Response to the SPC17 Draft Determination

August 2016

Table of Contents

Executive Summary

Firmus energy welcomes the opportunity to respond to the consultation on the Utility Regulator's Supply Price Control 2017 - 2019 ("SPC17") Price Control Draft Determination and looks forward to continuing productive dialogue prior to the Final Determination in November 2016.

This response is structured to acknowledge the common ground between firmus energy Supply and the Utility Regulator where it exists, and provide evidence relating to the areas which we believe require further Utility Regulator engagement.

Firmus energy Supply's Approach

Firmus energy Supply provided cost forecasts related to all its business activities for assessment by the Utility Regulator. For many of those activities the Utility Regulator has accepted our forecasts and we have welcomed that within this response.

We also deal with any divergent views from a regulatory perspective regarding our Business Plan submission and provide further evidence. In doing so we provide additional information and propose realistic alternatives where we believe the Draft Determination creates challenges which will adversely affect firmus energy Supply's ability to run its business in an efficient and cost effective manner, to the benefit of its customers.

We do so by addressing the three primary areas of focus; manpower, operating costs and billing costs in turn before providing detailed comment on the Utility Regulator's proposals in relation to margin.

Overview of firmus energy submission compared to the Utility Regulator Draft Determination

	FE Submission	UR determination	
TOTAL SPC17 Costs	**2017 - 2019 Annual Average £ '000s**	**2017 - 2019 Annual Average £ '000s**	**Difference between FE submission and UR DD**
Manpower Costs	897	778	-120
Operational Costs	650	513	-137
Billing Costs	879	810	-69
Total SPC17 Costs	**2,426**	**2,101**	**-326**

Manpower

As part of our initial SPC17 submission, we provided a detailed breakdown of the 19.3 full time equivalent (FTE) employees that are necessary to run the Ten Towns Supply business (regulated and non-regulated) for 2017-2019. The manpower section of this document addresses the reduction applied to this manpower allowance despite a forecasted 40% growth in customer numbers during the SPC17 period.

Operating Costs

Overall the operational allowances proposed within the draft determination are 21% lower than the firmus energy submission.

The difference between firmus energy Supply's submission and the Utility Regulator's proposed costs within the draft determination is largely explained by reductions to advertising costs and a revised approach to cost apportionment for provision of a new billing system. We have highlighted the necessity to reconsider these advertising costs reductions.

Billing Costs

The average annual Draft Determination Billing Cost allowances are £69k or 8% lower than the firmus energy submission. The difference between the firmus energy Supply submission and Utility Regulator's Draft Determination primarily relates to meter reading costs and bad debt provision.

This response also evidences the impact company size, scale and network sparsity have on firmus energy Supply's ability to further reduce meter reading costs.

Within this response document we provide further evidence regarding the impact on bad debt of the anticipated increase in customer numbers using credit meters.

Margin

Firmus energy Supply welcomes recognition by the Utility Regulator that a margin of 1.5% was not adequate for the Northern Ireland gas supply market. However, we believe there remain factors, not fully explored by the Utility Regulator, which demonstrate that 2% is not an adequate margin for firmus energy Supply.

Since opening to full competition 16 months ago, no other supplier has entered the Ten Towns domestic gas supply market. There is clearly no incentive for other suppliers to enter the residential market and this must be attributed to the combination of small market size restricting the opportunity for scale benefits, opex efficiencies and therefore margin. The unappealing nature of the market is further evidenced by the firmus energy Ten Towns Supply Regulatory accounts, submitted to the Utility Regulator, which demonstrate that despite our status as the incumbent supplier we made a net loss in 2015.

Given these facts, it is clear that if operating cost allowances continue to be rigidly overseen, thus providing little potential for efficiencies, then the Utility Regulator should consider a higher regulated margin. Particularly given the European obligations to promote competition, further explored in chapter 4 of this document.

Furthermore, there are significant challenges resulting from comparing firmus energy to Great Britain especially when suppliers in Great Britain earn significantly higher margins. In addition, there remains doubt on the suitability of comparisons with Northern Ireland energy suppliers. In particular the Draft Determination states: *"It was noted during that review and in previous reviews that Power NI would have a higher capital commitment relative to turnover than price-regulated gas supply businesses,*

because the payment terms in the electricity wholesale market are more frequent and at closer intervals than in the gas market."

While we recognise the particular pressures upon Power NI, we note that the small scale of our business, as noted in the above comments on benchmarking, creates similar collateral and working capital requirements for firmus energy Supply.

We address these issues in detail in chapter 4.

Benchmarking of Costs

For many aspects of the three primary areas of focus, (manpower, operating costs and billing costs) the Utility Regulator has proposed allowances by benchmarking firmus energy Supply costs against other energy supply companies, notably for meter reading, information technology, advertising and network maintenance.

There are some very significant differences between the Ten Towns network area, the Greater Belfast network area and network areas in Great Britain which impact on the activities of gas supply companies and therefore cannot be ignored when undertaking any benchmarking exercise.

Further analysis of these issues, notably in relation to meter reading costs, can be found in chapter 3.

1. Manpower

	FE Submission	UR determination	
Manpower Costs	**2017 - 2019 Annual Average £ '000s**	**2017 - 2019 Annual Average £ '000s**	**Difference between FE submission and UR DD**
Manpower Costs	821	739	-83
Staff and Client Engagement	23	3	-20
Travel and Subsistence	25	13	-12
Training	16	11	-5
Recruitment Costs	12	12	0
Total SPC17 Manpower Costs	**897**	**778**	**-120**

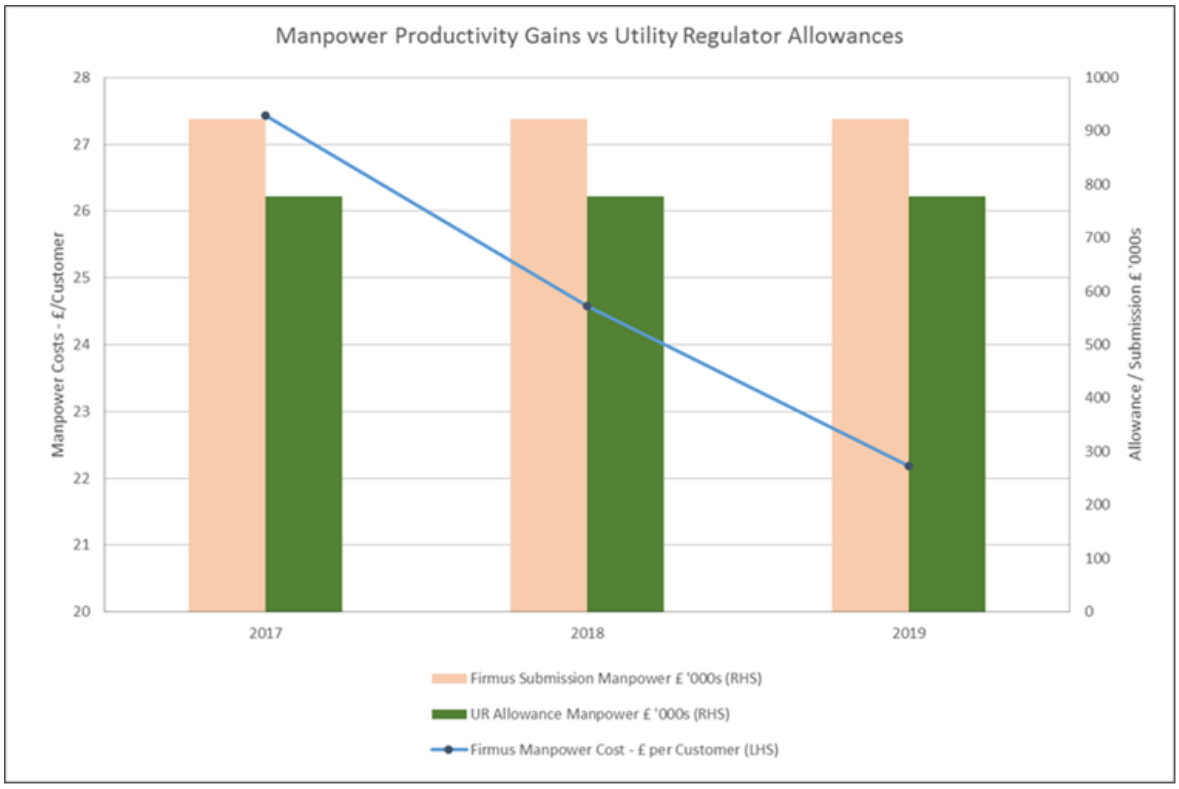
1.1. Manpower Costs

As part of our SPC17 submission, we provided a detailed breakdown of the 19.3 FTE employees that are necessary to run the complete Ten Towns Supply business for 2017-2019 (regulated and non-regulated). These FTEs have been accepted by the Utility Regulator with the exception of certain sales and marketing employees all of which were classed within the Draft Determination as working on non-tariff sector activities. The result of this determination is that firmus energy Supply's tariff FTEs have been reduced by 0.98 FTEs, which we do not believe to be justified.

In addition, it should be noted that our submission contained significant in-built productivity gains and for this reason we requested no additional staff over the price control period. These productivity gains will continue to rise throughout the SPC17 period given the projected growth in customer numbers of 40% by the end of 2019.

Figure 1.1 shows the manpower efficiencies of firmus energy Supply as the customer numbers increase over the price control period. The manpower cost per customer falls significantly from £27.40 per customer in 2017 to £22.20 per customer in 2019. This highlights firmus energy Supply's commitment to productivity gains and emphasises the need for efficiency in a competitive market place.

Figure 1.1 Manpower Allowances versus Customer Increases and Productivity Gains



The following tables show the breakdown of the specific firmus energy Supply personnel allocated to Ten Towns Supply that the Draft Determination proposes have non-tariff contribution only.

	FTEs		
FESL Submission SPC17	Tariff	Non Tariff	Total Ten Towns Supply
Director of Sales	0.25	0.25	0.50
Key Account Manager	0.15	0.60	0.75
Marketing Campaign Specialist	0.14	0.01	0.15
Marketing Manager	0.14	0.01	0.15
Online Marketing Specialist	0.14	0.01	0.15
Senior Key Account Manager	0.15	0.60	0.75
Total	**0.98**	**1.47**	**2.45**

	FTEs		
Utility Regulator Draft Determination SPC17	**Tariff**	**Non Tariff**	**Total Ten Towns Supply**
Director of Sales	**0.00**	0.25	0.25
Key Account Manager	**0.00**	0.60	0.60
Marketing Campaign Specialist	**0.00**	0.01	0.01
Marketing Manager	**0.00**	0.01	0.01
Online Marketing Specialist	**0.00**	0.01	0.01
Senior Key Account Manager	**0.00**	0.60	0.60
Total	**0.00**	**1.47**	**1.47**

As shown in the tables above firmus energy Supply has submitted conservative Ten Towns Supply allocations to various sales and marketing staff that are currently being disallowed by the Utility Regulator. It is our opinion that the job descriptions and roles of these staff should merit specific allocation to the Ten Towns Supply tariff sector.

Director of Sales

Given the overarching responsibility for managing various customer service advisors and staff whom the Utility Regulator accepted as being in the tariff sector, it is a rational assumption that the Director of Sales must also have an allocation to the tariff sector. We believe this to be 0.25 FTE.

Key Account / Senior Key Account Managers (KAMs)

KAMs look after larger I&C contract customers and also the requirements of large tariff SMEs. Furthermore, many large I&C customers have tariff meters within their locations and the KAMs will be responsible for any supply issues that arise from these tariff meterpoints. The KAMs also establish and validate commercial customers' Annual Quantity (AQ) determination values, in particular those customers that burn at around the tariff/contract volume threshold (20-30k therms per annum). The KAM will be obliged to liaise with and advise customers that they may (after the AQ determination) be required to leave the tariff regime and become a contract customer, or vice versa.

Marketing Campaign Specialist

This role is responsible for the coordination, design and publication of all Ten Towns Supply customer information literature, including but not limited to: bi-annual tariff letters, notices, tariff matrices, safety leaflets, welcome packs, energy saving advice leaflets, firmuscare leaflets, Terms and Conditions and Supply Codes of Practice. As these materials and publications relate directly to tariff customers we consider it is reasonable to allocate a proportion of that staff member's time and FTE to the Ten Towns tariff sector. Thus we believe the 0.14 FTE to be an accurate allocation.

Marketing Manager

The tariff elements of the work streams in connection with the Online Marketing Specialist and Marketing Campaign Specialist are finalised and overseen by the Marketing Manager. In addition the Marketing Manager is responsible for the Ten Towns Supply Public Relations and the Ten Towns every day media requirements. Similarly to the Director of Sales, staff allocated to tariff who are under the supervision of the Marketing Manager ultimately supports this role having allocation to the tariff sector. Thus we believe the 0.14 FTE to be an accurate allocation.

Online Marketing Specialist

Customer information must also be made available on our website and the Online Marketing Specialist ensures that all supply sections of the website are up-to-date, contain the correct and relevant supply publications and are compliant with statutory and regulatory requirements. The online specialist also ensures the smooth running of the supply sections of our website, co-ordinate the creative website

design, website technicians and project manage any website changes, glitches or technical issues that arise. Thus we believe the 0.14 FTE to be an accurate allocation.

1.2. Average Salary

In calculating the manpower allowances for the tariff sector in the Ten Towns, the Utility Regulator has used the 2014 actual costs as the basis for the average salary for each FTE. We believe it would be more appropriate to use 2015 costs as this is the most recent actualised salary information available. By using 2014 actuals for the average FTE cost, the Utility Regulator is further penalising firmus energy Supply in addition to its proposed tariff 0.98 FTE reduction. Indeed the result of using 2014 actuals instead of 2015 actual costs is the equivalent of a further 0.8 FTEs being removed from our submission. This is detailed below.

The result is as follows:

Average Cost of FTE - feSL Submission vs UR Draft Determination

(£ 2015 Prices)	Tariff FTEs	Average Cost Tariff FTE (2015 actual)
FESL Submission SPC17	12.7	£38,120

(£ 2015 Prices)	Tariff FTEs	Average Cost Tariff FTE (2014 actual)
Utility Regulator Draft Determination SPC17	11.7	£35,624

(£ 2015 Prices)	Tariff FTEs	Average Cost Tariff FTE (2015 actual)
Equivalent UR Draft Determination using 2015 average FTE costs	10.9	£38,120

The tables above show that by using 2014 costs the Utility Regulator has effectively reduced our allowance by 1.8 FTEs or 14%. Therefore, given our proposed increase in customers and our commitment to staff efficiency and productivity gain over the price control period, we believe this reduction is inappropriate for a small, developing market.

1.3. Staff and Client Engagement

Firmus energy welcomes the continued allowance of £150 per FTE as per HRMC guidelines and in line with our original submission. In addition to this we have also submitted costs (£20k per annum) in relation to client engagement, which we deem to be an essential element of operating in a competitive retail market, particularly with the IC1 and IC2 commercial sectors. Firmus energy continues to provide its clients with exceptional customer service and achieves this through extensive client engagement. This means engaging with customers to facilitate their needs whilst simultaneously ensuring their

energy supplier service expectations are met. An additional benefit of successful client engagement is that the process and resulting word-of-mouth will highlight the financial and environmental benefits of natural gas. This will promote further switches to natural gas, thereby assisting in the expansion and development of the gas industry throughout Northern Ireland.

1.4. Travel and Subsistence

As noted in paragraph 3.1.2 of this submission, firmus energy Supply holds concerns as to the impact of network sparsity and scale upon costs for activities undertaken within the Ten Towns network and we would welcome the opportunity to discuss this issue further with the Utility Regulator. The rate for travel and subsistence should reflect the different geographical spread of the Ten Towns network as compared to SSE Airtricity in Greater Belfast. The draft determination currently only allows for £710 per person, which reflects the allowance awarded to SSE Airtricity. Firmus energy considers it to be inappropriate for travel and subsistence allowances to be calculated using direct benchmarking and alignment to SSE Airtricity.

1.5. Training

The Utility Regulator has approved £25k of firmus energy's training costs, which included professional subscriptions, but reallocated them to the Legal and Professional Fees. Furthermore the Utility Regulator has approved an allowance of approximately £612 per FTE for training costs in line with the SSE Airtricity allowance. Firmus energy Supply accepts that geographical differences between the Ten Towns and Greater Belfast Networks do not have direct relevance to training costs and as a result accept the alignment of the firmus energy Supply and SSE Airtricity allowances proposed by the Utility Regulator.

1.6. Recruitment Costs

We welcome the Utility Regulator's approval of our recruitment costs.

2. Operating Costs

Operational Costs	FE Submission 2017 - 2019 Annual Average £ '000s	UR determination 2017 - 2019 Annual Average £ '000s	Difference between FE submission and UR DD
Advertising / Customer Information	88	18	-70
IT incl. New Billing System Capex	223	183	-40
Call Centre	30	17	-13
Office Costs	69	58	-11
Network Maintenance	118	117	-2
Rates	6	5	-1
Professional & Legal Fees	82	82	0
Insurance	31	31	0
Licence Fee	2	2	0
Total SPC17 Operational Costs	**650**	**513**	**-137**

2.1. Advertising and Customer Information

As a Supply business firmus energy Supply has specific requirements to provide certain information to existing customers. Unfortunately however, a significant proportion of the costs submitted for this purpose were not accepted as part of the Utility Regulator's Draft Determination.

Therefore we have provided further evidence, in the relation to our submitted costs for advertising and customer information, to demonstrate that these forecast costs will not be used for the purposes of attracting new customers or retaining existing customers. Instead, as the below paragraphs outline, most of firmus energy Supply's SPC17 submitted advertising costs reflect the costs necessary for the provision of information and service standards to our growing customer base.

In addition to the current information provision requirements, we note the increase in customer information obligations for suppliers that will arise from the implementation of an Energy Theft Code of Practice for the industry (see paragraph 5.6). The Draft Code, currently subject to consultation, states in paragraph 3.3.

"As a means of deterring gas theft, DNOs and gas suppliers should proactively engage with and educate customers, the general public and staff on the dangers and consequences of gas theft and interference with gas equipment..."

Such obligations to engage and educate consumers may result in additional costs for energy suppliers. Therefore, it is important that the Utility Regulator considers these costs when proposing the advertising and customer information allowances in the Final Determination. This will ensure firmus energy can comply with the Energy Theft Code of Practice if enacted.

2.1.1. Breakdown of SPC17 Advertising Submission

Firmus energy Supply submitted advertising costs within its Business Plan that relate solely to customer information provision. These are costs required in order to ensure the provision of information to customers as required under the terms of our Supply Licence.

Below is a breakdown of our average annual submission and commentary to substantiate their inclusion within our Business Plan. We believe these costs are a necessary inclusion within the Utility Regulator's allowances.

firmus energy SPC17 Submission Advertising Cost Elements	firmus energy Average Annual Cost £k
Website	27.3
Advertsing (Customer Information)	18.7
Sponsorship	27.8
Market Research	11.3
Corporate Events	2.9
Total Annual Average	**88.0**

2.1.2. Website - Information Technology

The Utility Regulator has proposed to approve an allowance in 2017 for website separation. However, there is no website allowance in 2018/2019.

Firmus energy Supply notes the statement contained within paragraph 7.3.38 of the Draft Determination;

"We propose the website development costs are allowed in 2017 only as firmus have failed to evidence why these costs would be ongoing for the duration of the price control."

Following further engagement with the Utility Regulator we have offered additional explanation outlining that these costs include an on-going website management and development cost. Therefore following further guidance we have resubmitted specific costs relating to these functions to the Utility Regulator under a more appropriate cost line (IT). This is explained in further detail in the IT section, paragraph 2.2.

2.1.3. Advertising (Customer Information)

The Utility Regulator has proposed to exclude these costs. The average annual cost submitted was £18k.

These costs were submitted as "advertising costs" in our original submission. However, these relate to customer information provision, as required in our licence. The costs are further explained below:

2.1.3.1. Design costs retainer

All customer information documentation and collateral documentation require graphic design. As recognised by the Utility Regulator during the recent Codes of Practice update process during which uniform design for documentation was a Utility Regulator stipulation prior to regulatory approval.

Other examples of information that incurs design costs include customer bills, statements, welcome packs, firmuscare information, terms and conditions booklets and tariff review notices.

Examples of documents held in collateral are meter reading advice to customers, billing advice to customers and firmuscare information. We have apportioned our total design costs retainer into Ten Towns Supply, Greater Belfast Supply and Distribution. The result is that we request the Utility Regulator to include an allowance of £16,800 per annum as advertising/customer information allowances. This is based on 2015 actual apportionment of £1,400 per month retainer for Ten Towns Supply only.

2.1.3.2. Agency Retainer

Firmus energy Supply has certain requirements relating to stakeholder and media engagement. To ensure 24/7 cover for media and stakeholder engagement, firmus energy Supply employs the services of a public relations agency (DCP Strategic Communication Ltd) on a retainer basis, as the most cost-effective way of fulfilling this requirement.

The most essential work the public relations agency undertakes on our behalf includes media engagement relating to emergencies and gas escapes. However the agency also undertakes important stakeholder engagement functions on our behalf including facilitation of presentations to local councils and customer evenings for communities when natural gas comes to new areas (split 80% Distribution 20% Supply), Ten Towns Business Press and the media management related to firmus energy Corporate Social Responsibility community events. The result is that we request the Utility Regulator include an allowance of £10,200 per annum as an agency retainer allowance. This is based on 2015 actual apportionment of £2,000 per month retainer for Belfast and Ten Towns Supply, which is further apportioned based on customer numbers.

2.1.4. Sponsorship

The Utility Regulator has proposed to cut all Sponsorship costs. Our annual average submission over the price control period was £27k, a nominal amount when calculated as a proportion of a customer's bill.

Sponsorship allows firmus energy to assist groups and charities throughout the Ten Towns carry out activities that benefit the social and physical well-being of all local communities. These community based health and well-being initiatives include facilitating mid-Ulster Saturday football leagues, Triathlons for children and adults in Derry/Londonderry and Newry, and the Super Seven athletics programmes and competitions for schoolchildren. These initiatives benefit thousands of people, all whilst simultaneously promoting the growth of the natural gas industry throughout Northern Ireland.

2.1.5. Market Research

The Utility Regulator has recognised that Market research and Customer research is an acceptable cost for firmus energy Supply as it will ultimately result in a net benefit for the consumer. This proposal will assist firmus energy to continue to provide first class and focussed customer service for gas customers.

2.1.6. Corporate Events

The Utility Regulator has proposed to cut all Corporate Events costs. In 2014 these amounted to £3k.

For the avoidance of doubt, this cost does not relate to corporate entertainment. Instead the submitted cost is entirely allocated to the firmus energy Supply 'Energy Briefing Morning' held annually for gas customers. This conference provides customers with information relating to the gas and oil commodity markets and the likelihood of future gas market movements through political and economic world events. In addition to this, firmus energy Supply has the opportunity at these information days to engage with clients in a bid to identify their current energy supply issues. The briefing also provides firmus energy with the opportunity to further develop the gas network and promote natural gas as being an efficient and environmentally friendly energy option for thousands of homes and businesses.

2.2. Information Technology

As part of our SPC17 submission process firmus energy Supply submitted a detailed IT business plan to the Utility Regulator. This plan included a detailed description of work and costs required to replace the outdated Integrated Utilities System (IUS) software that firmus energy Supply has used since being awarded its licence in 2005. This replacement will result in the provision of a new standalone billing system for firmus energy Supply.

We welcome the Utility Regulator's acceptance of the forecast costs.

As discussed in the advertising paragraph 2.1.2, and following engagement with the Utility Regulator, we have requested to include the day to day management of our website in the IT cost line. Eyekiller Limited is the company responsible for day to day management of the technical aspects of our website and we have reallocated their costs from the advertising costs as shown below.

Website Maintenance Costs – Supply only

Website Maintenance Costs	firmus energy 2015 actuals £
Monthly Retainer for Website maintenance	547
Monthly Activity Costs	173
Total costs per annum Supply	**8,640**

As discussed, these costs were previously posted by firmus energy Supply in the advertising accounts cost line as they relate to the website. It should be noted that from 2016 these costs will now be posted within the IT section of our accounts. The Eyekiller costs specifically relate to the day-to-day

technical management and administration of the website and are therefore more applicable to the IT cost line.

2.3. Call Centre

We welcome recognition from the Utility Regulator that our call centre costs are forecast to increase as a result of a large growth in customer numbers. The allowance provided will enable firmus energy to continue to provide and build upon the excellent customer service we offer.

2.4. Office Costs

The office costs allowances approved by the Utility Regulator have been based on 2014 actual costs. These allowances are also in line with our 2015 actual costs.

2.5. Network Maintenance

Firmus energy Supply notes that the Utility Regulator has accepted the forecast costs provided, at 2014 levels, and accepts that this will be considered retrospectively. These allowances will enable firmus energy Supply to continue to provide safety inspections for vulnerable customers and ensure the safety of tampered meters and disconnections. We would also request that other disconnection costs charged to firmus energy Supply by the Network Operator, that cannot be passed on to the specific customer, are also considered as a retrospective cost. An example of this is vacant properties where warrants are required and the resident is unknown.

2.6. Rates

Firmus energy Supply's SPC17 submission projected an increase in rates based on FTE numbers. This forecast envisaged greater office space requirements as a consequence of business growth and a subsequent requirement to increase staff numbers. The Utility Regulator has proposed to retain allowances at 2014 levels, which remain broadly aligned to our submitted annual costs. Based on the FTE allowances proposed within the Draft Determination we believe we can continue to accommodate all staff within our current office space and therefore accept the Utility Regulator's proposal to link costs directly to Land and Property Services rates.

2.7. Licence Fee and Professional and Legal Fees

We note that the Utility Regulator has accepted costs submitted for professional and legal fees including a re-allocation of £25k previously submitted under training costs. We support this re-allocation approach and also agree that the Licence Fee should continue to be treated as a pass through cost.

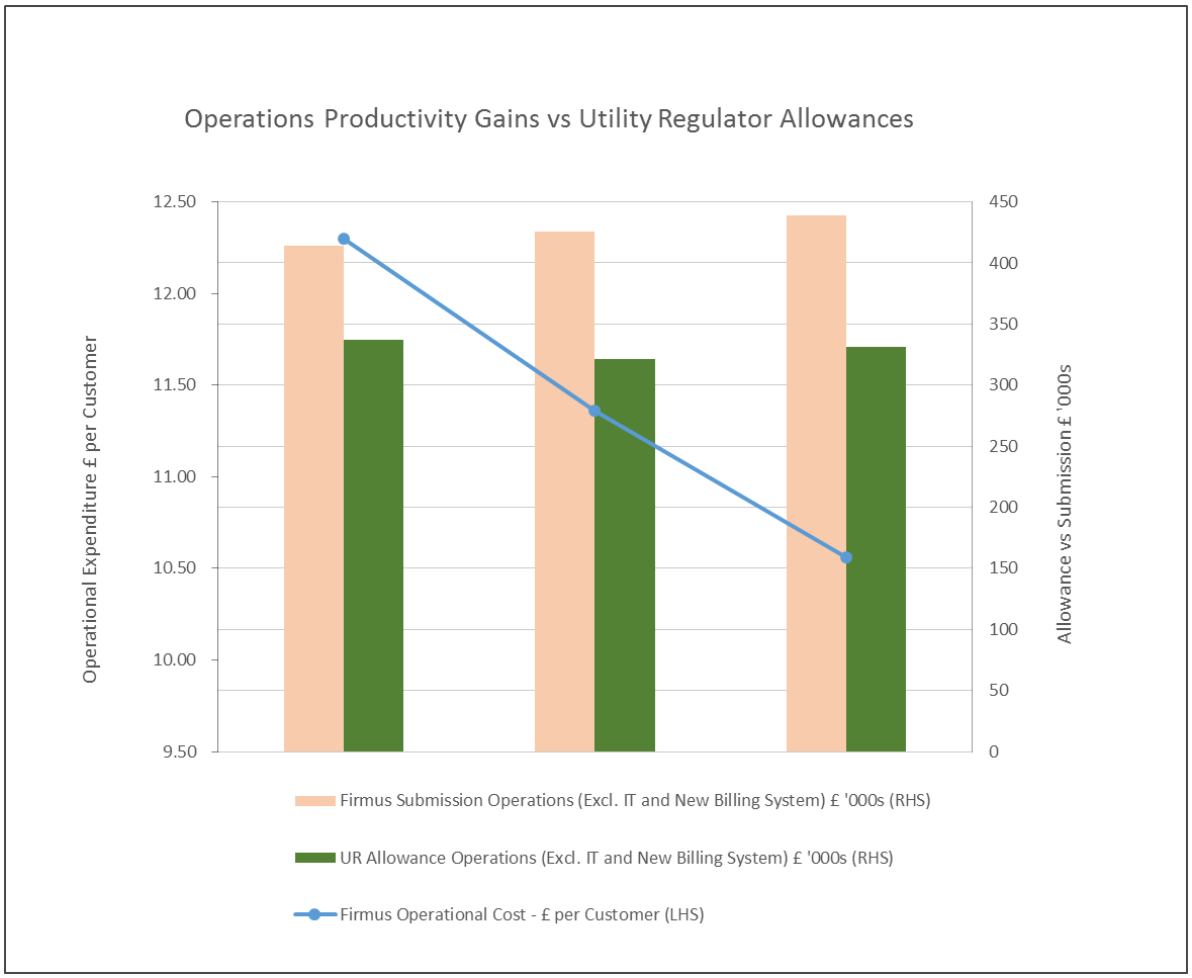
2.8. Insurance

We welcome the Utility Regulator's acceptance of the insurance costs as submitted. These were provided in detail and directly reflect the new insurance contract firmus energy Supply entered into last year following a successful re-brokering process.

2.9. Allowance, Submission and Actual Costs

Figure 2.1 below plots the operational costs (excluding IT and the new Billing System) submitted by firmus energy Supply for SPC17 against the Utility Regulator's Draft Determination allowances. The 40% increase in customer numbers forecast from 2016 - 2019 coupled with stable opex costs over 3 years, further demonstrates firmus energy's commitment to remain an efficient organisation. This is indicated on the graph by a reduction in operational expenditure from £12.30 per customer to £10.56 per customer over the price control period.

Figure 2.1



3. Billing Costs

	FE Submission	UR determination	
Billing Costs	**2017 - 2019 Annual Average £ '000s**	**2017 - 2019 Annual Average £ '000s**	**Difference between FE submission and UR DD**
Meter reading	251	203	-48
Bad debt	105	84	-21
Prepayment transaction costs	335	335	0
Customer Information Processing and Postage	156	156	0
Bank and Interest Charges	10	10	0
Prepayment Cards	8	8	0
Credit Check Costs	13	13	0
Virtual terminal	1	1	0
Total SPC17 Billing Costs	**879**	**810**	**-69**

3.1. Meter Reading

As noted in our SPC17 submission, at the outset of the 2015/16 price control firmus energy submitted unit rates as per our agreed tendered contract with a third party meter reading firm. The Utility Regulator granted allowances at these rates, however the company subsequently cancelled its contract with firmus energy Supply from 31st March 2015 as it was unable to carry out its meter reading services at the agreed rates. This forced firmus energy to re-tender for meter reading services and accept revised, but slightly higher, unit rates from another firm beginning on 1st April 2015 and continuing until April 2018.

Firmus energy Supply has a legal and regulatory obligation to read meters[1] and we have created efficiencies by training our meter readers to carry out meter inspections concurrently with meter reads. This means significant savings for customers and also increases the chance of identifying any instances of meter tampering. Should firmus energy Supply have proposed to conduct meter inspections separately from its meter reading activities, customers in the ten towns would have had been subject to huge increases in meter reading costs as bi-annual meter inspections are a Licence requirement.

Firmus energy believes that there exists the potential for improved practicality and efficiency if meter reading was to be the responsibility of the Distribution Network Operators. As such we would welcome Utility Regulator's engagement with the gas industry in order to change meter reading practice in Northern Ireland.

[1] Firmus energy notes the inclusion of a potential review of governance arrangements relating to gas metering in the Utility Regulator's work programme for 2016/17. As firmus energy believes that there exists the opportunity for improved practicality and efficiency if meter reading was to be the responsibility of the Distribution Network Operators we welcome the Utility Regulator's intention to advance this project.

Our SPC17 submission was based on the re-tendered market tested rates. Despite this the Utility Regulator has deemed firmus energy costs too high and has proposed a glide-path reduction in costs. In addition, we are concerned that this proposed cost reduction is not based on analysis that accounts for the unique nature of the network we operate within. This issue is further explored in paragraph 3.1.2. Firmus energy believes that a competitive tender is the most impartial method of obtaining pass-through meter reading rates. The results of a competitive tender reflect the market conditions at that time and given the efficiencies firmus energy Supply have demonstrated by combining meter reads with safety inspections, then it seems reasonable that our rates should be accepted by the Utility Regulator.

3.1.1. In-House Meter Reading Costs

The failure of our previous contractor highlights the cost challenges within the Ten Towns. If firmus energy cannot find an external provider the only other option available is to explore the option of bringing meter reading activities in-house. Subsequent to the Draft Determination firmus energy Supply has undertaken an exercise to scope costs to do so.

This analysis demonstrated that, as a result of reduced economies of scale achievable by firmus energy Supply against those achievable by an independent company with potentially multiple contracts, costs would increase by c. 25% if meter-reading activities were brought in-house.

The principle driver for this cost increase would be the diseconomies of scale experienced by firmus energy Supply. This is because, in order to service the Ten Towns through the employment of in-house FTEs, firmus energy would require additional headcount to ensure adequate cover for holiday periods and instances of sick leave.

3.1.2. Benchmarking - Maturity, Scale and Sparsity

As noted previously firmus energy Supply is concerned about the outworking of benchmarking on costs provided for meter reading activities undertaken within the Ten Towns network, due to the small customer numbers and the age of the network (scalability issues), and the sparsity of the network area.

When comparing the map (figure 3.1) of the licence areas, it can be clearly seen that the extent of the Ten Towns network compared to the Greater Belfast network is vastly different. The firmus energy licence area covers approximately. 5500 km^2 compared to Greater Belfast which is approximately. 550km^2, while the operational length of the Ten Towns network is 271km compared to that of Greater Belfast at approx. 45km.

Population density is also a major factor with average population densities in the Ten Towns network towns significantly lower than that of the Greater Belfast network area, confirming the fact that housing in the Ten Towns area is less dense, which has a resultant impact upon the productivity of meter readers.

The Ten Towns network is in the very early stages of development compared to the network areas in Great Britain, and Greater Belfast, where development began 10 years earlier. Due to the nature of network development to date, the Ten Towns is sparsely populated compared to the GB networks and Greater Belfast, which invariably impacts on travel times and consequently upon the average operational costs per customer.

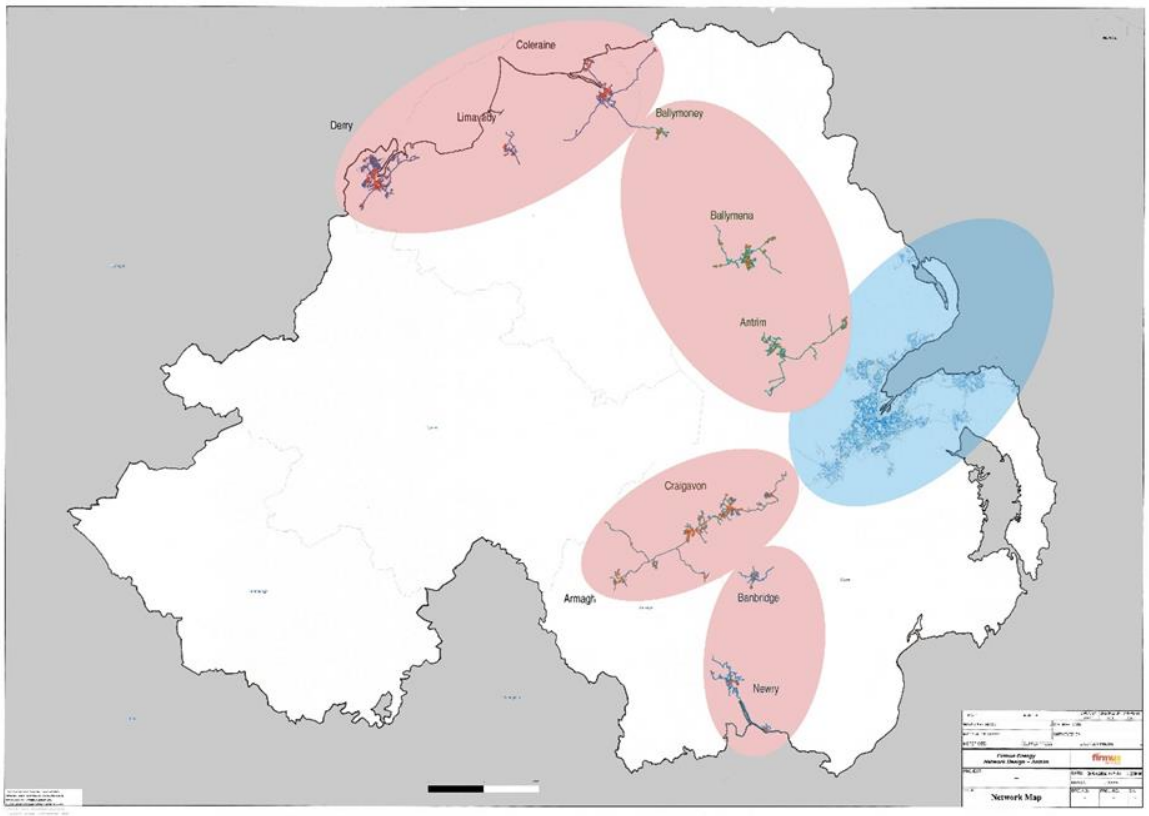
In addition, firmus energy Supply is one of the smallest incumbent supply companies with only c. 28,000 domestic customers and c. 2,500 industrial and commercial customers (I&C) in the Ten Towns Licensed Area. This is noted in the Draft Determination paragraph 2.9:

"The Ten Towns Market is a relatively small market, there are currently approximately 29,000 gas connections."

While firmus energy's Ten Towns customers benefit from some economies of scale resulting from our activity in the Greater Belfast Market, these benefits pale in comparison to the economies of scale leveraged by larger incumbent suppliers active in other network areas.

Despite this company scale differential the SPC17 Draft Determination appears to propose a higher opex allowance per therm for SSE Airtricity than that proposed for firmus energy, even though SSE Airtricity supply larger gas volumes in Greater Belfast than those supplied by firmus energy in the Ten Towns.

Figure 3.1 Meter Reading Activity Areas



The key result of the compounding effect of geographical, scale and maturity differences is reduced labour productivity resultant from additional travel times. This results in an uncontrollable increase to firmus energy Supply costs for meter reading.

As firmus energy Supply also has customers in the Greater Belfast Network Area we have been able to undertake our own benchmarking exercise in order to assess the differential in meter reading costs, between the two network areas.

This internal benchmarking of independent contractor's costs shows that costs in the Ten Towns are 14% higher than those in the Greater Belfast Area as a direct result of increased travel times for meter readers.

As a result of this firmus energy holds concerns over the Utility Regulator's application of benchmarking. We note that significant consideration of benchmarking techniques and issues to be addressed was undertaken by independent consultants on behalf of firmus energy Distribution as part of the GD17 Price Control. Of particular interest was the DNV-GL report into the impact of sparsity and scale on the weighted average daily travel time for firmus energy maintenance teams which found that inherent productivity is 15% lower as a consequence of increased travel time requirements.

Resultantly we request that the Utility Regulator undertake further assessment of the impact of sparsity, size and scale on network maintenance, travel and subsistence, and meter reading activities. This is particularly relevant when comparing the fixed cost base of the respective companies.

3.2. Bad Debt

Firmus energy Supply has an excellent record in managing bad debt and we welcome the recognition of this in paragraph 7.4.14 of the Draft Determination which states:

"firmus currently have an excellent bad debt level with the current bad debt level within the existing control at 0.2% of credit revenue."

However, firmus energy Supply is concerned as to the proposed continuation of a bad debt provision at the current level of 0.2% of credit revenue. There are two reasons for this concern, the small scale of debt provision and the plans for Distribution Network Growth which will result in a higher proportion of credit meters.

3.2.1. Scale of Debt Provision

Given the size of its business, the risk to firmus energy Supply of an adverse financial impact from individual I&C customers defaulting on payments is greater than that of suppliers with a larger customer base and revenue. Indeed firmus energy Supply estimates that the failing of just one or two SME customers (supplied as I&C tariff customers) could instantly exceed the proposed determined bad debt allowance.

3.2.2. Impact of Network Growth

As part of the GD17 network roll-out plan firmus energy Distribution will be concentrating on residential infill projects from 2017-2022 resulting in a substantial increase of domestic credit meter connections and an increase in credit meters as a proportion of total meter stock. Historically, firmus energy's bad debt levels have benefitted from the high ratio of pre-payment meters in the Ten Towns Licensed Area. However, this ratio is due to change over the next 6 years as new credit meter connections are expected to outnumber pre-payment meters. The result of this will be more bad debt attributed to domestic credit meters and as such we ask that the Utility Regulator set a bad debt allowance for firmus energy Supply at 0.25% of credit revenue. This change to the Draft Determination proposal would ensure adequate cover for firmus energy whilst continuing its excellent performance regarding debt recovery.

As discussed, firmus energy Supply has an excellent record of maintaining low bad debt levels (currently 0.2%) compared to SSE Airtricity (0.75%) and as such do not believe that our request for a level of 0.25% to be unrealistic. Further evidence of this is illustrated by firmus energy's on-going level of 90 day bad debt in the Ten Towns. This cost is a general indicator of actual bad debt and in May 2016 was approximately £73k in the Ten Towns tariff sector. To ensure a suitable provision for this bad debt firmus energy would require an allowance level of 0.8% – 1.0% of credit revenue, which is line with SSE Airtricity's allowance.

3.3. Prepayment Costs

The Utility Regulator has proposed that these charges will be retrospectively adjusted based on the actual rates charged to firmus energy Supply and the volume of activity. Firmus energy welcomes this proposal as it takes account of any change in rate over the Price Control period that may be implemented by PayPoint Ltd.

3.4. Customer Information Processing and Postage

Firmus energy Supply welcomes the Utility Regulator's proposal to allow the rates for this retrospective cost. However, we request that additional allowances for design and amendment of customer engagement materials which were previously submitted as advertising costs are accepted. We note that the Utility Regulator allowed a similar reallocation to SSE Airtricity as per paragraph 7.3.22. Details of the Draft Determination costs previously submitted under the advertising cost lines are included in the advertising paragraph 2.1.

3.5. Bank and Interest Charges

Firmus energy welcomes the Utility Regulator's decision to allow the submitted bank and interest charges.

3.6. Credit Check Costs

Firmus energy welcome that the Utility Regulator has allowed these costs in recognition of firmus energy Supply's excellent bad debt levels.

3.7. Retrospective Adjustment of Costs

Firmus energy Supply supports the retrospective adjustment of costs for SPC17 and agrees that these costs are reconciled on actual cost drivers.

3.8. Efficiency Factor

Firmus energy Supply supports the Utility Regulator's Draft Determination proposal of a 0% efficiency factor.

3.9. Apportionment of Costs

In the response to the Initial Consultation[2] we shared the detail of the apportionment methods utilised within our Supply businesses and the whole firmus energy business, which resulted in our requested tariff and non-tariff supply costs. The Utility Regulator's apportionment methodology is in most cases aligned to that of firmus energy and we have made comment on areas in which methodology differs.

[2] Firmus energy Supply SPC17 Submission 15th January 2016

4. Margin

As part of the initial engagement with the Utility Regulator in relation to SPC17 firmus energy Supply submitted a detailed proposal relating to allowed margin.

In developing this detailed margin paper we engaged assistance from specialist economic consultant Tim Keyworth and this detailed analysis resulted in an estimate of appropriate margin for our regulated retail business of between 6.0% and 7.7% over the SPC17 period.

Therefore, while firmus energy welcomes the move by the Utility Regulator to increase the margin allowed for the Supply business we believe that the Utility Regulator's draft determination does not fully consider all the factors necessitating a higher allowed margin.

As such, we request that further consideration is given to the issues outlined below, which are a reiteration and further development of the issues highlighted in our first submission which was drafted with assistance from Tim Keyworth.

The Utility Regulator has suggested that it is inappropriate to take account of the value of the existing customer base. This is in direct contradiction of the Competition Markets Authority's (CMA) findings in Great Britain, a source of precedent which the Utility Regulator has relied on in other areas. The CMA states that existing customer relationships "*meet our criteria for recognition … in that they represent a significant investment with the aim of generating revenues in the future*".

The Utility Regulator asserts that allowing prices to rise to facilitate competition, could not be to the benefit of customers. This assertion is inconsistent with European legislation and European obligations. Indeed, the Utility Regulator has independently recognised that, as well as protecting customers, it has an obligation under EU law to promote competition[3]. Therefore, a supply tariff which deliberately seeks to exclude some competitors from the market cannot be consistent with this obligation. We note that the EU energy commissioner has previously stated that "*price regulation is permitted under certain conditions, one of which is that it must not distort competition*", and the EC has made clear that below cost prices "*risk giving a false impression of protection that de-incentivizes consumers from actively exploring better options*".

We therefore request that the Utility Regulator reconsiders its approach and aligns it with both European obligations and the precedent set by the CMA following an exhaustive review of energy markets in Great Britain.

Secondly, we question the approach the Utility Regulator and its consultants have taken in estimating the cost of contingent capital.

The Utility Regulator's consultants have conceded the difficulty in estimating a cost of contingent capital. In particular, they note that "*we are not aware of any widely accepted model or tool that would enable us to price the contingent capital that sits behind FES' and Airtricity's businesses.*" Their

[3] Review of the Effectiveness of Competition in the Northern Ireland Energy Retail Market – Phase II, December 2015

report then goes on to quote two pieces of evidence suggesting a value of 2%, one suggesting a value of 2.5% (the higher end of this range being regulatory precedent set by Utility Regulator itself) and one further piece which suggests fees for contingent capital should be "*quite small*". We note that previous Northern Ireland precedent (4.5% was assumed when setting the cost of capital for Power NI) does not appear to have been taken into account.

The Utility Regulator's consultants themselves do not appear to be confident of the chosen value of 2%. Their report states that the analysis "*does not provide a definitive answer to the question. But the evidence does point clearly in the direction of a costing of around 2%.*"

The two areas of analysis which point to a value of 2% relate to:

1 **Evidence from the CMA in relation to the GB market**. In contrast to their position in relation to the historic asset base, the Utility Regulator has taken a quantitative benchmark from Great Britain without considering structural differences which might make contingent capital more expensive in Northern Ireland for potential competitors. In addition, there is no confirmation of whether the terms offered to Great Britain retailers are even commercially available to Northern Ireland companies.

2 **Evidence from firmus and Airtricity**. Firmus energy Supply stated that the basis on which we are able to secure letters of credit at this cost was through a 100% guarantee by our parent company. Hence, allowing just this value (i.e. without also allowing some cost related to the parent company guarantee) clearly understates the cost of contingent capital for one of the current competitors, let alone future entrants.

It is important that the Utility Regulator uses precedent from the CMA appropriately and with consideration of the local context and not solely to dilute margins. Similarly the Utility Regulator should not discount precedent which point to an increased margin.

We suggested in our submission that given the inevitable uncertainty regarding the robustness of key aspects of the analysis, the Utility Regulator needed to ensure that it "aimed up" in its estimation of a reasonable margin. The Utility Regulator's consultants have stated that the cost of contingent capital is inherently difficult to estimate, and yet the analysis appears to "aim down". We would suggest that the Utility Regulator revisits this area of analysis and with reference to the promotion of competition, reconsiders the Draft Determination proposal.

Thirdly, we would suggest that the Utility Regulator's analysis of Northern Ireland supply betas is incomplete. Comparing Northern Ireland and Great Britain betas, the Utility Regulator's consultants suggest that "*if anything, the two Northern Ireland suppliers are more likely to come in towards the bottom end of the range.*"

The reasons the Utility Regulator gave for moving towards the bottom of the range are debatable:

- **"FES and Airtricity both possess substantial market power"**: We presume the Utility Regulator's consultants intended to contrast Northern Ireland retailer market power to that in Great Britain. There is no analysis presented of this comparison, or discussion of how the

exercise of such market power might be manifested. If however there was more market power held by the Northern Ireland retailers, the very objective of supply price regulation is to mitigate any market power. Therefore, even if it were to exist in an unregulated market, it would be irrelevant to consider it in setting a regulatory beta. Network companies possess "substantial market power" and yet this is not taken into account in setting their beta, because network regulation acts to prevent its exercise;

- **"They also benefit from regulatory pass-through arrangements… shareholders in FES and Airtricity are exposed to less risk of cost under-recovery and consequent losses in comparison to a typical GB supplier"**: as a corollary, firmus energy Supply is also less exposed to the benefit of over-recovery. If the Utility Regulator is suggesting firmus energy Supply has a lower beta than its Great Britain counterparts, the Utility Regulator must also believe that those Great Britain counterparts are frequently able to pass through less than their efficient cost. The Utility Regulator does not provide any evidence of this, nor is it obvious that the CMA's findings on historic Great Britain profitability would support this theory.

In contrast, the Utility Regulator does not consider arguments which might put Northern Ireland retailers, and specifically firmus energy, higher in the range when compared to Great Britain companies. These include:

- competition with other fuels influencing the growth of our customer base
- exposure to a customer basis with low geographic and economic diversity; and
- exposure to the behaviour of a small number of large customers

This exposure to the behaviour of a few large customers has been clearly evidenced by the recent decisions to close two significant and substantial natural gas users in the Ten Towns area - Michelin and JTI UK (Gallaher's Ltd). The combined burn of these companies has historically been over 6 million therms of natural gas per year. This volume accounts for over 10% of the natural gas distributed in the Ten Towns Licensed Area each year, and subsequently underlines the risk that firmus energy Supply is exposed to.

Finally, we would reiterate the position set out in our submission that the approach taken by the Utility Regulator to provide for a return on capital has a number of difficulties. It involves a number of highly subjective judgements on both the volume and cost of capital required by the business, and it is based on an estimate of gas prices, which are inherently volatile. In this context, and particularly considering the objective of promoting competition, the Utility Regulator should ensure it "aims up" in setting a margin. Based on the Draft Determination, there appears to be little evidence to suggest this has been undertaken.

5. Price Control Principles and Mechanisms

5.1. Scope and duration

Given the essential requirement for a stable and predictable regulatory framework within Northern Ireland firmus energy welcomes the three year duration of the SPC17 price control.

5.2. Network Costs

Firmus energy Supply welcomes the proposal of the Utility Regulator to continue to treat network costs as pass through costs as this approach maintains agreed regulatory precedent.

5.3. The Regulated Tariff

5.3.1. Tariff Review

Firmus energy Supply recognises the clarity and transparency provided by the establishment of the formal tariff review process following our last Price Control. Consequently we welcome the retention of the process. As part of this engagement process firmus energy Supply requests the Utility Regulator to define any other potential items for reconciliation.

5.3.2. Trigger Mechanism

Firmus energy Supply recognise the requirement for the retention of a two-sided trigger mechanism, to be activated at any time between bi-annual tariff reviews by either the Utility Regulator or the company. We agree that retention of the +/-5% trigger point is appropriate to protect customers - and indeed supply companies - from volatility in the wholesale market and accept that the tariff review group should consider the volatility in the wholesale gas market, the time since last tariff review, the level of the k factor and the amount of gas purchased by the supplier alongside the wholesale cost of gas.

Firmus energy Supply note that the current timeline for the tariff review process is 11 weeks. In the eventuality of an emergency review resultant from use of the trigger mechanism, we request the opportunity to work with the Utility Regulator to reduce the timeline for such a review to 6 weeks, including the customer notification period of 21 days as required by licence. We believe this to be a reasonable timeframe which ensures continued consumer protection through retention of the consumer notification period.

5.3.3. Tariff Structure

As with all previous tariff reviews that firmus energy Supply has undertaken, we look forward to continuing to work with the Utility Regulator, Department for the Economy, and the Consumer Council in order that we can transparently demonstrate the assumptions we have used to derive our tariff structure and indeed to communicate this to customers.

Firmus energy Supply employs a flat rate and 2-tier tariff structure for its domestic customers and small commercial customers. The flat rate, used for pre-payment meters customers, is an average blended rate of the two tier structure.

Large I&C customers in the Ten Towns can further benefit from a 3-tier tariff. Tiered tariffs ensure that fixed costs are covered and the variable costs are distributed evenly and equitably to all customers.

5.3.4. k Factor

Firmus energy Supply welcomes the Utility Regulator's continued intention to retain the k Factor at a minimum level as noted in paragraph 5.15 of the Draft Determination and will work with the Utility Regulator during tariff reviews to continue this practice. This will avoid any possibility of distorting firmus energy Supply's regulated tariff and effecting the overall competitive environment across the Ten Towns Network. It will also assist firmus energy Supply in limiting requirements to secure additional finance to cover any costs of financing a k factor debt.

Continuation of the bi-annual tariff review and the trigger mechanism will help to ensure that the tariff remains close to actual costs and therefore minimises potential problems with the operation of the k Factor.

Firmus energy Supply agree with the list of retrospective cost lines outlined in the table in paragraph 5.12 of the Draft Determination for which forecasts will be included as part of the tariff. Further comment on the subsequent end of year reconciliation process is provided below.

5.3.5. Reconciliation

Firmus energy recognise the necessity for annual reconciliation of forecast costs that are allowed in the price control with the retrospectively adjusted allowed costs. We acknowledge that this reconciliation process should take into account the items outlined in Draft Determination paragraph 11.1, namely:

- Billing costs which are retrospectively adjusted
- Ring-fenced allowances
- Inflation
- Rate of interest applicable

Firmus energy would welcome further engagement with the Utility Regulator regarding the formal operational requirements that must be collectively undertaken in order to come to a common understanding. This should include the consideration of interest applicable to reconciled items.

5.4. Licence Modifications

Firmus energy welcome that the Utility Regulator has undertaken a pre-consultation process related to the Licence Modifications that will bring the SPC17 Price Control into effect.

The proposed licence modifications are intended to provide for inclusion in the licence of the price control calculations, and to permit disapplication of the Price Control condition within gas supply licences.

Firmus energy welcome the intention behind these changes, as under the current licence condition firmus energy Supply cannot seek to disapply a Price Control determination directly.

The changes are also welcome given that the Gas (Northern Ireland) Order 1996 (as amended by the Gas and Electricity Licence Modification and Appeals Regulations (Northern Ireland) 2015) now provides for the mechanism for appeal to the CMA and makes it incumbent upon companies, not the Utility Regulator, to appeal to the CMA.

Firmus energy Supply has undertaken a review of the proposed modifications to our Ten Towns Gas Supply Licence and have proposed some minor drafting changes to the Utility Regulator as part of the pre-consultation process. We intend to undertake further legal review of the proposed modifications at the consultation stage.

5.4.1. Differential in Timelines

We note that the SPC17 Price Control is to come into effect on 1st January 2017, while the licence modifications will not come into effect until a later date. We therefore sought clarification from the Utility Regulator as to the interaction between the two processes.

As a result of discussions with the Utility Regulator we understand that two separate determination processes will be undertaken. The first will be made on the basis of our existing licence and will be in place for the period until the new Licence Modifications take effect. We understand the indicative dates for this period to be 1st January 2017 to 1st April 2017. After this interim period the Licence Modifications will enact the Price Control which will be in place until 31st December 2019.

Given this complicating factor we have requested clarification from the Utility Regulator regarding the process we would use to appeal the totality of the Final Determination if required.

5.4.2. Margin Formula

As part of the pre-consultation process regarding Licence Modifications firmus energy Supply has shared our interpretation of the margin formula with the Utility Regulator as set out below in figure 5.1.

Figure 5.1 Licence Margin Calculation Formula

$$M_t = \left[\frac{(G_t+U_t+S_t+E_t+k_t)}{1-[\%]}\right] - (G_t+U_t+S_t+E_t+k_t)$$

We welcome the clarification the Utility Regulator has provided that this is the margin formula which will be adopted when the Licence Modifications are made.

5.4.3. Disapplication Process

A key element of the changes is the inclusion of disapplication for the first time in our licence. In order to have an accurate understanding of the process we have been in correspondence with the Utility Regulator as part of the Licence Modifications pre-consultation.

Key to this is confirmation of the interim arrangements following a disapplication request. In particular, we have requested clarification as to whether a company is required to set prices based on (i) the determination which is the subject of the disapplication request (ii) on the previous price control or (iii) on some other basis until a new determination is made/an appeal is refused.

5.4.4. Supplier of Last Resort (SoLR)

As part of its Draft Determination the Utility Regulator did not allow the submitted costs requested in the event of a Supplier of Last Resort being put in place. As an alternative these costs will be recovered by way of a licence modification that is still to be determined. This licence condition will also place a responsibility on the Network Operator to pay the Supplier for any reasonable costs incurred at the time of the event. The Distribution Company will then recoup those costs through its distribution network charges. Firmus energy Supply has accepted this methodology and continues to engage with industry stakeholders on these matters including finalising the SoLR Retail Development Plan.

5.5. Gas Costs

firmus energy Supply agrees that wholesale gas costs, including energy balancing allowances and trading desk management fees, should be treated as pass through costs for the duration of the price control and will continue to provide:

- the firmus energy Supply purchasing strategy
- the apportionment of costs between customer groups and firmus energy's businesses
- detailed gas purchasing information on a monthly basis; and
- full details of any over/under recoveries as part of the k factor calculation

5.5.1. Credit Costs

As per paragraph 9.7 in the Draft Determination, firmus energy welcomes the Utility Regulator's proposal to allow the credit support costs submitted. The firmus energy credit support costs were resubmitted at the request of the Utility Regulator in Information Request 3 (IR3 – Q15) and submitted 19th February 2016. Details of this submission (credit costs for the tariff sector only) are shown in the table below.

	SPC17 Tariff Only Submission			
Credit Cost	**2017**	**2018**	**2019**	**Comments**
Transmission	19,678	20,840	20,548	Increase from previous years due to new Entry Exit regime. Credit Cost calculated at 2% of required credit level.
Distribution	49,948	51,295	54,353	Costs calculated at 2% as per current Transmission credit costs. See above
Gas Purchasing	73,336	75,730	79,079	Ten Towns Tariff allocation of £25m parental guarantee
Total	**142,962**	**147,866**	**153,979**	

5.6. Energy Theft Code of Practice

Firmus energy note the July 18th 2016 publication of the Draft Energy Theft Code of Practice Consultation and request the opportunity to meet with the Utility Regulator to collectively consider the implications of, and the additional resource requirements that may result from, the proposed Code.