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

5 March 2015

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. From 1 April 2015, firmus energy (Supply) Limited (**feSL**) will operate under a price control determined by the Utility Regulator in the Ten Towns area. This is the first price control for feSL and therefore it is also the first time that the Utility Regulator will approve the maximum average price for tariff customers.

We initiated a review of the maximum average price with feSL in January 2015. The Utility Regulator has 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 review of the maximum average price has resulted in no change to the feSL tariffs for domestic and small business customers from 1 April 2015.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

feSL's domestic and small business customers in the Ten Towns area will not be impacted following this review as the price they pay for the gas they use will not change from 1 April 2015.

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

Summary

On 16th January 2015 the Utility Regulator, in conjunction with firmus energy (Supply) Limited (**feSL**), the Department of Trade, Enterprise and Investment (**DETI**) and the Consumer Council began a review of the feSL maximum average price for domestic and small business customers using less than 25,000 therms per annum. This is the first regulated price review for feSL as explained further in the Background section of this paper below. The review is a formal process agreed by feSL, DETI 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.

Following this initial review, we will now be carrying 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.

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.

This review of the feSL maximum average price has resulted in no change to the feSL tariffs from 1 April 2015. This was based on a maximum average price modelled and forecast over a period of 12 months.

We will complete another formal review of the maximum average price in advance of October 2015. We will also monitor the cost of wholesale gas on the forward curve, along with the forward purchases that feSL secures in advance to identify if an additional review is required before then.

[1] Final Determination on Price Control for firmus energy (Supply) Limited covering 1 April 2015 to 31 December 2016, 15 December 2014: http://www.uregni.gov.uk/uploads/publications/2014-12-15_Supply_Price_Control_final_determination.pdf

Background

In Northern Ireland there are two distinct distribution areas for natural gas. These are the Ten Towns area and the Greater Belfast area. firmus energy (Distribution) Limited (**feDL**) owns and operates the distribution network in the Ten Towns area while Phoenix Natural Gas Limited owns and operates the distribution network in the Greater Belfast 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. 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 business customers. From 1 April 2015 therefore, the supply market in the Ten Towns area will be open to competition from new entrant suppliers in all customer sectors. feSL currently supply just over 25,000 domestic and small business customers (referred to as tariff customers) in this area.

During the period of exclusivity supply costs were determined as part of the Distribution price control and as a result the Utility Regulator did not have a role in approving the feSL tariff. However, now that the exclusivity period has ended, 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 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" (Condition 2.4)*[2]

In December 2015 the Utility Regulator published its final determination[1] on the first price control for feSL applicable from 1 April 2015 to 31 December 2016. We determined that a price control was necessary as we did not consider that competition in the Ten Towns market will be sufficiently effective to protect customers from 1 April 2015.

The price control determination sets out feSL's allowed costs and how each of the costs will be treated in the maximum average price.

[2] feSL Licence for the supply of gas: http://www.uregni.gov.uk/uploads/licenses/2014-03-28_BGE_-_Supply_Licence_TenTowns.pdf

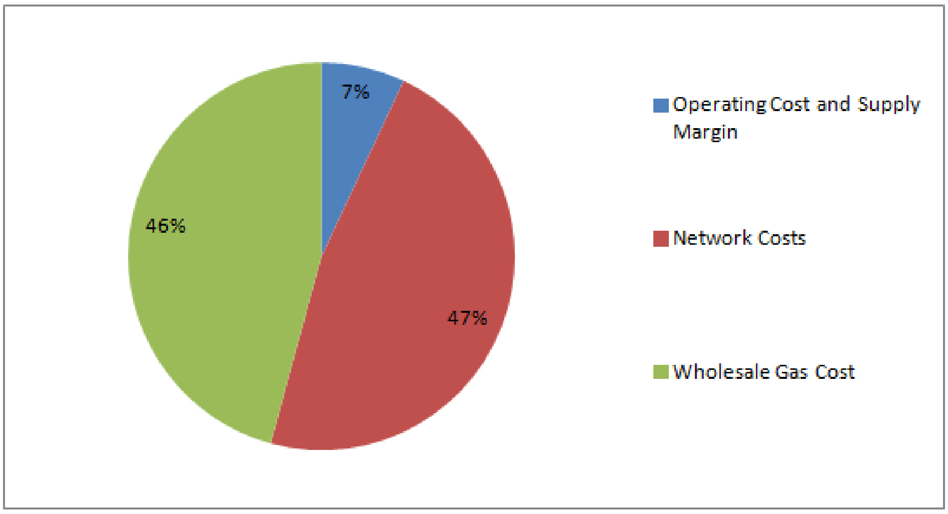
Elements of Maximum Average Price

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

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

The breakdown is shown in figure 1 below.

Figure 1 - Makeup of the maximum average price



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.

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, salaries, 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 1.5% of allowable turnover from tariff customers.

The current price control determination[1] runs from 1 April 2015 to 31 December 2016.

Network Costs

Network costs cover the charges for the use of the Northern Ireland transmission and distribution systems and are common across all suppliers within the Ten Towns. These charges are reviewed and approved by the Utility Regulator. 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. These costs are published on the Gas Networks Ireland website at http://www.gasnetworks.ie/en-IE/Gas-Industry/Northern-Ireland/Transportation-services/Postalised-Tariffs/.

The costs for the distribution system are those costs associated with moving gas throughout the Ten Towns area to homes and businesses. These can be found on the feDL website at http://www.firmusenergy.co.uk/about_us.aspx?dataid=507590.

For the purpose of setting a maximum average price from 1 April 2015, forecast estimates for these network costs have been used from October 2015 for transmission costs and from January 2016 for distribution costs. This is due to the fact that the current published transmission and distribution charges expire on the 30 September 2015 and 31 December 2015 respectively. Forecasts have therefore been assumed for these elements in the absence of actual costs.

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 from 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 some of their forecast 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.

Wholesale gas costs make up a large compoment of the maximum average price and as these costs can be volatile we need to consider 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 turn out to be less than was forecast in the maximum average price, feSL will 'over recover' and will subsequently refund the over recovered difference to customers in the following tariff periods. Or, where the wholesale gas costs turn out to be higher than forecast in the maximum average price, feSL will 'under recover' and 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. 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.

As this is the first regulated price review for feSL there is no historic over or under recovery to be included in the maximum average price. However going forward when each maximum average price is set it will include an amount of over or under recovery which was accumulated during previous tariff periods.

Both feSL and the Utility Regulator will 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.

Why is there no change to feSL's Tariffs?

As mentioned previously this is the first time that the Utility Regulator has approved a maximum average price for feSL. From 1 April 2015, the maximum average price for feSL's tariff customers in the Ten Towns area will be 130.85 pence per therm. This represents no change to the current tariffs which have been effective since October 2013 in the Ten Towns area.

The reason for no change in the feSL tariffs is explained below.

- ### *Decrease in Wholesale Gas Cost*

Wholesale gas costs on the forward curve have fallen over the last number of months. This means that the forecast cost of wholesale gas included in the April 2015 maximum average price is lower than the cost that feSL included in their previous tariff when it was set by feSL in October 2013. feSL employs a hedging strategy to purchase some of their gas in advance of the month, therefore the impact of falling wholesale prices takes longer to be reflected in the actual gas cost, but it reduces the impact of volatility in wholesale gas prices on the tariff. We note that during February 2015 the forward curve did start to show increases in gas costs highlighting the unpredictability of gas prices.

It is important to remember that gas prices included within the tariff are a forecast cost and the actual prices may be higher or lower. As mentioned earlier if the actual gas prices turn out to be lower than those forecast in the maximum average price then feSL will over recover, and if actual gas prices turn out to be higher than those forecast in the maximum average price then feSL will under recover. Any over or under recoveries will then be returned to customers or recovered from customers in the next tariff period.

- ### *Increase in Network Charges*

Although there has been a decrease in the cost of wholesale gas, this has been offset by the increase in network charges within the maximum average price.

There are two elements to network charges, distribution network charges and transmission network charges. Transmission charges have increased slightly compared to the charges at the time firmus set their tariff in October 2013, however distribution charges have increased substantially as detailed here.

feDL set the distribution charges in the Ten Towns area and these are approved by the Utility Regulator. Since feDL commenced operations their distribution charges have been set at a level that was lower than the required revenue. This was to ensure gas was competitive against alternative fuels to encourage customers to connect to gas and build the customer base. However the result is that feDL have built up an under recovery in relation to their distribution charges. Customers in the Ten Towns have therefore been benefitting to date from tariffs which have been lowered as a result of feDL not charging full distribution charges. The GD14 price control for Northern Ireland's Gas Distribution Networks sets out more detail on this subject[3].

Over the last number of years feDL has started to increase their distribution charges in order to start to recover the under recoveries that had built up previously. The feSL price control determined that network charges would be a pass through cost, meaning that customers would pay for the actual cost of the charges. Therefore the network charges element of the April 2015 maximum average price is substantially more than the equivalent charges at the time feSL set their tariff in October 2013.

- ***Summary***

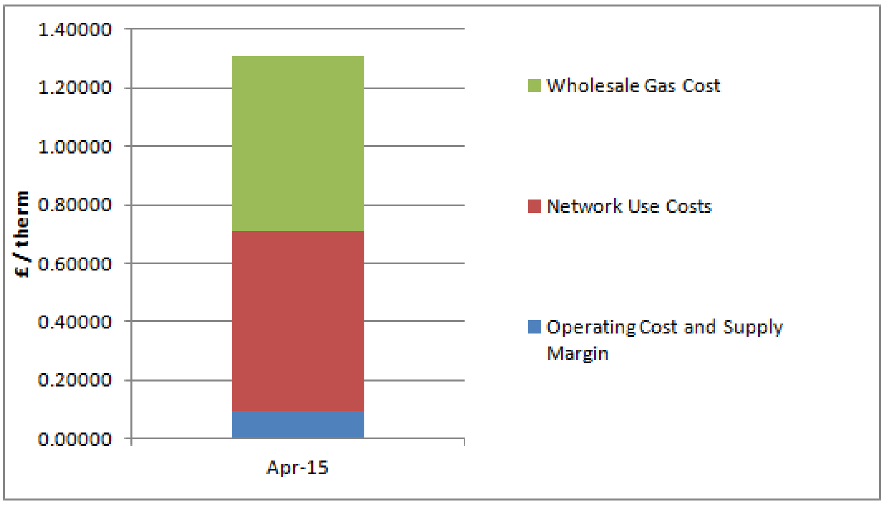
As explained above gas prices have fallen and this would result in a decrease to the tariff for that specific element in isolation. However the increase in the distribution charges in the maximum average price counterbalances the decrease in gas costs and as a result there will no change from 1 April 2015.

[3] GD14 Price Control for Northern Ireland's Gs Distribution Networks for 2014-2016 GD14 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

Breakdown of Tariff

Figure 2 below shows the breakdown of the feSL maximum average price which will come into effect from 1 April 2015.

Figure 2 – Breakdown of April 2015 maximum average price



As explained previously, customer tariffs in the Ten Towns will not change from 1 April 2015 as a result of the maximum average price that has been approved.

Comparison with GB and Ireland

Figure 3 below, shows the average annual bill of a domestic customer for feSL in the Ten Towns compared to the "Big 6"[4] supply companies in GB, Bord Gais in Ireland and SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) in NI.

This comparison is based on the latest available information on the standard domestic credit tariffs[5] 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 13,500 kWh[6]. This graph takes account of any tariff changes for supply companies in NI, GB and Ireland which have been published, even if the tariff change has not yet taken effect.

This graph illustrates that the feSL tariff for an average domestic credit customer in the Ten Towns area will be over 3% cheaper than the GB average standard tariff, even after the reductions in GB have taken effect.

Figure 3 - Comparison of average annual domestic bills (based on standard domestic credit customers with estimated usage 13,500 kWh per annum including VAT)

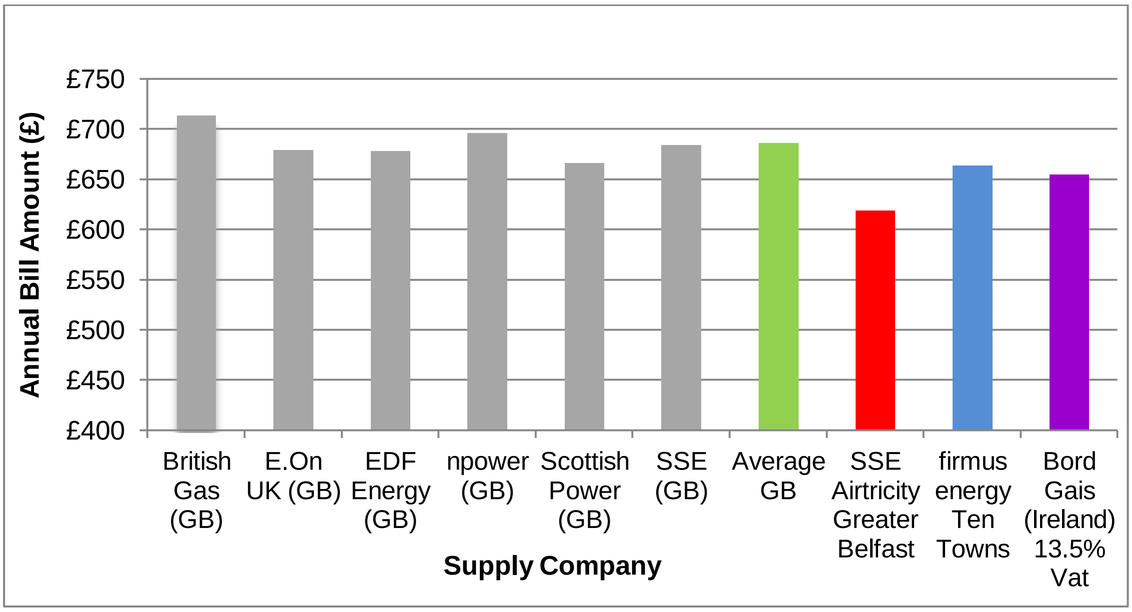


Figure 4 below shows a historic comparison of feSL's domestic annual bill amount against SSE Airtricity in NI, the average of the Big 6 suppliers in GB and Bord Gais in Ireland. The comparison uses the standard credit tariffs for domestic customers and assumes average annual consumption of 13,500 kWh. The graph shows that for more than three years, the average annual bill for a feSL customer in the Ten Towns has been

4 The Big 6 companies are British Gas, SSE, Scottish Power, npower, E.on UK and EDF Energy.

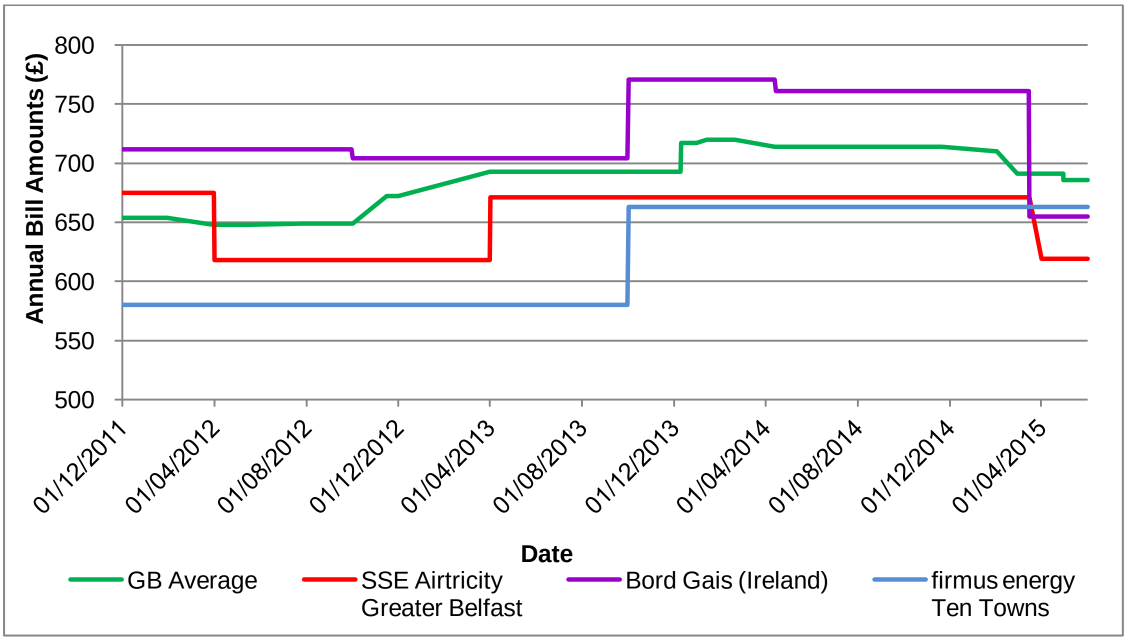
5 The tariffs used for comparison purposes are the standard tariff rates for domestic credit customers excluding any discounts available for payment by direct debit, viewing bills online etc.

6 13,500 annual usage estimate is based on the figure published by Ofgem in their Decision: New typical domestic consumption values, 13 September 2013: https://www.ofgem.gov.uk/ofgem-publications/86691/tdcvdecisionletterfinal2.pdf

lower than the equivalent annual bills for other suppliers in NI, the average of the Big 6 suppliers in GB and Bord Gais in Ireland. The annual bill for a feSL customer in Ten Towns will continue to be lower than the equivalent in GB, despite each of the GB suppliers decreasing their tariffs.

Each of the Big 6 Suppliers in GB has announced tariff decreases which are due to take effect between 13 January 2015 and 30 April 2015. These decreases range from 1.3% to 5%. For comparison purposes, all of these decreases are all reflected in the graph. Bord Gais in Ireland announced a decrease of 3.5% to its gas tariffs from 16 March 2015. This decrease has been included in this graph but is displayed as a much larger decrease. This is due to the changes in the exchange rate because for the purposes of this tariff comparison we convert the Bord Gais tariff from euro to pound sterling using the exchange rate applicable at the date of each tariff change (or as close to the date as possible).

Figure 4 - Historic Comparison of average annual domestic bills (based on standard domestic credit customers with estimated usage 13,500 kWh per annum including VAT)



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 130.85 pence per therm for tariff customers in the Ten Towns for one year. This will not have any impact on the tariffs for domestic or 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.