feSL, DfE and the Consumer Council. It is set out within the feSL price control[1] and details the processes to be followed and the timescales for the review process.

feSL uses the maximum average price to set the actual tariffs that are charged to customers. The tariffs are calculated on a weighted average basis, based on average usage and the number of customers using each tariff. feSL cannot charge more than the maximum average price overall. However, this means that the tariffs may vary at a different rate to the maximum average price.

The maximum average price for domestic and small business customers will be 139.10 pence per therm from 130.27 in the April 2017 tariff. The maximum average price set in the April 2017 tariff submission was 129.57; however, this included EUC2 customers. As these customers are excluded from the regulated tariff from April 2018, a recalculated April 2017 maximum average price of 130.27 has been shown for the purposes of the comparison between the 2018 and 2017 maximum average prices.

The new maximum average price has been modelled and forecast over a period of 12 months however it will be kept under constant review and adjusted within that time period

[1] Price Control for SSE Airtricity Gas Supply (NI) Ltd and firmus energy (Supply) Ltd Final Determination 29th November 2016: https://www.uregni.gov.uk/sites/uregni/files/media-files/SPC%2017%20Final%20Determination%20v1.0.pdf

if required. We will complete another formal review in advance of 1 October 2018 and will continue to monitor gas prices to identify if an additional review is required before that date.

From 5 April 2018, the unit rates of tariffs for feSL's customers in the Ten Towns area will increase by 6.8% on average. These unit rates are detailed in Table 4 later in this paper.

Background

In Northern Ireland, there are three distinct distribution areas for natural gas. These are the Greater Belfast area, the Ten Towns area and the West area. Phoenix Natural Gas Limited (PNGL) own and operate the distribution network in the Greater Belfast area, firmus energy (Distribution) Limited own and operate the distribution network in the Ten Towns area, while Scotia Gas Networks (SGN) own and operate the distribution network in the West area.

feSL holds a licence to supply gas to customers in the Ten Towns area. This licence was granted to feSL with a period of exclusivity for supplying gas to customers within this area, meaning that feSL was the only company allowed to supply gas within the Ten Towns during this period.

From 1 April 2015, the supply market in the Ten Towns area opened to competition from new entrant suppliers in all customer sectors. However feSL are currently the only supplier for domestic consumers in this market. feSL currently supply around 36,100 domestic and small business customers (referred to as "tariff" customers) in this area.

This review of feSL's maximum average price takes account of the Article 14 Decision for the 'Review of Firmus Energy (Supply) Ltd Price Control Scope' that the Utility Regulator published on 28 November. The licence modification will reduce the scope of the feSL's price control to exclude EUC2 customers in the Ten Towns area. As of 1 April 2018, non-domestic customers consuming between 2,500 and 25,000 therms (73,200 and 732,000 kWh) per annum will no longer be covered by the price control.

Under the terms of feSL's licence to supply gas, the Utility Regulator ("the Authority") has the power to control the maximum amount that feSL can charge for gas. These controls apply when customers are not protected by competition. The feSL licence states:

<u>Control over charges</u>

> "The Licensee shall take all reasonable steps to secure that in any Relevant Year the average price per unit of gas supplied by it to Regulated Premises shall not exceed the maximum price calculated in accordance with Condition 2.4.2"[2].

[2] firmus energy supply limited licence modification; https://www.uregni.gov.uk/sites/uregni/files/media-files/firmus%20energy%20licence%20modification%20decision%20notice%20January%202017.pdf

The Utility Regulator has established a price control determination which sets out feSL's allowed costs. The price control determination sets out how each of the cost elements which make up the maximum average price will be treated.

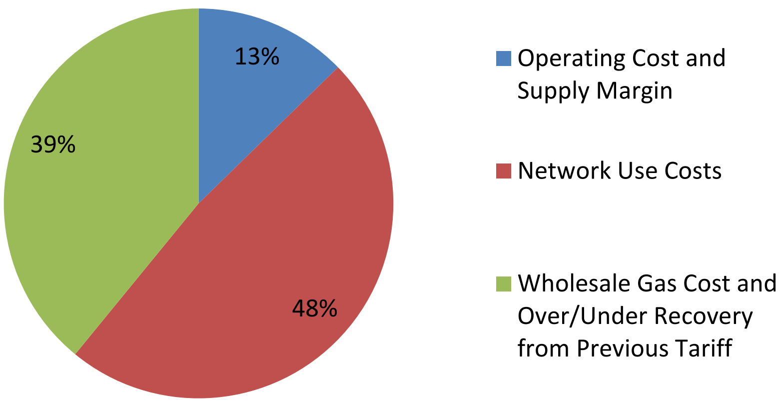
Elements of Maximum Average Price

The maximum average price is made up of a number of costs:

- Operating costs and supply margin;
- Network costs; and
- Wholesale cost of gas.

The breakdown is shown in figure 1 below.

Figure 1 – Makeup of the maximum average price from 5 April 2018



The Utility Regulator has taken an active role in scrutinising the costs within each of the elements of the maximum average price of feSL's submission. feSL uses the maximum average price to set the actual tariffs that are charged to customers. feSL cannot charge more than the maximum average price overall.

Operating Costs and Supply Margin

Operating costs are the costs necessary for feSL to run its supply business for tariff customers. For example the costs of billing, meter reading, customer service, offices, salaries and IT systems etc. The operating costs were determined under the price control carried out by the Utility Regulator.

The margin refers to the amount of profit feSL is allowed to make. The margin was determined within the price control and was set at 2% of allowable turnover from tariff customers.

In November 2016 we published the final determination for the firmus energy supply price control[3] which indicates the total amount of revenue that the Licensee can recover, in any relevant year, in respect of their gas supply business.

The price control determination runs from 1 January 2017 to 31 December 2019.

Network Costs

Network costs cover the charges for the use of the Northern Ireland transmission and distribution systems. These charges are reviewed and approved by the Utility Regulator as part of the network price controls.

The feSL price control determined that the transmission and distribution system charges will be treated as pass through charges which means that the customer pays for the actual cost of the network charges.

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, and all the transmission pipelines within Northern Ireland. These costs are published on the Premier Transmission website and on the Gas Networks Ireland website

The costs for the distribution system are those costs associated with moving gas throughout the Ten Towns area to homes and businesses. On the 15th September 2016 the final determination on the price control for Northern Ireland's gas distribution networks for 2017-2022 (GD17), and associated licence modifications for consultation, were published. GD17 is the distribution price control for Phoenix Natural Gas Limited (PNGL), firmus energy (Distribution) Limited and SGN Natural Gas Limited which will run from 1 January 2017[4]. The distribution price control determines the amounts that firmus energy Distribution can charge for suppliers to use the Ten Towns network. These can be found on the feDL website.

Wholesale Gas Costs and Over/Under Recovery from Previous Tariff Periods

This element of the maximum average price includes the forecast cost of wholesale gas and any over/under recovery from the previous tariff period that needs to be deducted/added in the maximum average price. This makes up 39% of the total. Further detail on these costs is provided below.

[3] Price Control for SSE Airtricity Gas Supply (NI) Ltd and firmus energy (Supply) Ltd
Final Determination 29th November 2016: https://www.uregni.gov.uk/sites/uregni/files/media-files/SPC%2017%20Final%20Determination%20v1.0.pdf

[4] https://www.uregni.gov.uk/news-centre/gas-distribution-networks-price-control-gd17-period-2017-2022-published

- ***Wholesale Gas Costs***

The feSL price control determined that the gas cost element of the maximum average price incorporates the wholesale cost of gas as well as charges for transporting gas through Great Britain and costs for securing credit.

The price control determines that gas costs are treated as pass through which means that the customer pays for the actual cost of gas. Therefore, where wholesale gas costs decrease or increase, the resulting savings or additional costs are passed on to the customer.

feSL has a gas purchasing strategy in place which means that they purchase a percentage of their forecast sales volumes in advance on an ongoing basis. This limits the exposure to fluctuations in wholesale gas prices and therefore aims to create more stability in the gas price for final customers.

When setting the maximum average price, the overall cost of gas is estimated based on a combination of actual gas purchases that have already been secured, along with forecast volumes of gas required, and the wholesale cost of gas from the forward curve. Buying gas in advance (hedging) can help to reduce any over/under recoveries building up as the price of the hedged gas in the maximum average price is known when the price is set.

- ***Over/Under Recovery from Previous Tariff Periods***

Wholesale gas costs make up a large component of the final maximum average price and as these costs can be volatile there will always be a difference between the outturn cost of the wholesale gas compared to the forecast costs that are included in the maximum average price.

Where the wholesale gas costs out turns less than was forecast in the maximum average price, feSL will ‘over recover’, this means that they have recovered more money from customers than they spent on gas costs and they will subsequently refund the over recovered difference to customers in the following tariff periods.

Or, where the wholesale gas costs turn out higher than forecast in the maximum average price, feSL will ‘under recover’, this means they have spent more on gas costs than they recovered from customers and they will therefore be able to recharge the under recovered difference to customers in the following tariff periods. This ensures that customers only pay for the actual cost of gas.

Therefore, each maximum average price includes an amount of over or under recovery which was accumulated during previous tariff periods.

Both feSL and the Utility Regulator strive to keep the over/under recovered amount as low as possible in order to reduce volatility in the tariff. This will be carried out through ongoing monitoring and tariff changes being put through when over or under recoveries are increasing to such an extent that a tariff change is required.

The maximum average price effective from 31 March 2017 included an amount of around £476k which feSL had over recovered previously. This was returned to customers through a 3.79 pence per therm reduction in the April 2017 tariff, and has now been fully handed back to customers. As of 5 April 2018 there will be a 0.91 pence per therm increase to the tariff to allow feSL to recoup a £111k under recovery. In terms of impact of on the tariff it is important to note that the previous over recovery had a dampening effect on the tariff. As the current tariff does not have an over recovery built into it, it is more reflective of current market conditions.

Why is the Maximum Average Price for feSL increasing?

The maximum average price for feSL's tariff customers in the Ten Towns area will increase to 139.10 pence per therm. The maximum average price set in the April 2017 tariff submission was 129.57; however, this included EUC2 customers. As these customers are excluded from the regulated tariff from April 2018, a recalculated April 2017 maximum average price of 130.27 has been shown for the purpose of comparison. Table 1 below shows the movement in the regulated maximum average price from April 2015 (the first regulated tariff) to date.

Table 1 - Historic maximum average price

Effective from date	Approved Maximum Average Price (pence per therm)
01-Apr-15	130.85
01-Oct-15	125.16*
01-Apr-16	115.51
31-Mar-17	130.27**
05-Apl-18	139.10

**This figure has been restated to take into account updated volume forecasts. At 01-Oct-15 the approved Maximum Average Price was 124.44 pence per therm.*

*** This figure has been recalculated to take account the removal of EUC2 customers from the regulated tariff. Previously the approved Maximum Average Price was 129.57 pence per therm.*

The overall increase in the feSL maximum average price is due to:

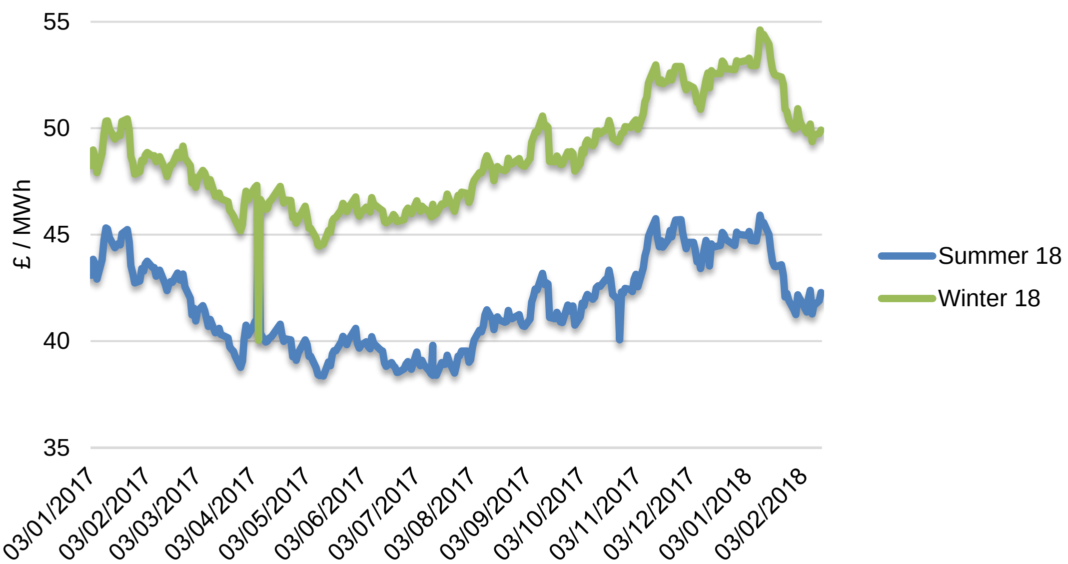
- the increase in the cost of wholesale gas;
- an increase in overall network costs (mostly driven by inflation);
- the reduction of the wholesale gas over recovery amount in comparison to the previous year.

These are explained in the section below.

- ***Increase in Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods***

The forecast gas costs on the forward curve have increased slightly over the last year. This is shown in the graph below.

Figure 2 – Movement in forward curve of wholesale gas cost



Source: Platts McGraw Hill Financial

Table 2 below shows that the forecast cost of gas within the maximum average tariff has increased from 52.37 pence per therm in the April 2017 tariff to 52.45 pence therm in the April 2018 tariff.

It is important to note that an element of the gas price included within the maximum average price is a forecast cost and the actual outturn prices may be higher or lower. This element is the cost of the gas that has not already be bought (hedged) to date.

If the actual gas prices turn out to be lower than those forecast then feSL will over recover, and if actual gas prices turn out to be higher than those forecast then feSL will under recover. Any amounts that are over or under recovered, will be returned to customers or recovered from customers respectively, in the following tariff period.

There was an over recovery of £476k at the setting of the April 2017 maximum average price and for the 5 April 2018 price there is a forecast under recovery position of £111k. This equates to a 0.91 pence therm increase to the tariff. The impact of the change in the over/under recovery on the maximum average price is shown in Table 2 below.

Table 2 - Wholesale Gas Costs and Over/Under Recovery from Previous Tariff Periods within Maximum Average Price

Elements within Maximum Average Price	April 2017 (pence per therm)	April 2018 (pence per therm)
Wholesale Gas Cost	52.37	53.45
Over/Under Recovery	-3.79	0.91
Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods	48.58	54.36

- ***Network Charges***

Transmission Network charges have increased slightly over the level set in the April 2017 maximum average price.

The distribution costs contribute an additional 2.2 pence per therm to the overall maximum average price from 1 April 2018. This is attributed to normal inflationary increases and the removal of the previous year over recovery which had a dampening effect on the previous distribution charge. These charges are available on the Phoenix Natural Gas website.

As a result, there is a small increase of around 4% in network costs (transmission and distribution combined). This can be seen in Figure 3.

Breakdown of Maximum Average Price

The graph shown in Figure 3 below compares the breakdown of the April 2018 maximum average price with a breakdown of the previous maximum average price set at April 2017. As explained previously, the increase in the maximum average price is due to slightly increased network costs, an increase in wholesale gas prices, and the reduction in the over recovered sum of revenue from 2017 level. This over recovery had a reducing effect on the 2017 tariff which is not now in the 2018 tariff.

Figure 3 – Breakdown of April 2018 maximum average price compared with previous maximum average price

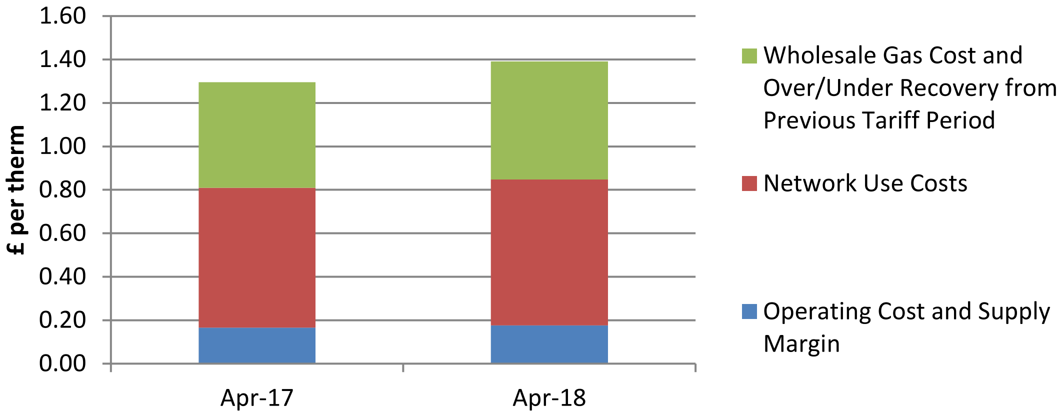
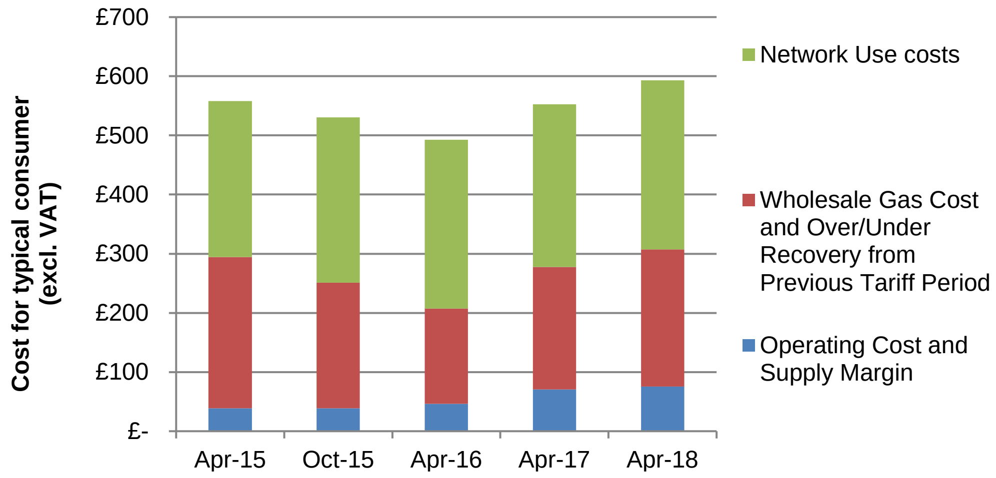


Figure 4 below shows the breakdown of the average customers annual cost under the maximum allowed price over time, illustrating the variation caused by different components. It can be seen that the increase in the maximum average price is mostly driven by changes in the wholesale gas cost and over / under recovery component.

The average annual bill amounts in this graph have been calculated based on the maximum average price set at each review (which excludes VAT) and are based on average annual consumption of 12,500kWh[5].

Figure 4 - Graph to show breakdown of average annual bill



Impact on Tariff

As stated earlier, feSL uses the maximum average price to set the actual tariffs charged to customers. The tariffs are calculated on a weighted average basis, based on average usage and the number of customers on each tariff. feSL cannot charge more than the maximum average price overall. From 5 April 2018, the unit rates of tariffs for feSL's customers in the Ten Town area will increase by 6.8%.

The new unit rates for tariff customers are shown in Table 4 below. Table 5 shows the percentage increase for each individual unit rate of the domestic and small business tariffs.

[5] 12,500 annual usage estimate is based on the figure published by Ofgem on their website at https://www.ofgem.gov.uk/gas/retail-market/monitoring-data-and-statistics/typical-domestic-consumption-values;

Table 4 – feSL's tariff unit rates from 5 April 2018 (shown in pence per kWh including VAT)

	Domestic inc 5% VAT	PAYG inc 5% VAT	IC1 ex VAT
Up to 2,000 kWh	7.144	4.952	7.307
Over 2,000 kWh	4.817		4.852
Over 73,200 kWh			
Direct Debit discount	£22.00		

The change in the feSL maximum average price equates to an increase in a domestic PAYG[6] customer bills of £39 per year (including VAT) based on a domestic customer with an average consumption of 12,500 kWh per annum (rounded to nearest pound).

Table 5 – Percentage Increase in feSL's tariff unit rates from 5 April 2018

	Domestic	PAYG	IC1
Up to 2,000 kWh	6.78%	6.79%	6.8%
Over 2,000 kWh	6.78%		6.8%
Over 73,200 kWh			

Comparison with GB and Ireland

Figure 5 below shows the average annual bill of a standard credit domestic customer for feSL in the Ten Towns compared to the "Big Six"[7] supply companies in GB and Bord Gais in Ireland. This comparison is based on the latest available information on the standard domestic credit tariffs[8] of each company. The average annual bill amounts in this graph have been calculated based on actual tariff unit rates (including VAT) and are based on average annual consumption of 12,500kWh.

This graph illustrates that the feSL tariff for an average domestic standard credit customer in the Ten Towns area will be above the GB average standard tariff and around 7% cheaper than the Bord Gais standard tariff in Ireland[9].

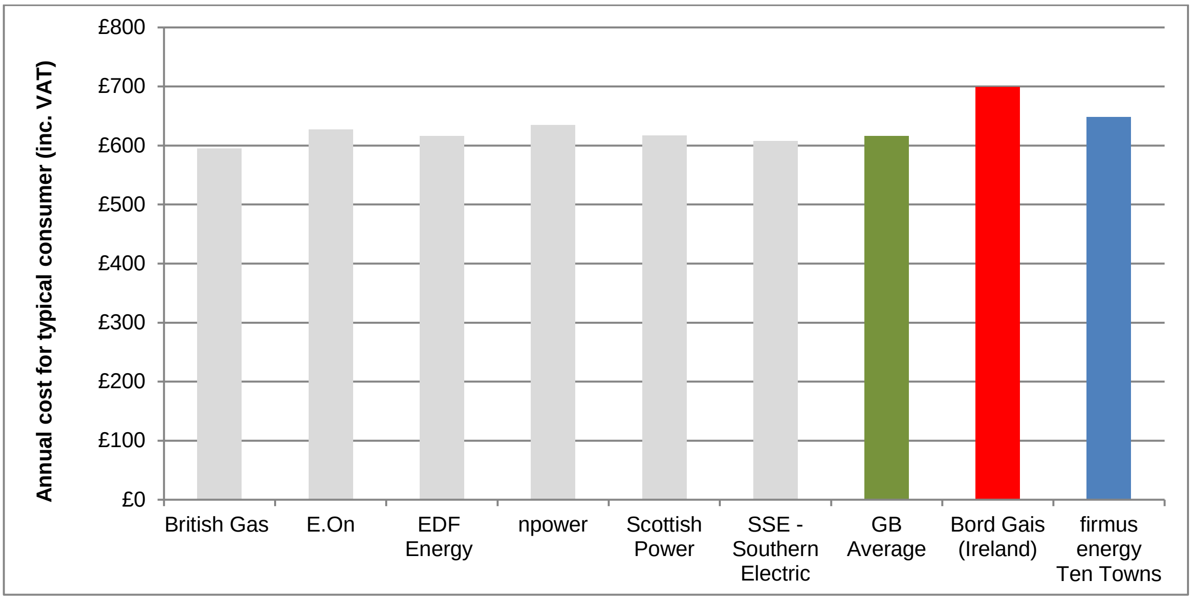
[6] In Q417 domestic PAYG customers made up 85% of all domestic and small I&C connections.

[7] The Big Six companies are British Gas, SSE, Scottish Power, npower, E.on UK and EDF Energy.

[8] The tariffs used for comparison purposes are the standard tariff rates for domestic credit customers excluding any discounts available for payment by direct debit, viewing bills online etc. They are based on the West Midlands gas distribution area. For feSL this will differ from the values in the figure 4, which is a representation of the maximum allow price and therefore includes PAYG and IC1.

[9] VAT rates in GB and NI are equal. Comparison of RoI and NI exclusive of VAT shows that Comparison of RoI and NI exclusive of VAT shows that NI is 20% cheaper that Bord Gais in RoI. Exchange rates as of 20/02/18.

Figure 5 - Comparison of average annual domestic bills (based on standard domestic credit customers with estimated usage 12,500kWh per annum including VAT)



The GB comparisons include any recent tariff change made by the Big Six energy providers

Outcome

The Utility Regulator has reviewed the maximum average price submission provided by feSL and reviewed the feSL forecasts against its own market analysis. The Utility Regulator is satisfied that it is appropriate to set a maximum average price of 139.10 pence per therm for tariff customers in the Ten Towns for one year. This represents an average increase of 6.8% in the actual tariff unit rates that feSL uses to charge domestic and small business customers in the Ten Towns.

The Utility Regulator continues to retain the flexibility to initiate a review of gas prices at any stage if it is considered to be in the interest of customers.