The Consumer Council

Price Control for firmus energy (Supply) Ltd 2020-2022

July 2019

1 Introduction

1.1 The Consumer Council is a non-departmental public body (NDPB) established through the General Consumer Council (Northern Ireland) Order 1984. Our principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland.

1.2 The Consumer Council has specific statutory duties in relation to energy, postal services, transport, and water and sewerage. These include considering consumer complaints and enquiries, carrying out research and educating and informing consumers.

1.3 UR must ensure that the consumer voice informs and helps deliver an efficient, economic and co-ordinated gas industry in Northern Ireland with adequate levels of consumer protection. The Consumer Council believes that the Consumer Principles framework can be an effective tool to help inform the development of this and future price controls.

2 Executive Summary

2.1 The Consumer Council supports the promotion and ongoing development of natural gas in Northern Ireland. Natural gas offers consumers a choice of fuel that provides consumer protection through its regulatory framework, is cleaner than other fossil fuels and provides payment methods that help consumers manage their spending on energy.

2.2 The SPC20 Price Control is an opportunity for the Utility Regulator (UR) to continue to safeguard consumers, and promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland. The interests of consumers must be at the heart of the Final Determination.

2.3 We acknowledge the work carried out by UR and firmus energy (Supply) Ltd. (FES) in delivering this price control draft determination. The main points in our response are:

- Continued work is required to develop competition within the domestic Ten Towns retail market;
- We would like UR to identify best practice organisations, including organisations in Great Britain (GB) and elsewhere, in order to benchmark FES' performance and help identify efficiencies;
- Costs should be properly identified and allocated to FES' regulated and unregulated businesses, as well as to supply and distribution businesses;
- We believe that where costs are adjusted retrospectively, any up front allowance should reflect, as closely as possible, what the actual spend will be; and
- We believe that the existing 2% margin level for FES is sufficient.

3 Consumer Context

3.1 The typical annual cost of the regulated gas supply tariff in Ten Towns is 31% more expensive than the regulated gas tariff in Greater Belfast[1]. Also, the average price of Home Heating Oil is currently 23% cheaper than the regulated gas supply tariff in Ten Towns[2].

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[1] The Consumer Council calculations using a consumption of 12,000kWh and the unit rates in Table 25 of UR's Quarterly Transparency Report Q1 2019.

[2] The Consumer Council calculations using a consumption of 12,000kWh and £0.49/per litre of home heating oil based on the average price of a 500 litres refill from our Oil Prices Survey on 11 July 2019 and the unit rates in Table 25 of UR's Quarterly Transparency Report Q1 2019.

3.2 Research highlights that disposable income levels in NI are nearly half that of the UK average[3] and that the median gross weekly earnings in Northern Ireland are lower than in GB, £521 and £569 respectively[4].

3.3 The Consumer Council research in 2019 showed the following:

- Half of Northern Ireland adults have £300 or less to spend after essential outgoings each month. This figure is significantly higher for C2DEs (59%), those not working (62%), those with an income of <£20,000 (68%), renters (69%) and those with a disability (62%)[5].
- Around 33% of natural gas consumers using a prepayment meter struggle at times to pay for their gas and around 20% could not heat their homes in the last 12 months because they couldn't afford to top up[6].

4 Scope and Duration

4.1 FES remains the only domestic supplier in the Ten Towns area and the dominant supplier in the small business market segment, therefore The Consumer Council completely agrees with UR that the price control should remain for End User Category 1 (EUC1) up to 73,200kWh per annum.

5 The Regulated Tariff and Network Costs

5.1 The cost of energy is a primary concern for Northern Ireland consumers. The Consumer Council strongly supports UR's proposals for bi-annual tariff reviews and a trigger mechanism to monitor the tariff closely and maintain the k-factor at a minimal level. The trigger mechanism adds additional consumer protection from this risk and we agree with the 5% level.

5.2 With regards to Network Costs, we recognise that these are outside the control of FES. Therefore The Consumer Council supports UR's proposal to set them as a pass through element of the regulated tariff.

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[3] £106 in Northern Ireland and £205 in GB. Source: Asda Income Tracker, Centre for Economics and Business Research, October 2018.
[4] Source: NISRA ASHE report- published 25 October 2018.
[5] Source: The Consumer Council Consumer Insight Survey 2019, 15 May 2019.
[6] Source: The Consumer Council Research on the Consumer Experiences of Electricity & Gas Prepayment Meters, August 2019.

6 Supply Operating Costs

6.1 In this section of our response we comment on the key elements of FES's Operating Costs from a consumer perspective. Where we do not comment on proposals about specific cost items, we implicitly show our support for UR's proposals, provided up-front allowances reflect as closely as possible what FES' actual spend will be.

6.2 The consultation sets out the apportionment cost drivers between FES' regulated and unregulated businesses, but does not provide any explanation for the choice or level of those cost drivers. This is important to ensure that customers of the regulated business are not cross-subsidising the unregulated business. The same explanation should be provided when apportioning cost drivers between firmus energy's supply and distribution businesses.

Manpower Costs

<u>Salaries</u>

6.3 The Consumer Council notes that the UR's proposal to allow an increase of 0.5 Full Time Equivalents (FTE) in each year of the SPC20 period is based on FES' forecast to increase its number of domestic and Industrial and Commercial (I&C) consumers using less than 73,200 kWh by 20,000 in the next four years.

6.4 Our main concern is that that there is no evidence of any benchmarking of FES's FTE current and proposed levels per number of customers against SSE Airtricity Gas Supply, FES unregulated business, or suppliers in GB, and in addition that UR has not set any efficiency targets in this regard.

6.5 We recommend that UR benchmarks FES' manpower costs with a reasonable pool of comparable suppliers in Northern Ireland, GB and elsewhere to identify whether there are opportunities to achieve further efficiencies in manpower costs.

6.6 We note that salaries are not broken down by different grades or salary bands. We would expect that salaries, given their significance, should be allocated based on Full Time Equivalents (FTE) at different grades or within different salary bands. This would ensure that if the unregulated business has a higher proportion of staff on higher salaries, that they pay their fair share, rather than setting an average rate per employee. The same principle should apply to staff working on FE's distribution and/or supply businesses.

6.7 With regards to FES' customer growth forecast, we have compared it to FES' actual number of new customers per year for the four year period ending on 31 March 2019. Using the figures in Table 1, FES' forecast would exceed by 17% the number of domestic and IC1 customers acquired over the four years ending on 31 March 2019. Furthermore, in two of those years, 2019 and 2016, the number of new customers fell short of the annual target of 5,000 by around 30%. We ask UR to clarify whether it has considered the lower than forecasted customer growth when proposing the 0.5 annual increase of FTEs and if so to explain the methodology used.

Table 1. FES Annual Domestic and IC1 customer growth

Period	**Number of new domestic and IC1 customers**
Year ending 31 March 2019	3,826
Year ending 31 March 2018	5,050
Year ending 31 March 2017	4,424
Year ending 31 March 2016	3,792
Total four year period ending 31 March 2019	**17,092**

Source: UR Quarterly Transparency Reports Q1 2015-2019.

6.8 Another factor that UR ought to consider is the fact that 82% of FES' regulated business customers are on pay as you go tariffs[7]. The ratio is unlikely to change during the SPC20 period. These customers do not receive bills nor require account management. We ask UR to clarify whether it has considered this when proposing the 0.5 annual increase of FTEs and if so to explain the methodology used.

6.9 These are areas that The Consumer Council believes deserve further analysis by UR to ensure FES delivers good value for money and satisfactory levels of customer service. This is particularly important in the Ten Towns domestic market where there is no competition, and given the growing price differential with Greater Belfast.

[7] The Consumer Council calculations using UR's Quarterly Transparency Report Q1 2019.

Travel and Subsistence

6.10 On the Travel and Subsistence category, we note that FES' actual costs for the period 2017-2019 are much higher than the allowance that UR set out in the SPC17 FD, £19-£21k compared to £12k. Given that UR is using FES' actual costs to calculate the SPC20 allowance, it is important that FES explains the reasons for the increase. Also, we would welcome assurances that firmus energy's Travel and Subsistence costs are allocated fairly and transparently between firmus energy's distribution and supply businesses, and between FES' regulated and unregulated customers.

Operations Costs

IT OPEX and CAPEX

6.11 Overall The Consumer Council supports the investment in a high functioning IT system, if the evidence demonstrates that it will deliver more accurate bills and a better consumer experience. However, we are of the opinion that any benefits to consumers must be evidenced and quantifiable.

6.12 We note that UR's decision to approve FES' submission on the basis that Gemserv deemed the costs to be "reasonable" and that they benchmark "well against a comparative regulated IT OPEX". The Consumer Council accepts UR's considered judgement on this issue, but we would welcome the publication of the Gemserv report and the "comparative regulated IT OPEX" data to help our assessment and ensure the decision is transparent.

6.13 Our concern is how the proposed SPC20 IT allowances and supporting rationale fit within the actual IT CAPEX and OPEX during the current SPC17 period. To sum up, FES requested a substantial increase in IT costs for SPC17 to procure a new billing system and software. The following extract from point 7.3.60 of the SPC17 FD explains FES rationale to request the allowance.

"firmus stated that the existing billing system uses an obsolete language and that the software is not fit for purpose and is in urgent need of replacement. Furthermore, firmus stated that their present system is not flexible enough and too expensive for their future needs. firmus stated that a new billing platform will result in enhanced accuracy in regulatory and internal reporting and will improve productivity via improved billing operations, meter reading and customer service."

6.14 In SPC17, UR approved the expenditure under Gemserv's recommendation adding that "there will be efficiency gains from the new systems.[8]" However, we note that FES has not carried out any IT CAPEX investment in the first two years of SPC17 despite receiving allowances of £378k for the period. FES has forecasted £444k of investment for 2019 but we have not received any updates about this.

6.15 This raises a numbers of concerns for consumers including the following:

- Consumers have not yet benefited from the improved efficiency that UR expected from the new IT system;
- FES has benefited from unspent SPC17 IT allowances for over two years;
- FES' actual combined IT OPEX and CAPEX[9] for the SPC17 period will be £985k[10] compared to the allowance of £555k that UR set in its SPC17 FD;
- Despite FES' forecasted £444k IT CAPEX in 2019, UR proposes to set FES' IT CAPEX and OPEX at a combined £531k for SPC20; and
- We have not seen any evidence in the SPC20 Consultation Paper that shows or quantifies how FES' IT system will make its operations and billing processes more efficient and cost effective, particularly in areas such as billing and manpower costs.

6.16 The Consumer Council asks UR to address each of our concerns to consider whether UR's proposed IT allowances are appropriate.

6.17 We support UR's proposal to apportion IT OPEX and CAPEX between FES' regulated and unregulated businesses by customer bills, as this seems a fairer and more cost reflective methodology given that 82% of the FES Ten Towns customers on the regulated tariffs are on prepayment meters[11]. On this point, we are interested to find out how FES intends to pass through the IT OPEX and CAPEX allowance to its regulated customers given that it is the bill customers who will benefit from this expenditure. Will FES spread it equally or weight the allowance so that bill customers bear the majority of the cost?

[8] UR SPC17 FD, point 7.3.66.
[9] Excluding website development.
[10] The figure includes forecasted IT CAPEX of £444k in 2019.
[11] Source: UR Quarterly Transparency Report Q1 2019.

Professional and Legal Fees

6.18 We believe UR's approach and rationale to Professional and Legal Fees to be fair and evidence based, in using the average of FES fees in 2017 and 2018 to set the SPC20 allowance and disallowing the GDPR related fees.

Advertising, Website and Sales

6.19 We agree with UR's assessment that an incumbent supplier should not be given an additional allowance in respect of sales and marketing during SPC20 if another supplier enters the domestic market. Unlike Power NI (PNI) and SSE Airtricity Gas (SSE), FES shares the brand with the Ten Towns distribution businesses and therefore benefits directly from the marketing and sales allowanced given under GD17.

Office Costs

6.20 With regards to Office Costs, Firmus Energy operates its regulated supply businesses from the same premises as its distribution and unregulated supply businesses and many costs may be common or jointly incurred. Therefore it is particularly important that costs are properly identified and allocated to the relevant business. Firmus Energy will have an incentive to favour allocation to its regulated business and it is important that UR properly oversees the cost allocation.

6.21 Provided UR scrutinises the allocation of Office Costs between Firmus Energy's various businesses, we are minded to accept UR's rationale to use the average of FES' costs for 2017 and 2018. We are interested to see whether FES moves towards a more sustainable office environment during SPC20 and if this has any downward pressure on office costs.

Rates

6.22 The Consumer Council believes that the rates element of the SPC20 should be the pass-through of the Lands and Property Services (LPS) bill. However, we would expect FES to seek advice from LPS to minimise its rates bill or mitigate any planned increases.

Insurance

6.23 We note UR's proposal to allow an allowance of £10k for cyber security insurance. The suggestion is that firmus energy will split this allowance 50:50 between its distribution and supply businesses. We ask UR to explain the rationale for the 50:50 split.

6.24 UR has not clarified whether this insurance covers the regulated and unregulated FES business and if so how the £5k will be apportioned between the two. If the allowance only applies to FES' regulated business, we would be interested to know for comparison purposes whether FES has procured a similar insurance for its unregulated supply business, and if so how much this amounts to.

Network Maintenance

6.25 We note that UR's Firmus Energy GD17 Final Determination set out an allowance for Network Maintenance of £17.3 per weighted connection. When setting the GD17 allowance, UR identified the activities that Firmus Energy would undertake and the cost involved.

6.26 In the SPC20 consultation paper however, we note that there is a separate allowance for Network Maintenance under Operation Costs in addition to the pass through Network Costs.

6.27 We ask UR to identify what activities are included under the SPC20 Network Maintenance allowance, and compare those to the same allowance in GD17 to determine whether or how they should be accounted for in SPC20, and to help identify synergies and efficiencies.

6.28 We note also the significant increase in proposed Network Maintenance costs for SPC20 compared to the actual and LBE for 2017 and 2018. We ask UR to explain the differential and confirm that the allowance is as cost reflective as possible.

Billing Costs

Bad Debt

6.29 The Consumer Council believes that the methodology to set FES' Bad Debt allowance should be based around the following principles:

- Being cost reflective;
- Requiring FES to have processes and systems in place to reduce risk of bad debt;
- Providing an incentive to increase FES' efficiency;
- Reflecting investment in other areas such as IT systems that may have a positive impact on debt management; and
- Considering the socioeconomic profile of FES' regulated customers.

6.30 With regards to UR's proposals in respect of Bad Debt for SPC20, we note the gap between the allowance in UR's SPC17 Final Determination and FES' actual Bad Debt costs for 2017 and 2018. SPC17 set out FES' bad debt at 0.25% of total credit revenue for the price control period resulting in annual allowances of £109k for 2017, and £105k each for 2018 and 2019. However, FES' actual, Latest Best Estimate and Forecast figures for 2017, 2018 and 2019 are minus £13k, £80k and £85k respectively.

6.31 Based on this evidence, and without an explanation of the reasons for the disparity between the SPC20 allowance and FES' actual costs, The Consumer Council believes that FES' Bad Debt SPC20 allowance should be based on historical data for FES' regulated business. In this case, using the figures for the SPC17 period.

6.32 If UR decides to continue using the percentage of total credit revenue methodology, The Consumer Council believes that UR should also compare the medium-term target with the level set for energy companies in England & Wales as well as SSE Airtricity, which could lead to a lower figure by the end of the price control period.

6.33 UR proposes to use a 45:55 ratio to apportion the Debt Costs allowance between FES' regulated and unregulated businesses. This is based on FES' analysis that would show that "larger unregulated I&C customers are less likely to default on payments."

6.34 The Consumer Council's own analysis of gas consumption in Ten Towns by FES customer type shows that regulated bill pay customers only account for 7% of all the gas that FES sells in Ten Towns. This is shown in Table 2. Given that pay as you go customers cannot fall into debt[12], we ask UR to re-examine the Bad Debt weighting to ensure that it is as cost reflective as possible.

[12] With the exception of instances of meter interference.

6.35 It would be helpful if Table 4 in UR's consultation paper showed the Bad Debt figures split between FES' regulated and unregulated businesses for each year of the price control. This will provide more clarity about the actual allowance as well as providing a comparison between both businesses.

Table 2. FES Ten Towns Consumption Analysis by market segment

	Consumption (MWh)	% share of overall consumption
Regulated pay as you go	121,412	22%
Regulated bill pay (domestic credit & I&C <73,200kWh)	40,951	7%
I&C >73,200 kWh	399,824	71%
Total	562,187	100%

Source: UR Quarterly Transparency Report Q1 2019

Bill Processing and Postage

6.36 We welcome UR's proposals because we believe that communications with consumers can be undertaken at a very low marginal cost by including non-billing customer information such as energy theft or energy efficiency with scheduled mail shots. Furthermore, FES can avail increasingly of low cost digital and online tools that make print runs obsolete.

6.37 The Consumer Council believes that rather than increasing or even staying constant during the price control period, there is a strong argument that the average cost per customer should be declining as more customers move to online and digital methods for receiving customer information and billing.

6.38 However, in point 7.4.40 of FES' SPC17 Final Determination, UR stated that the Processing and Postage costs cover all the customer literature and information that "the company must provide to its customers under licence requirements." Given that FES only spent around 30% of its allowance in the first two years of SPC17, we ask UR to clarify whether this is the result of efficiencies that FES has achieved during the period, or a reflection of changes in consumers' behaviours and preferences, rather than FES not meeting its licence obligations.

Paypoint Costs incl. PAYG Cards

6.39 At present FES pay as you go (PAYG) customers can only top on PayPoint outlets. From the perspective of the PAYG users it would be a positive development to have a greater choice of options to top up. We ask UR and FES to consider assessing the feasibility during the SPC20 period. Also, given that that this allowance is mostly a pass-through of the charges that PayPoint applies, we would encourage FES to try and negotiate a lower cost.

Meter Reading

6.40 The Consumer Council has three concerns about UR's proposals for FES' meter reading allowance. First of all, it is our understanding that suppliers are responsible for taking meter readings from their customers. We are surprised to read in UR's consultation paper that FES' meter reading rates "are set" without any explanation or evidence about the methodology used, or how UR has scrutinised the rates or benchmarked those with SSE Airtricity Gas and suppliers outside Northern Ireland. We ask UR to provide a detailed analysis on this issue in the final determination.

6.41 We note also that FES advises and incentivises its customers to provide their own meter reads through discounts and billing advice[13]. We are interested in finding out whether such incentives have reduced the number of meter readings that FES has had to undertake for its regulated and unregulated businesses and if so, whether UR has considered this when setting the SPC20 allowance.

Table 3. FES Meter Reading Costs, Forecasts and Allowances for SPC17 and SPC20.

	2017 (actual)	2018 (Latest Best Estimate)	2019 (forecast)	2020 (forecast)	2021 (forecast)	2022 (forecast)
SPC17 FES Submission	£226k	£252k	£274k	N/A	N/A	N/A
SPC17 UR FD	£227k	£194k	£199k	N/A	N/A	N/A
SPC17 Actuals	£127k	£146k	£166k	N/A	N/A	N/A
SPC20 FES Submission and UR DD	N/A	N/A	N/A	£187k	£200k	£231k

Source: UR SPC17 Final Determination and UR SPC20 Consultation Paper

[13] https://www.firmusenergy.co.uk/home/help-advice/network/billing-payments/can-i-manage-my-account-online-to-monitor-my-consumption

6.42 With regards to the meter reading costs that UR proposes, we would like to point out that the parallels in how UR is setting FES' meter reading allowance for SPC20 compared to SPC17 and FES' actual costs in SPC17 suggests that the allowance could be much lower. We have included our analysis in Table 3.

7 Gas Costs

Energy Balancing

7.1. The Consumer Council believes that FES should be able to forecast actual demand with greater accuracy and therefore have an active incentive to purchase a greater proportion of its gas in advance[14].

7.2. We believe also that UR should benchmark both aspects of the energy balancing cost against gas suppliers in GB.

8 Margin

8.1 In our response to UR's SPC17 consultation[15], The Consumer Council suggested that UR should not increase FES' margin at the time, 1.5%. UR's SPC17 Final Determination set FES' margin at 2% and UR is now proposing to set the same level for SPC20.

8.2 We agree with UR's assessment that the regulated retail market conditions in Ten Towns have not changed sufficiently during the first two years of the SPC17 period. Therefore we believe that the existing 2% margin level for FES is adequate.

9 Reconciliation Costs

Inflation

9.1 UR proposes using the Retail Price Index (RPI) as its measure of inflation. The RPI has been widely discredited as an appropriate measure of inflation. However, we note that Paul Johnson in his report to the UK Statistics Authority on the use of consumer price indices concluded: "RPI is not a credible measure of consumer price change … Taxes, benefits and regulated prices

[14] SLG's note for The Consumer Council in respect of UR SSE Airtricity Consultation Paper. We will include the complete note in our response to the SSE Airtricity SPC20 consultation.
[15] https://www.uregni.gov.uk/sites/uregni/files/media-files/CCNI%20Final%20Response_0.pdf

should not be linked to RPI … Government and regulators should work towards ending the use of RPI as soon as practicable "[16]. Other regulators such as Ofcom, Ofwat and Ofgem have already moved partially or completely to using the Consumer Price Index (CPI) or are considering its use in their current regulatory reviews.

9.2 Since vulnerable consumers rely on pensions and benefits that are linked to the CPI, there is a significant risk of these consumers being disadvantaged if the CPI and RPI measures diverge (as for example occurred in 2008-09) and the price-adjustments in their incomes do not rise in line with their gas costs. We therefore believe that it is strongly in consumers' interests to move to using CPI rather than RPI for indexing FES' regulated tariffs[17].

Rate of Interest

9.3 The Consumer Council believes that FES should have an incentive to under or over recover as little as possible. We therefore propose that the rate of interest for over recovery is slightly lower than the rate of interest for under recovery, so that accurate forecasting of costs and revenues is incentivised[18].

10 Conclusion

10.1 The Consumer Council aims to strike a balance between the growth and development of natural gas whilst ensuring the interests of consumers are protected. In our view many aspects of this price control do achieve this balance.

10.2 We have sought to offer views on how we believe consumers can be better protected. Specifically we would welcome work to introduce benchmarking against industry best organisations and consider efficiencies that help minimise FES' costs.

10.3 The Consumer Council remains committed to working in partnership with UR and the gas industry to develop natural gas and its accessibility, to promote competition and most importantly, to protect the interests of consumers.

[16] https://www.statisticsauthority.gov.uk/news/uk-consumer-price-statistics-a-review-2/
[17] SLG's note for The Consumer Council in respect of UR SSE Airtricity Consultation Paper. We will include the complete note in our response to the SSE Airtricity SPC20 consultation.
[18] Idem.

10.4 If you would like further information or to discuss any issues in this paper, please contact Paulino García on 028 9025 1645 or Paulino.Garcia@consumercouncil.org.uk.

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