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

27 February 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 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 monitor the costs incurred by SSE Airtricity for purchasing gas on an ongoing basis and we also monitor the forecast costs of wholesale gas into the future. Using this information we have carefully monitored the regulated maximum average price of SSE Airtricity to identify if the changes in purchased and forecast gas costs were sufficient to warrant a change in the tariff.

We initiated a review of the maximum average price with SSE Airtricity in January 2015. The Utility Regulator has 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 decrease to 125.17 pence per therm from 1 April 2015.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

SSE Airtricity customers in the Greater Belfast area will benefit directly from this review as the price they pay for the gas they use will be on average 7.8% lower. This change will affect domestic and small business customers. The change will take effect from 1 April 2015.

The impact of the tariff change on a domestic customer on a standard credit tariff with average consumption of 13,500 kWh per annum will be a saving of £53 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 16 January 2015 the Utility Regulator, in conjunction with SSE Airtricity Gas Supply (NI) Limited (**SSE Airtricity**), the Department of Trade, Enterprise and Investment (**DETI**) and the Consumer Council began a review of the SSE Airtricity maximum average price for domestic and small business customers using less than 25,000 therms per annum. The current maximum average price has been effective from 1 April 2013.

We carry out formal reviews of the SSE Airtricity maximum average price on a bi-annual basis (in advance of April and October) and from these reviews we determined in October 2013, April 2014 and October 2014 that there would be no change to the SSE Airtricity maximum average price.

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. This analysis did not indicate that a full review of the maximum average price was required until January 2015 which was in line with the formal review that was scheduled to commence mid January. We therefore initiated the formal review to establish the new maximum average price to become effective from 1 April 2015. The review is a formal process agreed by SSE Airtricity, DETI and the Consumer Council. It is set out within the SSE Airtricity[1] price control and details the processes to be followed and the timescales for the review process.

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.

The maximum average price for domestic and small business customers will be 125.17 pence per therm from 1 April 2015. 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

[1] 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 purchases Phoenix Supply Limited in June 2012)

in advance of October 2015 and will continue to monitor gas prices to identify if an additional review is required.

From 1 April 2015, the unit rates of tariffs for SSE Airtricity's customers in the Greater Belfast area will decrease by 7.8% on average. These unit rates are detailed in Table 3 later in this paper.

Background

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

In the Greater Belfast area SSE Airtricity[2] has operated as the incumbent gas supplier since 1996. One competing supplier has been active in the domestic gas market since 2010. Customer switching has been largely constant since 2010, however levels have started to fall over the past year. SSE Airtricity remains the dominant supplier in the Greater Belfast area for customers using less than 25,000 therms per annum (referred to as tariff customers), they currently supply around 127,000 tariff customers.

Under the terms of SSE Airtricity's licence to supply gas, the Utility Regulator ("**the Authority**") has the power to control the maximum amount that SSE Airtricity 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)*[3]

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.

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).

3 SSE Airtricity Licence for the supply of gas: http://www.uregni.gov.uk/uploads/licenses/2014-03-28_Airtricity_Gas_Supply_NI_Ltd_(PSL)_Supply_Licence.pdf

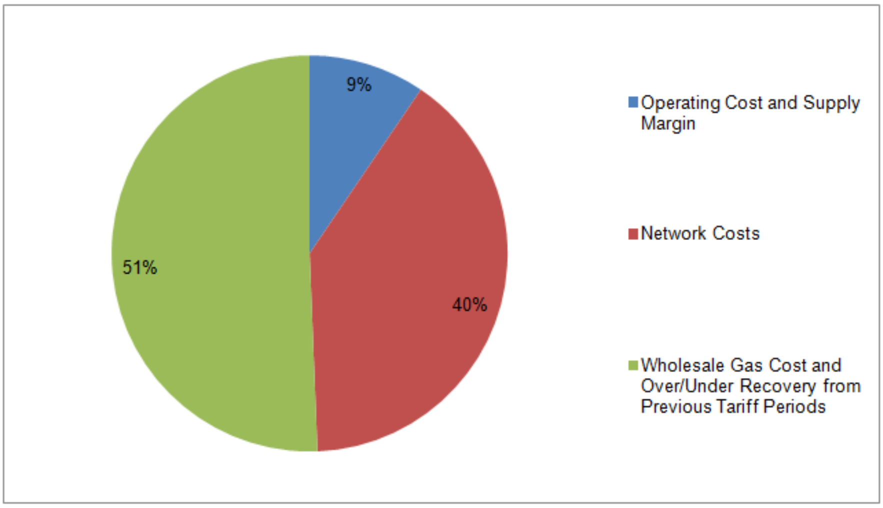
Elements of Maximum Average Price

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

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

The breakdown is shown in figure 1 below.

Figure 1 - Makeup of the maximum average price



The Utility Regulator takes an active role in scrutinising 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 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. For example the costs of billing, meter reading, salaries, IT systems etc. The operating costs are determined under the price control carried out by the Utility Regulator.

The margin refers to the amount of profit SSE Airtricity is allowed to make. The margin is also determined within the price control and is currently set at 1.5% of allowable turnover from tariff customers.

The current price control determination[4] runs from 1 January 2012 to 31 December 2016.

[4] 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 purchases Phoenix Supply Limited in June 2012)

Network Costs

Network costs cover the charges for the use of the Northern Ireland transmission and distribution systems and are common across all suppliers. 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 for the actual cost of the network charges.

The costs for the transmission system are those costs involved in bringing gas from Scotland to Northern Ireland, via the Scotland to Northern Ireland Pipeline and all the transmission pipelines within Northern Ireland. These costs are published on the Premier Transmission website at http://www.premier-transmission.com/.

The costs for the distribution system are those costs associated with moving gas throughout the Greater Belfast area to homes and businesses. These can be found on the Phoenix Natural Gas website at http://www.phoenixnaturalgas.com/help-and-advice/networks/charges/.

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 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 that needs to be employed into the maximum average price. This is the largest element of the maximum average price making up around 50% 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 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.

SSE Airtricity 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.

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 wholesale cost of gas from the forward curve. Buying gas in advance (hedging) can help to reduce any over/under recoveries building up as the price of the hedged gas in the maximum average price is known when the price is set.

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

Wholesale gas costs make up a large component of the final maximum average price and as these costs can be volatile 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, SSE Airtricity 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, SSE Airtricity 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. Each maximum average price therefore includes an amount of over or under recovery which was accumulated during previous tariff periods

The maximum average price effective from 1 April 2015 includes an amount of £1.8m which SSE Airtricity have under recovered previously and will now be collected from customers.

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

Why is the Maximum Average Price for SSE Airtricity decreasing?

The maximum average price for SSE Airtricity's tariff customers in Greater Belfast will reduce to 125.17 pence per therm from 1 April 2015. 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

The overall decrease in the SSE Airtricity maximum average price is driven by two main elements, namely the reduction in network charges and the decrease in the cost of wholesale gas as explained below.

- ### *Decrease in Network Charges*

The key factor causing the decrease in the overall maximum average price is the change in network charges. There are two elements to network charges, distribution network charges and transmission network charges. The transmission charges have increased slightly over the level set in the April 2013 maximum average price. However the distribution charges have decreased significantly since the level set in the April 2013 maximum average price.

When the maximum average price was set in April 2013, the distribution charges at that time were based on the Competition Commission's determination[5] on the Phoenix Natural Gas Limited (PNGL) price control for 2012-2013. Since then the Utility Regulator has published a new price control determination[6] (GD14) for PNGL covering 2014-2016. The GD14 determination stated that that the Utility Regulator's decisions would result in the

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[5] Competition Commission's price determination on PNGL12: http://www.uregni.gov.uk/publications/competition_commission_final_pngl_price_determination

[6] 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

distribution charges in the Greater Belfast area falling compared with the levels previously determined by the Competition Commission. The determination also highlighted that the impact on customer bills would only be fully realised in 2015 as the 2014 distribution charges had already been set at the time when the GD14 price control was finalised.

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

The other driver for the reduction in the maximum average price is the decrease in the forecast wholesale cost of gas (when compared with the forecast wholesale gas cost included in the maximum average price set in April 2013).

Overall forecast gas costs on the forward curve have fallen over the last number of months. This has resulted in the forecast cost of gas employed in the April 2015 maximum average price being lower than the wholesale cost which was forecast at the time of the last tariff setting in April 2013. Table 2 below shows that the forecast cost of gas within the maximum average tariff has reduced from 72.0 pence per therm in the April 2013 tariff to 59.65 pence per them in the April 2015 tariff.

It is important to remember 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. We note that during February 2015 the forward curve has started to show increases in gas costs highlighting the unpredictability of gas prices.

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

As mentioned previously the maximum average price coming into effect from 1 April 2015 will include an under recovery. This acts to increase the maximum average price as SSE Airtricity need to recover the previous under recoveries from customers. The position has moved from an over recovery of £3.6m at the setting of the April 2013 maximum average price to a forecast under recovery position of £1.8m from 1 April 2015 (estimated up until the point of the maximum average price change). The impact of the change in the over/under recovery on the maximum average price is shown in Table 2 below.

This change in the over/under recovery position has been generated as a result of two main factors:

- An over recovery was included in the maximum average price which became effective on 1 April 2013. This had the effect of lowering the price as it aimed to return the over recovered amount to customers over the 12 month tariff period. However as there has been no change to this price for 24 months it has resulted in SSE Airtricity returning a greater amount to customers than was required. This created a net under recovery which will be recovered from customers through the maximum average price from 1 April 2015.

- Over the last number of months wholesale gas prices have fallen. This means that in recent months the actual cost of gas was lower than the cost forecast in the April 2013 maximum average price. As a result, SSE Airtricity has over recovered on the wholesale gas element of the maximum average price. However this over recovery was outweighed by the new under recovery generated as detailed above.

This 'swing' in the over/under recovery position (from a £3.6m over recovery in the April 2013 price to a £1.8m under recovery in the April 2015 price) results in an increase to the maximum average price for that specific element in isolation. However when we look at the overall wholesale gas costs and over/under recovery element of the maximum average price that will be effective from 1 April 2015, it is lower than the equivalent cost elements in the April 2013 price. This is because the reduction in forecast gas costs outweighs the increase from the swing in the over/under recovery position. This is clearly visible in Table 2 below which shows that the total gas costs and over/under recovery element of the maximum average price has reduced from 64.84 pence per therm to 63.38 pence per therm.

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

Elements within Maximum Average Price	April 2013 (pence per therm)	April 2015 (pence per therm)
Wholesale Gas Cost	72.00	59.65
Over/Under Recovery	-7.16	3.73
Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods	64.84	63.38

Breakdown of Maximum Average Price

The graph shown in Figure 2 below compares the breakdown of the April 2015 maximum average price with a breakdown of the previous maximum average price set at April 2013. The graph demonstrates that the operating costs and margin remain largely the same. As explained previously, the decrease in the maximum average price is as a result of a reduction in network costs and wholesale gas costs. There is however a change in the over/under recovery element which offsets some of the overall decrease to the maximum average price.

Figure 2 – Breakdown of April 2015 maximum average price compared with the previous maximum average price

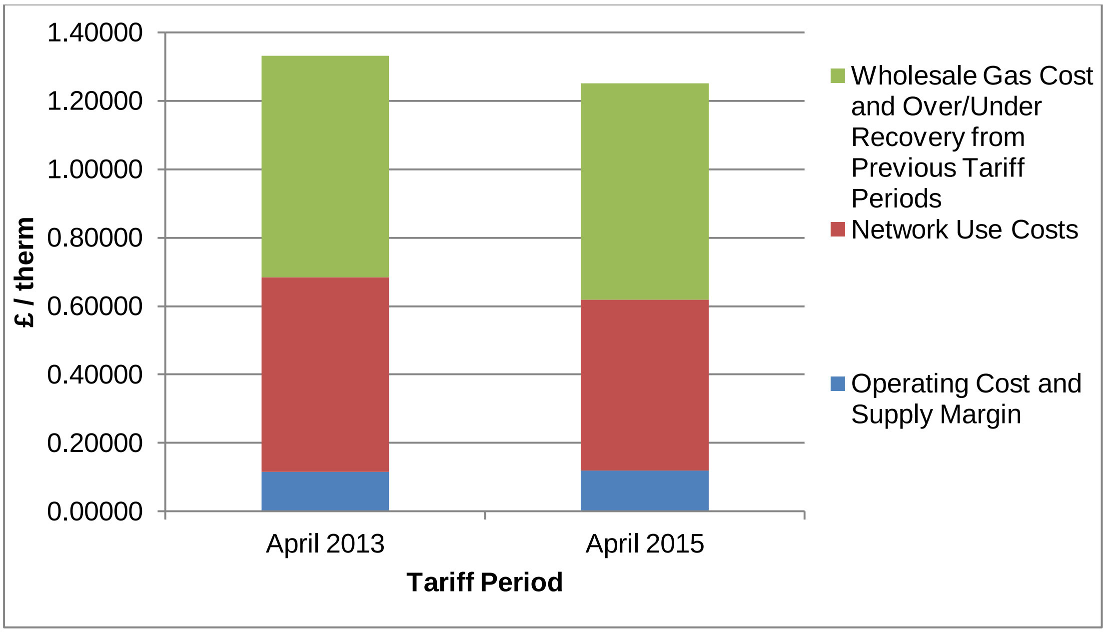
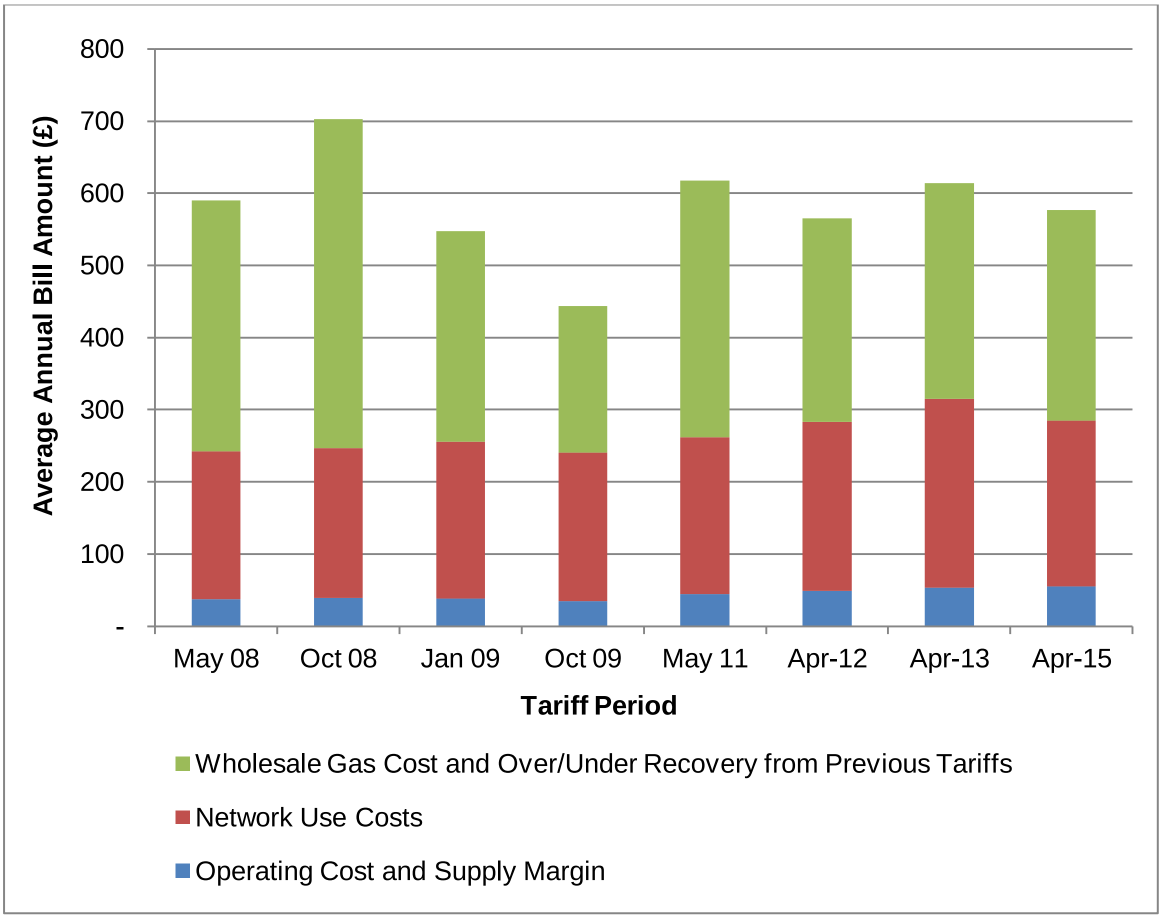


Figure 3 below shows the breakdown in the average annual bill for SSE Airtricity tariff customers over the past few years and illustrates again the variation caused by various components of the maximum average price. As expected, it can be seen that the variations in the maximum average price are largely driven by variations in the network charges and also in the wholesale cost component and resulting over/under recovery positions.

The average annual bill amounts in this graph have been calculated based on the maximum average price set at each review (which excludes VAT) and are based on average annual consumption of 13,500kWh[7].

[7] 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

Figure 3 - Graph to show breakdown of average annual bill



Impact on Tariff

As stated earlier, 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. From 1 April 2015, the unit rates of tariffs for SSE Airtricity's customers in the Greater Belfast area will decrease by an average of 7.8%. Table 3 below shows the movement in the tariffs from May 2008 to date.

Table 3 – 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%

The new unit rates for tariff customers that will apply from 1 April 2015 are shown in Table 4 below. Table 5 shows the percentage decrease for each individual unit rate of the domestic and small business tariffs.

Table 4 – SSE Airtricity's tariff unit rates from 1 April 2015 (shown in pence per kWh including VAT)

Pence per kWh	**Home Energy** inc. 5% VAT	**PAYG** inc. 5% VAT	**IC1** inc. 20% VAT	**IC2** inc. 20% VAT
Up to 2,000 kWh	6.261	4.556	7.156	7.156
Over 2,000 kWh	4.291	4.556	4.904	4.904
Over 73,200 kWh				4.540
Direct Debit discount	22.05		25.20	25.20

Table 5 – Percentage decrease in SSE Airtricity's tariff unit rates from 1 April 2015

	Home Energy	**PAYG**	**IC1**	**IC2**
Up to 2,000 kWh	-10.0%	-7.8%	-10.0%	-10.0%
Over 2,000 kWh	-7.3%	-7.8%	-7.3%	-7.3%
Over 73,200 kWh				-7.3%

Comparison with GB and Ireland

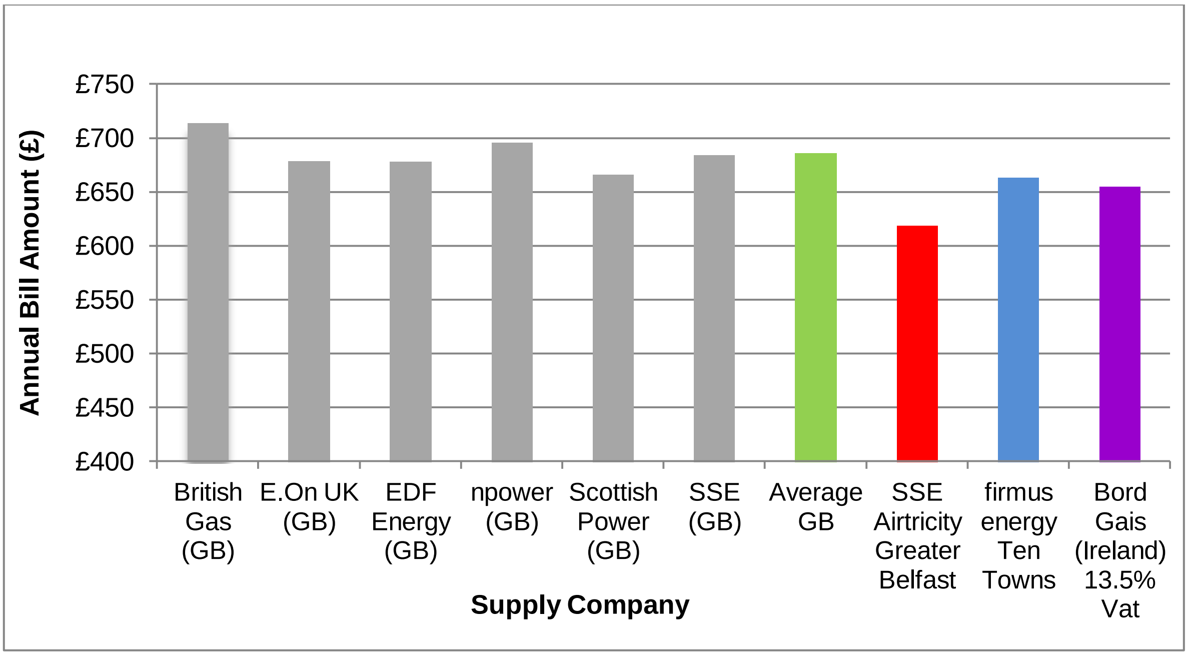
Figure 5 below, shows the average annual bill of a domestic customer for SSE Airtricity compared to the "Big 6"[8] supply companies in GB, Bord Gais in Ireland and firmus energy in the Ten Towns.

This comparison is based on the latest available information on the standard domestic credit tariffs[9] of each company and is based on average annual consumption of 13,500 kWh[7]. 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 13,500kWh[7].

This graph shows the SSE Airtricity tariff that will become effective on 1 April 2015 and also takes account of any tariff changes for supply companies in GB and Ireland which have been published, even if the tariff change has not yet taken effect.

Figure 5 below illustrates that the SSE Airtricity tariff for an average domestic credit customer will be just over 9% cheaper than the GB average standard tariff and around around 5% cheaper than the Bord Gais tariff in Ireland.

Figure 5 - Comparison of average annual domestic bills (based on standard domestic credit tariffs with estimated usage 13,500 kWh per annum including VAT)



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

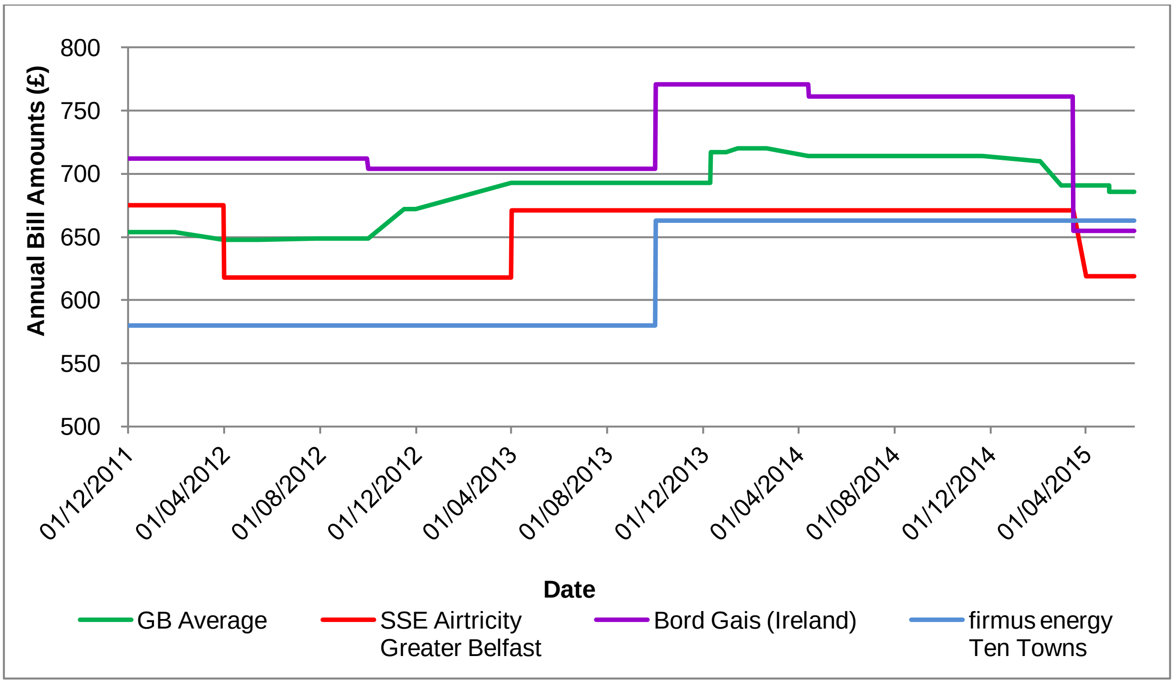
9 The tariffs used for comparison purposes are the standard tariff rates for domestic credit customers excluding any discounts available for payment by direct debit, viewing bills online etc.

Figure 6 below shows a historic comparison of SSE Airtricity's domestic annual bill against firmus energy in the Ten Towns, the average in GB and Bord Gais in Ireland. The comparison uses the standard credit tariff unit rates for domestic customers and assumes average annual consumption of 13,500 kWh. The graph shows that since April 2012, SSE Airtricity's prices have been lower than the average standard tariff in GB of the Big 6 Gas Suppliers.

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.

In Ireland, Bord Gais 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 6 - Historic Comparison of average annual domestic bills (based on standard domestic credit tariffs with estimated usage 13,500 kWh per annum including VAT)



The change in the SSE Airtricity maximum average price from 1 April 2015 equates to a decrease in domestic customer bills of £53 per year (including VAT) based on the SSE Airtricity standard domestic credit tariff unit rates using average annual consumption of 13,500 kWh (rounded to nearest pound).

Outcome

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 decrease is appropriate and therefore approves the new maximum average price of 125.17 pence per therm for SSE Airtricity's tariff customers in Greater Belfast. This maximum average price will be effective from 1 April 2015 for one year. This represents an average decrease of 7.8% in the actual tariff unit rates that SSE Airtricity uses to charge customers.

However 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.