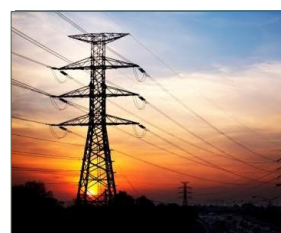


Conclusion of the Utility Regulator's Review of the SSE Airtricity Gas Supply (NI) Ltd Maximum Average Price in the Greater Belfast Area

August 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: Compliance and Network Operations, Finance and Network Assets, Wholesale, Retail and Consumer Protection and Corporate Affairs. 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 SSE Airtricity Gas Supply (NI) Limited (SSE Airtricity) is a core part of our work.

We commenced a review of the maximum average price with SSE Airtricity in August 2018. We have scrutinised the submission provided by SSE Airtricity 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 SSE Airtricity's domestic and small business customers in Greater Belfast will increase to 131.17 pence per therm from 1 October 2018. This equates to an increase of 10.9% to the bills of domestic and small business customers.

SSE Airtricity are the commissioning/default supplier within the West area and as such the UR applies a supply price control to SSE Airtricity in the West area for domestic and small business customers. The review includes the West area in the maximum average price.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

For SSE Airtricity customers in the Greater Belfast area the cost of gas they use will be 10.9% higher. This change will affect all domestic and small business customers using less than 2,500 therms per annum. The change will take effect from 1 October 2018.

The impact of the tariff change on a domestic customer on a standard credit tariff with average consumption of 12,000 kWh per annum will be an increase of £56 per annum (including VAT) on their gas bill.

Approval by the Utility Regulator of the SSE Airtricity Gas Supply (NI) Limited Maximum Average Price in the Greater Belfast area

Summary

On 6th August 2018 the Utility Regulator, in consultation with SSE Airtricity Gas Supply (NI) Limited (SSE Airtricity), the Department for the Economy (DfE) and the Consumer Council Northern Ireland (CCNI) began a review of the SSE Airtricity maximum average price for domestic and small business customers using less than 2,500 therms per annum. The current maximum average price has been effective from 1 April 2018 and covers approximately 152,000 domestic and small business customers within the Greater Belfast Area.

The Utility Regulator carries out formal reviews of the SSE Airtricity maximum average price on a bi-annual basis (in advance of April and October). The Utility Regulator can also initiate a further review of the maximum average price 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 SSE Airtricity has made to date.

We initiated the formal review to establish the new maximum average price to become effective from 1 October 2018. The review is a formal process agreed by SSE Airtricity and the UR, and includes consultation with DfE and the CCNI. It is set out within the SSE Airtricity¹ price control.

SSE Airtricity 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. SSE Airtricity cannot charge more than the maximum average price overall.

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>

The maximum average price for domestic and small business customers will be 131.17 pence per therm from 1 October 2018. 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 if required. We will complete another formal review in advance of 1 April 2019 and will continue to monitor gas prices to identify if an additional review is required.

From 1 October 2018, the unit rates of tariffs for SSE Airtricity's customers in the Greater Belfast area will increase by 10.9%. These unit rates are detailed in Table 5 of 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.

In the Greater Belfast area SSE Airtricity² has operated as the incumbent gas supplier since 1996. Only one competing supplier has been active in the domestic gas market since 2010. SSE Airtricity is still the dominant and commissioning/default supplier in the Greater Belfast area and so the UR applies a price control which covers all domestic customers and small business customers using less than 2,500 therms (73,200 kWh) per annum. The market for business customers using more than 2,500 therms is more competitive and SSE Airtricity are not in a dominant position in that market so there is no price control for that sector.

² In June 2012, Airtricity Energy Supply (Northern Ireland) Ltd purchased the entire issued share capital of Phoenix Supply Ltd and was subsequently renamed SSE Airtricity Gas Supply (NI) Limited (SSE Airtricity).

In the new gas West area, which covers amongst others the areas around Strabane and Enniskillen, SSE Airtricity are the commissioning/default supplier and as such the UR applies a supply price control to SSE Airtricity in the West area for domestic and small business customers³.

Under the terms of SSE Airtricity's licence⁴ to supply gas, the Utility Regulator ("the Authority") has the power to control the maximum amount that SSE Airtricity can charge for gas. This price control is included in SSE Airtricity's licence. Below is an extract from the SSE Airtricity licence:

Control over charges

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.

The Utility Regulator has established a price control determination which sets out SSE Airtricity's allowed costs. The price control determination sets out how each of the costs will be treated in the maximum average price.

Elements of Maximum Average Price

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

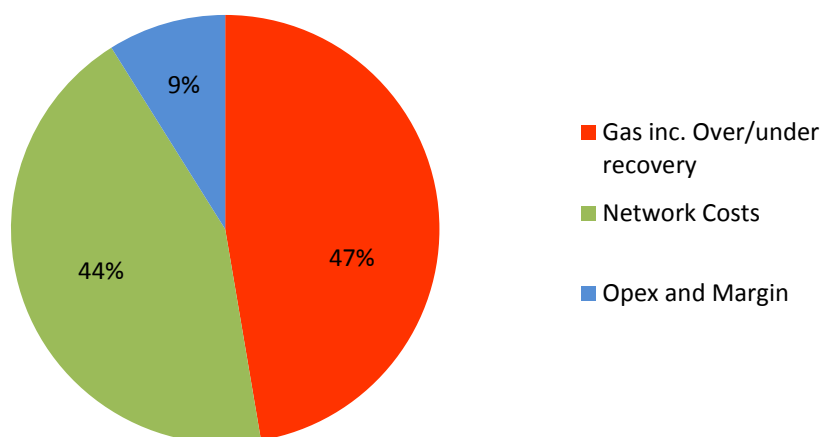
- Operating costs and supply margin;
- Network costs; and
- Wholesale cost of gas and over/under recovery from previous tariff periods.

The breakdown is shown in Figure 1 below.

³The West area is still in its infancy, with the latest UR Quarterly Transparency Report indicating only ten domestic and small business connections <https://www.uregni.gov.uk/sites/uregni/files/media-files/2018-05-31%20Transparency%20Report%20Q1%202018.pdf>

⁴ SSE Airtricity Licence for the supply of gas: <https://www.uregni.gov.uk/sites/uregni/files/media-files/2016-09-01%20SSE%20Airtricity%20Gas%20Supply%20NI%20Ltd%20%28PSL%29%20Supply%20Licence%20v2.pdf>

Figure 1 - Makeup of the maximum average price October 2018



The Utility Regulator scrutinises the costs within each of the elements of the maximum average price of SSE Airtricity's submission. SSE Airtricity uses the maximum average price to set the actual tariffs that are charged to customers. SSE Airtricity cannot charge more overall than the maximum average price.

Operating Costs and Supply Margin

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

In November 2016 we published the final determination for the SSE Airtricity price control⁵ which indicates the total amount of revenue that the Licensee can recover, in any relevant year, in respect of their gas supply businesses.

⁵ 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>

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

The price control determination⁶ runs from 1 April 2017 to 31 March 2020.

Network Costs

Network costs are the charges incurred by each supplier for their use of the Northern Ireland transmission and distribution systems. These charges are reviewed and approved by the Utility Regulator.

The SSE Airtricity price control determined that the transmission and distribution system charges will be treated as pass through charges, which means that the customer pays no more or less than 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 at <http://www.premier-transmission.com/>.

The costs for the distribution system are those costs associated with moving gas throughout the Greater Belfast area and the West 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 the period 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 was effective from 1 January 2017⁷. The distribution price control determines the amounts that PNGL

⁶ Utility Regulator Determination on Phoenix Supply Price Control 2012 – 2016, November 2011: http://www.uregni.gov.uk/uploads/publications/PSL_PC03_Determined_to_Position_Table_26_blanked_for_website2.pdf (Note that SSE Airtricity purchased Phoenix Supply Limited in June 2012)

⁷ <https://www.uregni.gov.uk/news-centre/gas-distribution-networks-price-control-gd17-period-2017-2022-published>

can charge for suppliers to use the Greater Belfast network. These can be found on the Phoenix Natural Gas website at <http://www.phoenixnaturalgas.com/help-and-advice/networks/charges/>.

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 47% of the total. Further detail on these costs is provided below.

- **Wholesale Gas Costs**

As determined within the SSE Airtricity price control, 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 cover associated with purchasing wholesale gas.

The SSE Airtricity price control determines that gas costs are treated as pass through which means that the customer pays no more or less than the actual cost of gas. Therefore where wholesale gas costs decrease or increase over those set in the tariff, the resulting savings or additional costs are passed on to the customer.

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

At the time of review, the overall cost of gas for the maximum average price is estimated based on a combination of actual gas purchases that have already been secured, along with forecast volumes of gas required, and the forecast wholesale cost of that gas which has yet to be bought (based on the gas price 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 that has yet to be purchased compared to the forecast costs that were included when the maximum average price was set.

Where the wholesale gas costs out turn less than was forecast in the maximum average price, SSE Airtricity will 'over recover'. This means that they 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, SSE Airtricity will 'under recover', the means they 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 the previous tariff period.

Both SSE Airtricity and the Utility Regulator strive to keep the over/under recovered amount as low as possible in order to avoid distortion of the maximum average price. This is carried out through ongoing monitoring and tariff changes being put through when over or under recoveries are accumulating to such an extent that they would adversely affect the tariff.

Regarding the previous tariff period which was set from 1 April 2018, the maximum average price effective from that date included an amount of around £447k which SSE Airtricity had over recovered in the previous tariff period, and this has now been returned to customers. There will be a new over/under recovery position for the Maximum Average Price as of 1 October 2018.

Why is the Maximum Average Price for SSE Airtricity increasing?

The maximum average price for SSE Airtricity's tariff customers in Greater Belfast and now in the West will increase to 131.17 pence per therm from 1 October 2018. Table 1 below shows the movement in the regulated maximum average price from May 2008 to date.

Table 1 - Historic maximum average price

| Effective from date | Approved Maximum Average Price (pence per therm) |
|---------------------|--------------------------------------------------|
| 01-May-08 | 128.00 |
| 01-Oct-08 | 152.58 |
| 08-Jan-09 | 118.92 |
| 01-Oct-09 | 96.32 |
| 01-May-11 | 133.97 |
| 01-Apr-12 | 122.64 |
| 01-Apr-13 | 133.26 |
| 01-Apr-15 | 125.17 |
| 01-Oct-15 | 112.50 |
| 01-Apr-16 | 101.01 |
| 31-Mar-17 | 109.63 |
| 01-Apr-18 | 118.25 |
| 01-Oct-18 | 131.17 |

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

- the significant increase in the cost of wholesale gas;
- an under recovery of wholesale gas costs
- an increase in transmissions costs;

These are explained in the section below.

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

Forecasted gas costs on the forward curve have increased significantly over the last year, as is shown in Figure 2. This has been primarily driven by falling gas imports and production, as well as volatile weather.

Figure 2 – Movement in forward curve of wholesale gas cost



Source: Platts McGraw Hill Financial

This rise in commodity costs is the key driver of the forthcoming tariff increase. As can be seen in Table 2, Wholesale Gas Costs rose from 51.68 p/therm in the current tariff to 58.34 p/therm in the 1 October 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.

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

| Elements within Maximum Average Price | April 2018 (pence per therm) | October 2018 (pence per therm) |
|---------------------------------------|---------------------------------|-----------------------------------|
| Wholesale Gas Cost | 51.68 | 58.34 |
| (Over)/Under Recovery | -0.75 | 3.73 |

| | | |
|-------------------------------------------------------------------------------|-------|-------|
| Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods | 50.93 | 62.07 |
|-------------------------------------------------------------------------------|-------|-------|

The maximum average price coming into effect from 1 October 2018 also includes an under recovery of £2.4m from the existing tariff period. This is primarily due to the increased commodity costs that we have already discussed, which resulted in SSE Airtricity spending more on gas than it recovered from customers in the period since the tariff was last set. This amount will be recovered by SSE Airtricity through a 3.73 p/therm increase to the 1 October 2018 tariff.

As shown in Table 2 above overall, the combined cost of wholesale gas and over/under recovery has increased from 50.93 p/therm in the 1 April 2018 tariff to 62.07 p/therm in the 1 October 2018 tariff. This increase makes up 9.5 percentage points of the overall 10.9% increase.

- **Transmission Charges**

Transmission network charges have increased⁸ since the tariff was last set in April 2018. This is attributed to a 28.7% increase to the Moffat Entry capacity charge and a 4.1% increase to the Transmission Commodity charge.

As can be seen in Table 3, distribution costs have remained broadly flat.

As a result, there is a small increase of around 3.5% in total network costs (transmission and distribution combined). This can be seen in Figure 3.

Table 3 – Network costs from Previous Tariff Periods within Maximum Average Price

| Elements within Maximum Average Price | October 2018 (pence per therm) | October 2018 (pence per therm) |
|-------------------------------------------------------------------------------|-----------------------------------|-----------------------------------|
| Transmission | 12.32 | 14.35 |
| Distribution | 43.12 | 43.05 |
| Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods | 55.44 | 57.40 |

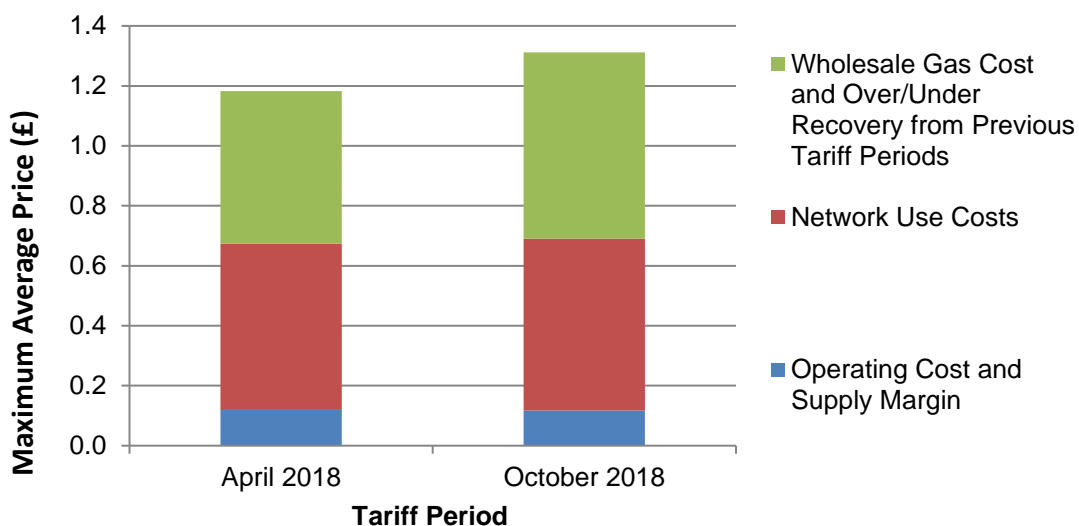
Breakdown of Maximum Average Price

The graph shown in Figure 3 below compares the breakdown of the October 2018 maximum average price with a breakdown of the previous maximum average price

⁸ <http://gmo-ni.com/assets/documents/1819-Postalised-Tariff-Explanatory-Note-V0.1.pdf>

set at April 2018. As explained previously, the increase in the maximum average price is due to the significant increase in the cost of wholesale gas and an under recovery (again due to the increase in wholesale costs), as well as a small increase in transmission costs.

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



Impact on Tariff

As already stated, SSE Airtricity 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. SSE Airtricity cannot charge more than the maximum average price overall. From 1 October 2018, the unit rates of tariffs for SSE Airtricity’s customers in the Greater Belfast area will increase by 10.9%. Table 4 below shows the movement in the tariffs from May 2008 to date.

Table 4 – Historic changes in tariffs

| Effective from date | Change |
|---------------------|---------|
| 01-May-08 | +28.00% |
| 01-Oct-08 | +19.20% |
| 08-Jan-09 | -22.10% |
| 01-Oct-09 | -19.00% |
| 01-May-11 | +39.10% |
| 01-Apr-12 | -8.50% |
| 01-Apr-13 | +8.70% |
| 01-Apr-15 | -7.8% |

| | |
|-----------|--------|
| 01-Oct-15 | -10% |
| 01-Apr-16 | -10.2% |
| 01-Apr-17 | +7.6% |
| 01-Apr-18 | +7.8% |
| 01-Oct-18 | +10.9% |

The new unit rates for tariff customers that will apply from 1 October 2018 are shown in Table 5 below. Table 6 shows the percentage increase for each individual unit rate of the domestic and small business tariffs.

Table 5 – SSE Airtricity’s tariff unit rates from 1 October 2018 (shown in pence per kWh including VAT)

| SSE Airtricity Gas Supply (NI) Tariffs | Home Energy | PAYG | IC1 | Large Home |
|-----------------------------------------------|--------------------|-------------|------------|-------------------|
| Up to 2,000 kWh | 6.508 | 4.734 | 7.438 | 6.508 |
| Over 2,000 kWh | 4.459 | 4.734 | 5.096 | 4.459 |
| Over 73,200 kWh | - | - | - | 4.129 |
| Direct Debit discount | £22.05 | - | £22.05 | £22.05 |

Table 6 – Percentage Increase in SSE Airtricity’s tariff unit rates from 1 October 2018

| SSE Airtricity Gas Supply (NI) % change | Home Energy | PAYG | IC1 | Large Home |
|------------------------------------------------|--------------------|-------------|------------|-------------------|
| Up to 2,000 kWh | +10.85% | +10.85% | +10.85% | +10.85% |
| Over 2,000 kWh | +10.85% | +10.85% | +10.85% | +10.85% |
| Over 73,200 kWh | - | - | - | +10.85% |

SSE Airtricity’s typical domestic credit bill will rise to £576 per annum⁹ from 1 October 2018. This equates to an increase of around £56 per year compared with the existing tariff.

Comparison with GB and Ireland

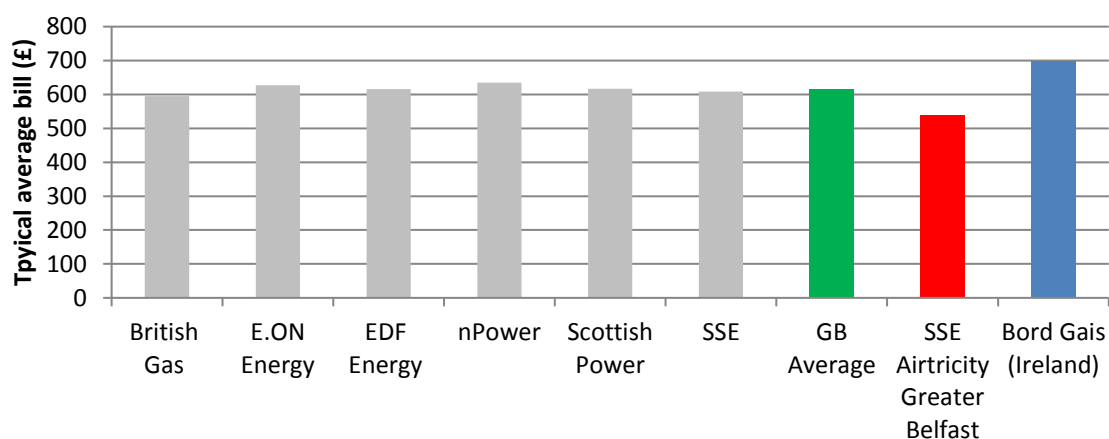
Figure 4 below, shows the average annual bill of a domestic customer for SSE

⁹ Based off a typical consumption of 12,000 kWh per annum. Including VAT. Excluding discounts.

Airtricity compared to the “Big Six”¹⁰ supply companies in GB and Bord Gais in Ireland. This comparison is based on the latest available information on the standard domestic credit tariffs¹¹ of each company (excluding any discounts) and is based on average annual consumption of 12,000 kWh¹².

From 1 October 2018, SSE Airtricity’s tariff will cost the typical domestic credit customer £576 per annum, which is 9.1% less than the GB average Big Six standard tariff and 22.8% cheaper than the Bord Gais standard tariff in Ireland (inc VAT)¹³.

Figure 4 - Comparison of average annual domestic bills (based on standard domestic credit tariffs with estimated usage 12,000 kWh per annum including VAT)



Conclusion

The Utility Regulator has reviewed the maximum average price submission provided by SSE Airtricity and reviewed SSE Airtricity’s forecasts against its own market analysis. The Utility Regulator is satisfied that this increase is appropriate and justified and therefore approves the new maximum average price of 131.17 p/therm for SSE Airtricity’s tariff customers in Greater Belfast. This maximum average price will be effective from 1 October 2018. This represents an increase of 10.9% in the actual tariff unit rates that SSE Airtricity charge customers.

¹⁰ The Big Six companies are British Gas, SSE, Scottish Power, npower, E.ON UK and EDF Energy.

¹¹ 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 and correct as 20/08/2018

¹² 12,000kWh / annum is the Typical Domestic Consumption Value for a medium domestic gas consumer as determined by Ofgem <https://www.ofgem.gov.uk/gas/retail-market/monitoring-data-and-statistics/typical-domestic-consumption-values>

¹³ VAT rates in GB and NI are equal. Comparison of RoI and NI exclusive of VAT shows that NI is 20% cheaper than Bord Gais in RoI. Exchange rates as of 20/08/18.

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