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

September 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 firmus energy Supply Ltd (feSL) is a core part of our work.

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

The maximum average price for feSL's domestic and small business customers in the Ten Towns area will increase to 155.80 pence per therm from 139.10. This equates to an increase of 12.0% to the bills of domestic and small business customers.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

feSL's customers in the Ten Towns area will see an average increase of 12.0% increase in their annual bill. This change will affect all domestic customers and small business customers using less than 2,500 therms per annum, and will take effect from 1 October 2018.

The impact of the tariff change on a domestic credit customer with average consumption of 12,000 kWh per annum will be an increase of approximately £75 per annum (including VAT) on their gas bill.

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

Summary

On 20 August 2018 the Utility Regulator—in consultation with firmus energy (Supply) Limited (feSL), the Department for the Economy (DfE) and the Consumer Council Northern Ireland (CCNI)—began a review of the feSL maximum average price for domestic customers 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 38,000 domestic and small business customers [1] within the Ten Towns area.

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

The formal review was initiated to establish the new maximum average price to become effective from 1 October 2018. The review is a formal process agreed by the UR, feSL, DfE and the CCNI. It is set out within the feSL price control[2] and details the processes to be followed and the timescales for the review process.

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

From 1 October 2018, the maximum average price for domestic and small business customers will be 155.80 pence per therm (p/therm); increasing from 139.10 in the April 2018 tariff. 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.

[1] https://www.uregni.gov.uk/sites/uregni/files/media-files/2018-08-31%20Transparency%20Report%20Q2%202018%20FINAL.pdf

[2] 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 unit rates of tariffs for feSL's customers in the Ten Towns area will increase by 12.0% from 1 October 2018. These unit rates are detailed in Table 4 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.

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

From 1 April 2015, the supply market in the Ten Towns area opened to competition from new entrant suppliers in all customer sectors. However feSL are currently the only supplier for domestic consumers in this market. feSL currently supply around 38,000 domestic and small business customers (referred to as "tariff" customers) in this area.

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

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"[3].

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

Elements of Maximum Average Price

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

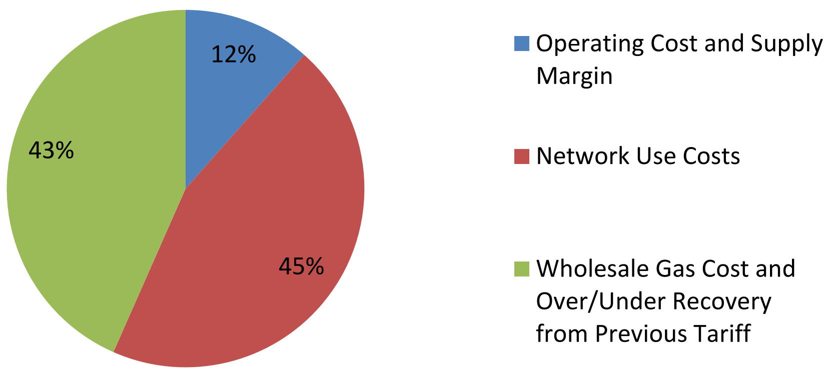
- Operating costs and supply margin;

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

- Network costs; and
- Wholesale cost of gas.

The breakdown is shown in figure 1 below.

Figure 1 – Makeup of the maximum average price from 1 October 2018



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

Operating Costs and Supply Margin

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

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

In November 2016 we published the final determination for the firmus energy supply price control[4] which indicates the total amount of revenue that the Licensee can recover, in any relevant year, in respect of their gas supply business.

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

[4] 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

Network Costs

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

The feSL price control determined that the transmission and distribution system charges will be treated as pass through charges which means that the customer pays 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 and on the Gas Market Operator NI website

The costs for the distribution system are those costs associated with moving gas throughout the Ten Towns area to homes and businesses. On the 15th September 2016 the final determination on the price control for Northern Ireland's gas distribution networks for 2017-2022 (GD17), and associated licence modifications for consultation, were published. GD17 is the distribution price control for Phoenix Natural Gas Limited (PNGL), firmus energy (Distribution) Limited and SGN Natural Gas Limited which will run from 1 January 2017[5]. The distribution price control determines the amounts that firmus energy Distribution can charge for suppliers to use the Ten Towns network. These can be found on the feDL website.

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

This element of the maximum average price includes the forecast cost of wholesale gas and any over/under recovery from the previous tariff period that needs to be deducted/added in the maximum average price. This makes up 43% of the total. Further detail on these costs is provided below.

- ***Wholesale Gas Costs***

As determined within the feSL 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 feSL 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

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

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.

feSL has a gas purchasing strategy in place which means that its purchases a percentage of its 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, feSL 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, feSL 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 feSL 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 £111k which feSL had under recovered in the previous tariff period, and this has now been recovered by feSL. 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 feSL increasing?

The maximum average price for feSL's tariff customers in the Ten Towns area will increase to 155.80 p/therm from 1 October 3018. Table 1 below shows the movement in the regulated maximum average price from April 2015 (the first regulated tariff) to date.

Table 1 - Historic maximum average price

Effective from date	Approved Maximum Average Price (p/therm)
01-Apr-15	130.85
01-Oct-15	125.16*
01-Apr-16	115.51
31-Mar-17	130.27**
05-Apr-18	139.10
01-Oct-18	155.80

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

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

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

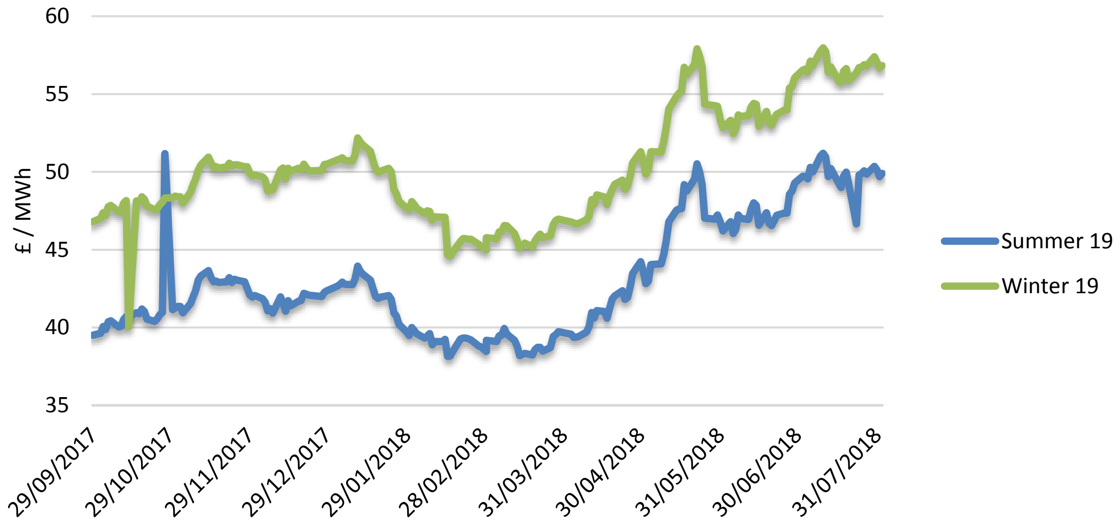
- the significant increase in the cost of wholesale gas;
- an under recovery of wholesale gas costs
- an increase in transmissions costs;

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 53.45 p/therm in the current tariff to 64.74 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 (p/therm)	October 2018 (p/therm)
Wholesale Gas Cost	53.45	64.74
(Over)/Under Recovery	0.91	2.86
Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods	**54.36**	**67.60**

The maximum average price coming into effect from 1 October 2018 also includes an under recovery of £367k from the existing tariff period. This is primarily due to the increased commodity costs that we have already discussed, which resulted in feSL spending more on gas than it recovered from customers in the period since the tariff was last set. This amount will be recovered by feSL through a 2.86 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 54.36 p/therm in the 1 April 2018 tariff to 67.60 p/therm in the 1 October 2018 tariff. This increase makes up 9.5 percentage points of the overall 12.0% increase.

- ***Transmission Charges***

Transmission network charges have increased[6] 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 seen a slight increase.

As a result, there is an increase of around 4.6% 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

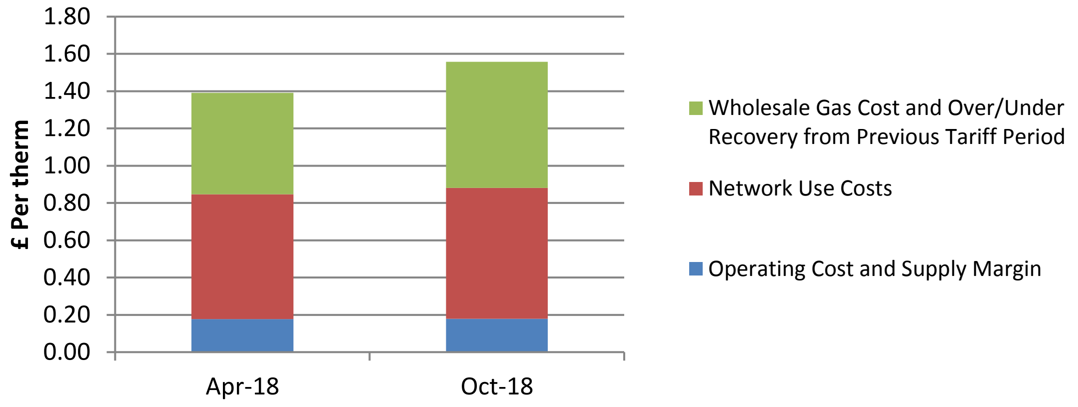
Elements within Maximum Average Price	April 2018 (p/therm)	October 2018 (p/therm)
Transmission	11.34	13.94
Distribution	55.74	56.29
Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods	**67.08**	**70.23**

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 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.

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

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



Impact on Tariff

As already stated, feSL uses the maximum average price to set the actual tariffs charged to customers. The tariffs are calculated on a weighted average basis, based on average usage and the number of customers on each tariff. feSL cannot charge more than the maximum average price overall. From 1 October 2018, the unit rates of tariffs for feSL's customers in the Ten Town area will increase by 12.0%.

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

Table 4 – feSL's tariff unit rates from 1 October 2018 (shown in p/kWh including VAT)

	Domestic inc 5% VAT	**PAYG inc 5% VAT**	**IC1 inc 20% VAT**
Up to 2,000 kWh	8.001	5.546	9.821
Over 2,000 kWh	5.395	-	6.521
Over 73,200 kWh	-	-	-
Direct Debit discount	£22.00	-	-

Table 5 – Percentage Increase in feSL's tariff unit rates from 1 October 2018

	Domestic	**PAYG**	**IC1**
Up to 2,000 kWh	12.00%	12.00%	12.00%
Over 2,000 kWh	12.00%	-	12.00%
Over 73,200 kWh	-	-	-

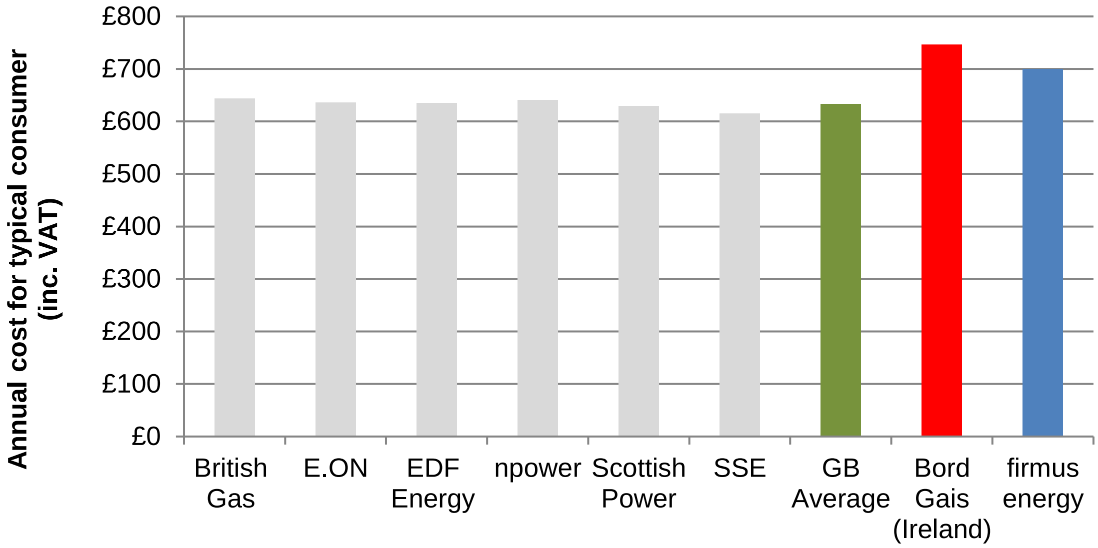
feSL's typical domestic credit bill will rise to £700 per annum[7] from 1 October 2018. This equates to an increase of around £75 per year compared with the existing tariff.

Comparison with GB and Ireland

Figure 5 below shows the average annual bill of a standard credit domestic customer for feSL in the Ten Towns compared to the "Big Six"[8] supply companies in GB and Bord Gais in Ireland. This comparison is based on the latest available information on the standard domestic credit tariffs[9] of each company. The average annual bill amounts in this graph have been calculated based on actual tariff unit rates (including VAT) and are based on average annual consumption of 12,000kWh.

This graph illustrates that the feSL tariff for an average domestic standard credit customer in the Ten Towns area will be 10.5% above the GB average standard tariff and around 6.2% cheaper than the Bord Gais standard tariff in Ireland[10]**.**

Figure 5 - Comparison of average annual domestic bills (based on standard domestic credit customers with estimated usage 12,000kWh per annum including VAT)



Conclusion

The Utility Regulator has reviewed the maximum average price submission provided by

[7] Based off a typical consumption of 12,000 kWh per annum. Including VAT. Excluding discounts.
[8] The Big Six companies are British Gas, SSE, Scottish Power, npower, E.ON 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. They are based on the West Midlands gas distribution area.
[10] VAT rates in GB and NI are equal. Comparison of RoI and NI exclusive of VAT shows that Comparison of RoI and NI exclusive of VAT shows that NI is 20% cheaper that Bord Gais in RoI. Exchange rates as of 20/08/18.

feSL and reviewed the feSL forecasts against its own market analysis. The Utility Regulator is satisfied that it is appropriate and justified to set a maximum average price of 155.80 p/therm for tariff customers in the Ten Towns for one year. This represents an average increase of 12.0% in the actual tariff unit rates that feSL uses to charge domestic and small business customers in the Ten Towns area.

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