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

September 2019

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, Markets and Networks. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our mission

To protect the short- and long-term interests of consumers of electricity, gas and water.

Our vision

To ensure value and sustainability in energy and water.

Our values

- Be a best practice regulator: transparent, consistent, proportionate, accountable and targeted.
- Be professional – listening, explaining and acting with integrity.
- Be a collaborative, co-operative and learning team.
- Be motivated and empowered to make a difference.

Abstract

Protecting customers is at the heart of the Utility Regulator's role and ensuring that customers pay the correct price for gas from the price regulated supplier firmus energy Supply Ltd (FES) is a core part of our work.

We commenced a review of the maximum average price with FES in August 2019. We have scrutinised the submission provided by FES 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 FES' domestic and small business customers in the Ten Towns area will decrease to 142.14 pence per therm from 155.80. This equates to a decrease of 8.77% to the bills of domestic and small business customers.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

FES' customers in the Ten Towns area will see an average decrease of 8.77% 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 2019.

The impact of the tariff change on a domestic credit customer with average consumption of 12,000 kWh per annum will be a decrease of approximately £61 per annum (including VAT) on their gas bill.

1. Context

1.1 On 20 August 2019 the Utility Regulator—in consultation with firmus energy (Supply) Limited (FES), the Department for the Economy (DfE) and the Consumer Council Northern Ireland (CCNI)—began a review of the FES 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 October 2018 and covers approximately 40,000 domestic and small business customers[1] within the Ten Towns area.

1.2 The Utility Regulator carries out formal reviews of the FES 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 FES has made to date.

1.3 The formal review was initiated to establish the new maximum average price to become effective from 1 October 2019. The review is a formal process agreed by the UR, FES, DfE and the CCNI.

1.4 FES 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. FES 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.

1.5 From 1 October 2019, the maximum average price for domestic and small business customers will be 142.14 pence per therm (p/therm); decreasing from 155.80 in the October 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 2020 and will continue to monitor gas prices to identify if an additional review is required.

1.6 The unit rates of tariffs for FES's customers in the Ten Towns area will decrease by approximately 8.77% from 1 October 2019. These unit rates are detailed in Table 4 of this paper

[1] https://www.uregni.gov.uk/sites/uregni/files/media-files/2019-06-13%20Transparency%20Report%20Q1%202019%20final%20for%20review%20UPDATED.pdf

2. Background

2.1 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.

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

2.3 From 1 April 2015, the supply market in the Ten Towns area opened to competition from new entrant suppliers in all customer sectors. However FES are currently the only supplier for domestic consumers in this market. FES currently supply around 40,000 domestic and small business customers (referred to as "tariff" customers) in this area.

2.4 Under the terms of FES's licence to supply gas, the Utility Regulator ("the Authority") has the power to control the maximum amount that FES can charge for gas. These controls apply when customers are not protected by competition. The FES 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*"[2].

2.5 The Utility Regulator has established a price control determination which sets out FES'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

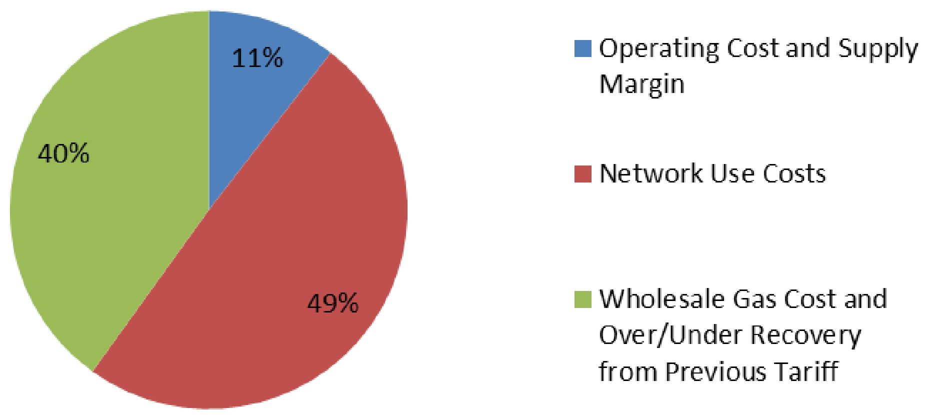
2.6 The maximum average price is made up of a number of costs:

[2] 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

- Operating costs and supply margin;
- Network costs; and
- Wholesale cost of gas.

2.7 The breakdown is shown in Figure 1 below.

Figure 1 – Makeup of the maximum average price from 1 October 2019



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

Operating Costs and Supply Margin

2.9 Operating costs are the costs necessary for FES 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.

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

2.11 In November 2016 we published the final determination for the firmus energy supply price control[3] which indicates the total amount of revenue that the Licensee can recover, in any relevant year, in respect of their gas supply

[3] 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

business.

2.12 The price control determination runs from 1 January 2017 to 31 December 2019. As there is as yet no new price control set for 1 January 2020 onwards, the assumption for this tariff has been to keep the operating costs and supply margin flat with no change for the period 1 January 2020 to 30 September 2020.

Network Costs

2.13 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.

2.14 The FES 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.

2.15 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 Mutual Energy website and on the Gas Market Operator NI website.

2.16 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 runs from 1 January 2017[4]. 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

2.17 As determined within the FES 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.

2.18 The FES price control determines that gas costs are treated as pass through

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

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.

2.19 FES 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 more short term fluctuations in wholesale gas prices, and therefore aims to create more stability in the gas price for final customers. **It is important to note that FES' hedging strategy will be specific to it, and due to the specific timing of forward gas purchases the price paid will be different from other suppliers who will purchase different volumes at different time periods (and hence at different prices as the gas market moves on a daily basis). Hence, the overall wholesale cost of FES will likely always differ from that of other gas suppliers even though they are purchasing from the same gas market.**

2.20 At the time of review, the overall cost of gas for the maximum average price is estimated based on a combination of actual forward 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

2.21 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.

2.22 Where the wholesale gas costs out turn less than was forecast in the maximum average price, FES 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.

2.23 Alternatively, where the wholesale gas costs turn out higher than forecast in the maximum average price, FES 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.

2.24 Therefore, each maximum average price includes an amount of over or under recovery which was accumulated during the previous tariff period.

2.25 Both FES 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.

3. Why is the Maximum Average Price for FES decreasing?

3.1 The maximum average price for FES' tariff customers in the Ten Towns area will decrease to 142.14 p/therm from 1 October 2019. 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[5]
01-Apr-16	115.51
31-Mar-17	130.27[6]
05-Apr-18	139.10
01-Oct-18	155.80
01-Oct-19	142.14

3.2 The overall decrease in the FES maximum average price is due to:

- the decrease in the cost of wholesale gas;
- a fall in the under recovery of wholesale gas costs; and

[5] *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*

[6] *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.*

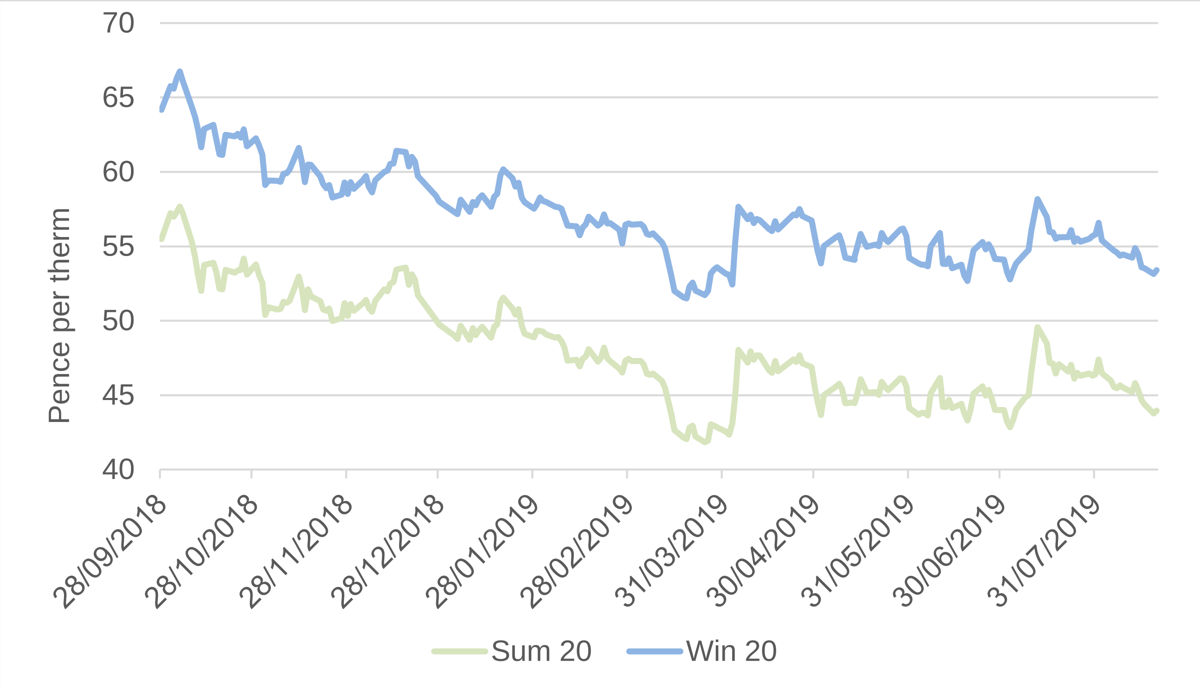
- OPEX p/therm costs reducing due to higher demand.

3.3 These are explained in the sections below.

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

3.4 Forecasted gas costs on the forward curve have decreased over the last year, as is shown in Figure 2.

Figure 2 – Movement in forward curve of wholesale gas cost



Source: Platts McGraw Hill Financial

3.5 This fall in firmus' own commodity costs is the key driver of the forthcoming firmus tariff decrease. As can be seen in Table 2, firmus' wholesale gas costs fell from 64.74 p/therm in the current tariff to 56.25 p/therm in the 1 October 2019 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. As outlined in section 2.19 the resulting wholesale gas cost is a function of FES own specific purchasing strategy.

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

Elements within Maximum Average Price	Oct 2018 (p/therm)	October 2019 (p/therm)
Wholesale Gas Cost	64.74	56.25
(Over)/Under Recovery	2.86	0.70
Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods	**67.60**	**56.95**

3.6 The maximum average price coming into effect from 1 October 2019 also includes an under recovery of £115k from the existing tariff period, which has fallen from £367k in October 2018. FES has been recovering this amount throughout the last tariff period at a rate of 2.86 p/therm which was factored into the tariff. The remaining amount will be recovered by FES through a lower 0.7 p/therm rate from 1 October 2019.

3.7 As shown in Table 2 above, overall the combined cost of wholesale gas and over/under recovery has decreased from 67.60 p/therm in the 1 October 2018 tariff to 56.95 p/therm in the 1 October 2019 tariff. This decrease makes up 6.84 percentage points of the overall 8.77% decrease.

OPEX

3.8 As shown in Table 3, OPEX costs in pence per therm have fallen since the tariff was last set in 1 October 2018. This was driven by an increase in tariff volume since the tariff was last set due to:

- an increase in forecast consumption estimates; and
- approximately 5,500 new tariff connections

3.9 This increase in customers and forecast consumption means an increase in the number of units over which the largely fixed OPEX cost is recovered, hence the cost per unit decreases. This decrease makes up 1.78 percentage points of the overall 8.77% decrease.

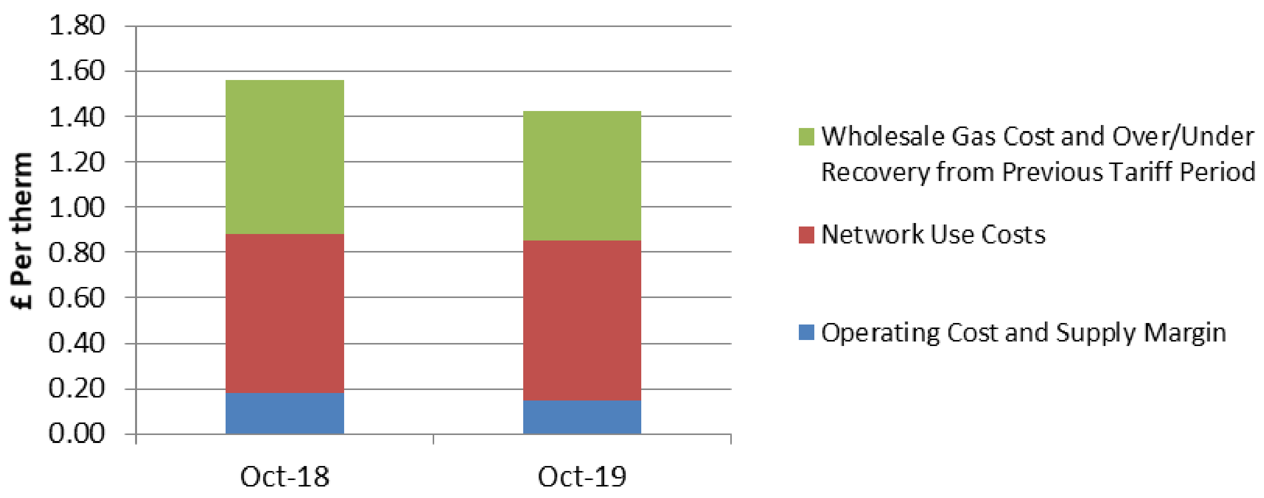
Table 3 – OPEX from Previous Tariff Periods within Maximum Average Price

Elements within Maximum Average Price	Oct 2018 (p/therm)	October 2019 (p/therm)
OPEX	14.86	12.09

4. Breakdown of Maximum Average Price

4.1 The graph shown in Figure 3 below compares the breakdown of the October 2019 maximum average price with a breakdown of the previous maximum average price set at October 2018.

Figure 3 – Breakdown of October 2019 maximum average price compared with previous maximum average price



Impact on Tariff

4.2 As already stated, FES 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. FES cannot charge more than the maximum average price overall. From 1 October 2019, the unit rates of tariffs for FES's customers in the Ten Town area will decrease by around 8.77%.

4.3 The new unit rates for tariff customers 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 – FES's tariff unit rates from 1 October 2019 (shown in p/kWh including VAT)

FES gas supply tariffs Ten Towns	Domestic (inc. 5% VAT)	PAYG (inc. 5% VAT)	IC1 (ex. VAT)
Up to 2,000 kWh	7.30	5.06	7.47
Over 2,000 kWh	4.92	-	4.96
Over 73,200 kWh	-	-	-
Direct Debit discount	22.00	-	-

Table 5 – Percentage decrease in FES's tariff unit rates from 1 October 2019

FES gas supply tariffs Ten Towns	Domestic	PAYG	IC1
Up to 2,000 kWh	-8.76%	-8.77%	-8.77%
Over 2,000 kWh	-8.78%	-	-8.77%
Over 73,200 kWh	-	-	-

4.4 FES's typical domestic credit bill will decrease to £638 per annum[7] from 1 October 2019. This equates to a decrease of around £61 per year compared with the existing tariff.

Comparison with GB and Ireland

4.5 Figure 5 below shows the typical FES domestic credit tariff from 1 October 2019, compared with Bord Gais[8] in Ireland and the Default Tariff Cap[9] level in GB. 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.

4.6 This graph illustrates that the FES tariff for an average domestic standard credit customer in the Ten Towns area will be 16% above the Default Tariff Cap level in GB. This can expected due to the:

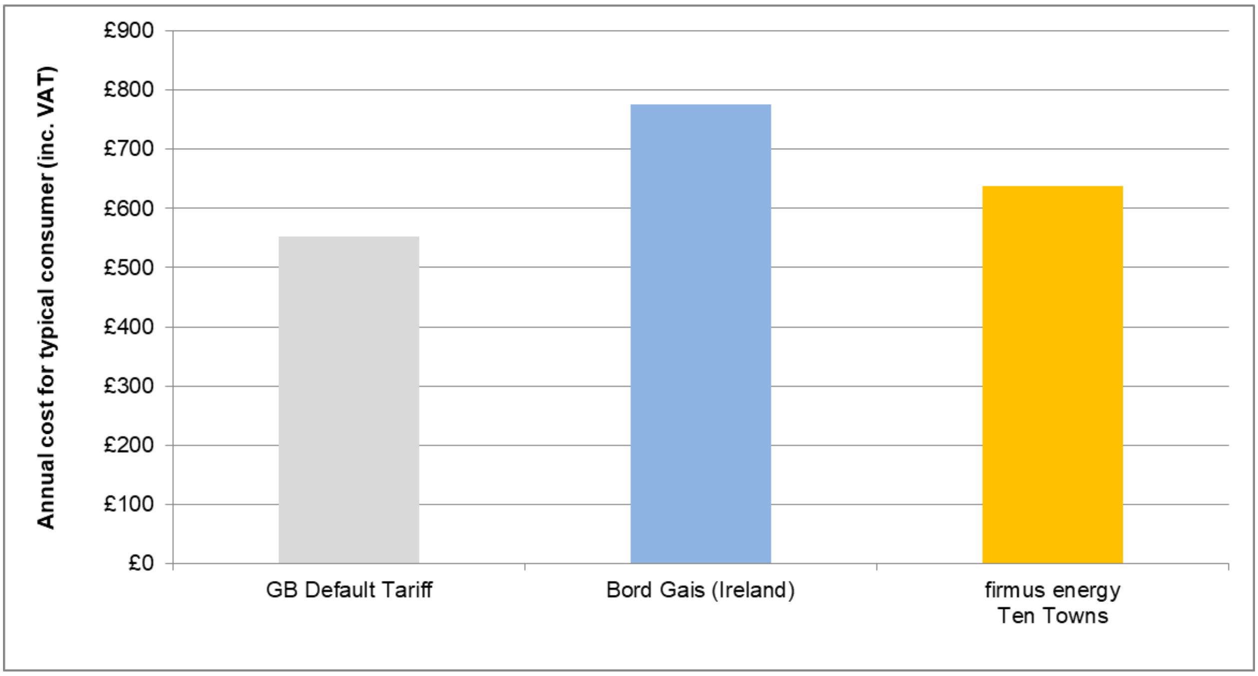
- added cost of transporting gas from GB to Northern Ireland; and
- smaller market in NI meaning network costs are spread across a smaller customer base.

4.7 The FES tariff for an average domestic standard credit customer is 18% below the Bord Gais standard tariff in Ireland**.**

[7] Based off a typical consumption of 12,000 kWh per annum. Including VAT. Excluding discounts.
[8] https://www.bordgaisenergy.ie/home/our-tariffs. Exchange rates as of 04/09/19.

[9] https://www.ofgem.gov.uk/system/files/docs/2019/08/default_tariff_cap_level_-_1_october_2019_-_31_march_2020.pdf. Average across all regions.

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



Conclusion

4.8 The Utility Regulator has reviewed the maximum average price submission provided by FES and reviewed the forecasts against its own market analysis. The Utility Regulator is satisfied that it is appropriate and justified to set a maximum average price of 142.14 p/therm for tariff customers in the Ten Towns for one year. This represents an average decrease of 8.77% in the actual tariff unit rates that FES uses to charge domestic and small business customers in the Ten Towns area.

4.9 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.