Price Control for firmus energy (Supply) Ltd 2023-2026

Draft Determination for consultation

May 2022

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

This document sets out the UR's consultation proposals for the price control on firmus energy (Supply) Ltd (FES) in the Ten Towns gas supply market.

This consultation follows our Supply Price Control Information Note published in November 2021. This paper outlines our proposals in relation to the main areas within the FES control: structure and form; scope and coverage of regulated tariffs; duration of control; operating costs levels and allocations; and allowed margin.

Audience

Industry, consumers, and their representative bodies and statutory bodies.

Consumer impact

The price control will protect customers by setting a maximum limit on the average price that FES can charge its price regulated customers for gas in the Ten Towns area. This ensures that customers only pay for the cost of the gas they receive and a fair profit margin.

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Glossary

Name	Definition
CAPEX	Capital Expenditure
CCNI	Consumer Council for Northern Ireland
CMA	Competition and Markets Authority
DfE	Department for the Economy
EUC	End User Category
FES	firmus energy (Supply) Ltd
firmus distribution	firmus energy (Distribution) Ltd
FTE	Full Time Equivalent
GB	Great Britain
HMRC	Her Majesty's Revenue & Customers
IT	Information Technology
LBE	Latest Best Estimates
NBP	National Balancing Point
NI	Northern Ireland
OPEX	Operating Expenditure
PAYG	Pay As You Go
PNGL	Phoenix Natural Gas Ltd
PSL	Phoenix Supply Limited
Power NI	Power NI Energy Ltd
RPI	Retail Price Index
SGN	SGN Natural Gas Limited
SNIP	Scotland to Northern Ireland Pipeline
SSE Airtricity	SSE Airtricity Gas Supply (NI) Ltd
UR	Utility Regulator

1. Introduction

1.1 The principal objective of the Utility Regulator (UR) in relation to gas is "to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland" while having regard to "the need to ensure a high level of protection of consumers of gas".

1.2 To help meet this objective we retain price controls on dominant, former monopoly, gas suppliers. This consultation sets out our proposals for the price control for firmus energy (Supply) Ltd (FES) in the Ten Towns area.

1.3 We propose the control will apply for the four year period of 1 January 2023 to 31 December 2026.

1.4 This document sets out the proposals and principles that will form the basis of the price control and provides background information on the Ten Towns gas market.

1.5 This consultation follows the UR's Information Note published in November 2021 which set out our high level proposals for the FES and SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) price controls. A separate consultation for SSE Airtricity's supply price control will be published in June.

1.6 We consider that our approach has been consistent with the principles of better regulation[1] which the UR continues to apply: transparent, consistent, proportionate, accountable, and targeted.

1.7 All costs presented are in October 2021 prices. These prices will be adjusted within the tariff for inflation as discussed in Section 9.

[1] Department for Business Innovation & Skills, *Principles for Economic Regulation,* April 2011: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

2. Background

2.1 In Northern Ireland (NI) there are three distinct distribution areas for natural gas. These are the Greater Belfast area, the West area, and the Ten Towns area. The Greater Belfast area is served by Phoenix Natural Gas Ltd (PNGL) and the price regulated supplier is SSE Airtricity. The West area is served by SGN Natural Gas Ltd (SGN) and the price regulated supplier is also SSE Airtricity. The Ten Towns area is served by firmus energy (Distribution) Ltd (firmus distribution) and the price regulated supplier is FES.

2.2 The Ten Towns area covers a geographical region that includes Londonderry, Limavady, Coleraine (including Portstewart and Bushmills), Ballymoney, Ballymena (Broughshane), Antrim (including Ballyclare and Templepatrick), Craigavon (including Portadown and Lurgan), Banbridge, Newry (Warrenpoint) and Armagh (Tandragee).

2.3 The Ten Towns area is a relatively small market, and there are currently approximately 61,088 gas connections (comprising of 2,956 I&C connections and 58,132 domestic connections)[2].

2.4 This market opened in two stages with the market for large I&C users (those using above 25,000 therms per annum) opening in October 2012 and the market for domestic and small I&C customers opening in April 2015. Currently there are four active suppliers in the market, though FES remains the monopoly supplier to domestic properties.

2.5 The current FES price control applies for the period from 1 January 2020 to 31 December 2022.

2.6 firmus energy is an integrated business that includes firmus energy (Distribution) Ltd which operates the distribution network in the Ten Towns area. The distribution company is also subject to price control. The current control, GD17, ends on 31 December 2022.

[2] Quarterly Transparency Report (Q421) - https://www.uregni.gov.uk/files/uregni/documents/2022-02/q4-2021-qremm-final.pdf

3. Scope and Duration

Scope

3.1 The SPC17 Final Determination stated that the control would apply to two distinct End User Categories (EUC):

- EUC1 – all domestic customers and those small businesses using less than 2,500 therms (73,200 kWh); and
- EUC2 – those businesses using between 2,500 and 25,000 therms (73,200 and 732,000 kWh) per annum.

3.2 However, following that determination the UR issued a further consultation in October 2017. The result of that consultation was a decision to reduce the scope of the FES price control to exclude EUC2 customers. This was due to the reduction in FES market share in the EUC2 sector, meaning that it no longer held a dominant position. Thereafter, as of 1 April 2018 non-domestic customers consuming between 2,500 and 25,000 therms (73,200 and 732,000 kWh) per annum were no longer to be covered by the price control.

3.3 Due to the continued dominance of FES in the EUC1 category, for SPC23 we propose to retain the scope of the control at domestic and small business customers using up to 2,500 therms (73,200kWh) per annum.

Duration

3.4 In the November 2021 Information Paper we stated that we considered a four year period to be the most appropriate duration for the price controls as it balances the resource implications of carrying out a control with the ability to forecast accurately over the medium term.

3.5 Therefore, it is our proposal to apply the control for a period of four years; from 1 January 2023 to 31 December 2026.

4. The Regulated Tariff

4.1 The gas supply licence confers on the UR the power to control charges if deemed necessary:

2.4.1 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[3] *shall not exceed the maximum price calculated"*

4.2 A price control is the mechanism that the UR uses to determine the costs which make up the maximum average price per therm that a price regulated gas supply company can charge.

4.3 In granting consent we review the maximum average price to ensure that it is constructed in line with the provisions within the price control.

4.4 This price control sets out the treatment of each cost element which makes up the maximum average price. These are:

- Network Costs
- Wholesale Gas Costs
- Supply Operating Costs
- Margin

K Factor

4.5 In addition to the costs outlined above the maximum average price will also include a k factor adjustment.

4.6 Within this consultation we have proposed that some costs should be treated as retrospective costs. Some of the retrospective costs will be pass through costs, meaning that the company is allowed to recover the actual levels of costs incurred; whereas other retrospective costs will be subject to a retrospective adjustment to calculate the level of allowed cost based on pre-determined factors.

4.7 The costs which we have proposed in this price control to treat as retrospective costs are listed in the table below along with our proposal for determination basis of each cost.

[3] Regulated Premises means premises supplied by the Licensee in the Ten Towns Area at which the normal annual consumption of gas is reasonably expected not to exceed 73,200 kilowatt hours.

Retrospective cost line	Determination Basis
Network costs	Pass through cost (see Section 5 of this draft determination)
Wholesale gas costs	Pass through cost (see Section 7 of this draft determination)
Prepayment transaction costs (within Billing costs)	Retrospective adjustment (see section 6.39 of this draft determination)
Bad debt (within Billing costs)	Retrospective adjustment (see section 6.31 of this draft determination)
Meter reading costs (within Billing costs)	Retrospective adjustment (see section 6.42 of this draft determination)
Customer information (processing & postage) (within Billing costs)	Retrospective adjustment (see section 6.36 of this draft determination)
Safety inspections and meter exchanges (within Operations Costs)	Retrospective adjustment (see section 6.28 of this draft determination)

4.8 Within the tariff we will include a forecast for these retrospective costs based on historical performance and latest best estimates. Each year a reconciliation is carried out to calculate the actual allowed costs based on pass through cost, or the retrospective adjustment as appropriate.

4.9 The k factor is the difference—whether positive or negative—between all of the pass through and retrospectively adjusted actual costs incurred, and what was forecast for them. This difference will then be taken off or added to the next tariff revenue requirement respectively at the next tariff change.

4.10 It is our intention to maintain the k factor at a minimum level through the use of regular tariff reviews and a trigger mechanism to monitor the tariff closely and thus minimise the impact of the k factor on the tariff.

Tariff Review

4.11 A tariff review is the process of analysis and discussion of the tariff to consider if a change to the tariff is needed, and to decide the magnitude and timing of any change.

4.12 We review the gas tariffs on a bi-annual basis. In addition we will be able to initiate a tariff review under the trigger mechanism as discussed below. We consider that regular reviews minimise the impact of k factor on the tariff and can help mitigate tariff volatility for consumers.

4.13 We have established a process in consultation with the FES, the Consumer Council NI (CCNI), and the Department for the Economy (DfE) which sets out the timescales and information required in setting the tariff.

4.14 The tariff review process is a consultative one where all parties bring their expertise and opinion in relation to the needs of the gas supplier, the needs of the consumer, and the wider impact on the economy. Therefore, it is important that all parties are aware of and in agreement with the formal process.

4.15 This process provides a robust procedure, which is in line with the requirements of the licence to ensure that all parties are consulted in a timely, prescribed, and comprehensive manner for both anticipated and unanticipated tariff reviews.

Trigger Mechanism

4.16 In addition to the bi-annual tariff reviews we establish a trigger mechanism within the price control. The aim of this trigger mechanism is to initiate a tariff review should the cost of wholesale gas purchased by the gas supplier vary significantly from the cost forecast within the tariff.

4.17 The trigger mechanism will operate to allow the UR to initiate a tariff review should the tariff costs change between review periods, either increase or decrease, so as to change the tariff by 5%.

4.18 We consider the 5% level to be an appropriate level, any level under this and volatility in the wholesale market could necessitate a number of tariff reviews in a year. Tariff reviews can be costly and complex for the company.

4.19 Where a review is initiated by the trigger mechanism, the tariff review group will look at a number of factors including:

- Volatility in the wholesale gas market
- Time since last tariff review
- Level of k factor
- Amount of gas purchased by the supplier

4.20 The UR also retains the flexibility to initiate a review at any stage it considers is in the interest of customers.

Tariff Structure

4.21 The domestic credit tariff for FES is made up of two charges; a higher charge for the first 2,000 kWh used per annum and a second charge for any usage above 2,000 kWh per annum[4].

4.22 Pay as You Go (PAYG) customers pay a flat tariff for each unit used[5].

4.23 Industrial and commercial customers using less than 73,200 kWh (2,500 therms) are charged a two tiered tariff; with different charges for usage up to 2,000 kWh per annum, and between 2,001 kWh and 73,200 kWh per annum.

4.24 At each tariff review we will require the supplier to demonstrate the assumptions used to create the tariff structure in order to ensure that the average weighted price charged to customers is equal to or less than the maximum average tariff.

[4] FES domestic tariff https://www.firmusenergy.co.uk/home/tariffs-offers/all-tariffs

[5] FES PAYG tariff https://www.firmusenergy.co.uk/home/tariffs-offers/all-tariffs

5. Network Costs

5.1 Network costs are the charges incurred by FES for their use of the NI gas transmission and distribution systems. These charges are reviewed and approved by the UR.

5.2 The costs for the transmission system are those costs involved in bringing gas from Scotland to NI, via the Scotland to NI Pipeline (SNIP), and all the transmission pipelines within NI. These costs are published on the Gas Market Operator for NI (GMO NI) website[6].

5.3 The costs for the distribution system are those costs associated with moving gas throughout the distribution networks area to homes and businesses. These can be found on the firmus website[7].

5.4 Distribution costs are also subject to price control by the UR. The current price control, GD17, runs from the period of January 2017 for to 31 December 2022.

5.5 Within the previous controls for FES, the network costs have been treated as pass through costs. This means that the customer pays for the actual cost of the network charges that FES incur, and no more than that.

5.6 We propose that network costs remain as pass through costs as these are costs which are outside the control of the supplier.

[6] GMO NI charges: https://gmo-ni.com/assets/documents/NI-Forecast-Tariff-Publication-GY2122.pdf

[7] FES conveyance charge statement: https://www.firmusenergy.co.uk/publications/category/conveyance-charges/specific/conveyance-charge-statement-2022

6. Supply Operating Costs

6.1 Supply operating costs are those costs which relate to the day to day operating of the FES supply business; and include among other things salaries, IT costs, metering costs, rent and rates, consultancy/legal fees and bad debt.

6.2 In November 2021 the UR provided FES with an initial information request for the operating costs wholly incurred by the supply business in the provision of gas to customers within the Ten Towns. This included the total operating costs for serving both price controlled and non-price controlled customers using more than 73,200 kWh per annum.

6.3 The submission requested historical actual costs and a forecast of costs for 2022 and the four years of the price control period 2023-2026. We stated that we would welcome any evidence to support the figures given in the submission. Additionally, the information request was clear that the burden of proof rests with FES to justify the cost base set out in the submission.

6.4 The costs shown throughout this paper are the total FES Ten Towns Supply business costs only (i.e. not including the FES Greater Belfast supply business costs). The apportionment allocation of costs determines the appropriate level of costs to the tariff sector (i.e. the price regulated sector of FES). This ensures there is no cross-subsidisation between the tariff and non-tariff parts of the FES business. In order to calculate the apportionment, each cost line is apportioned on the basis of the most appropriate cost driver and these apportionments summed to provide the overall percentage. A list of the apportionment cost drivers can be found in Annex 1.

6.5 In January 2022 the supplier presented its initial submission to the UR.

6.6 Over the past four months we have engaged with FES to understand this submission through meetings and various additional information requests. We have analysed the forecast cost figures against historical costs and previous determinations and benchmarked information against other companies where appropriate. We have also engaged consultants to review specific elements of the submissions (i.e. Profit Margin).

6.7 As a result we present below our proposals for the allowable operating costs within the price control for FES. These proposals are shown against the previous year's actuals and future costs requested by the supplier.

6.8 In the submission FES presented its costs broken down into detailed costs lines. We present here the costs summarised into three main cost categories; **Manpower**, **Operations**, and **Billing**. It is not our intention to provide a line-by-line budget for the supplier to spend, but rather to provide an efficient overall allowance, derived from a reasonable assessment of the various cost requirements, for it to spend running the price regulated supply business.

6.9 In setting out how we have reached our proposed allowances we will refer to the submissions and detailed cost lines and discuss in more detail those areas where our proposals vary significantly from the FES' submissions.

6.10 Table 1 below shows the total (price regulated and non-price regulated) costs for the FES Ten Towns supply business.

Table 1 SPC23 submission and consultation proposals (£000)

Tariff Costs	Actuals/Forecast			Initial Submission				Consultation Proposals			
	2020 (Actual)	2021 (Actual)	2022 (Forecast)	2023	2024	2025	2026	2023	2024	2025	2026
Manpower Costs	998	1,054	1,052	1,100	1,121	1,142	1,163	1,100	1,121	1,142	1,163
Operations Costs	907	914	852	597	642	734	729	570	608	694	682
Billing Costs	802	1,006	1,137	1,245	1,350	1,452	1,552	1,209	1,309	1,407	1,503
Total Costs	**2,707**	**2,974**	**3,041**	**2,942**	**3,113**	**3,329**	**3,444**	**2,880**	**3,039**	**3,243**	**3,348**

6.11 The following section discusses each of these three main cost headings above in greater detail to explain the basis for the consultation proposals.

Manpower Costs

Table 2 Manpower Costs (£000)

Tariff Costs	Actuals/Forecast			Initial Submission				Consultation Proposals			
	2020 (Actual)	2021 (Actual)	2022 (Forecast)	2023	2024	2025	2026	2023	2024	2025	2026
Manpower	918	964	984	1030	1049	1069	1088	1030	1049	1069	1088
Entertainment	23	31	3	4	4	4	4	4	4	4	4
Training	10	18	19	19	20	20	20	19	20	20	20
Travel and subsistence including Fleet	22	16	20	21	22	22	23	21	22	22	23
Recruitment Costs Contract staff	24	25	26	27	27	28	28	27	27	28	28
Total	**998**	**1054**	**1052**	**1100**	**1121**	**1142**	**1163**	**1100**	**1121**	**1142**	**1163**

Salaries

6.12 Salaries make up the vast majority (93%) of the manpower cost submission along with some other smaller items of manpower cost. The submission for manpower costs for FES' Ten Towns gas supply company reflects an increase of 0.5 Full Time Equivalents (FTE) for each year until the end of the 2026. FES has stated that this FTE increase is a direct result of the additional c.30k tariff customers forecast over the next 4 years (overall a 50% increase in current customer numbers). The extra 0.5 FTEs per year was said to be needed to cover the additional billing resource and customer service staff necessary to facilitate this customer growth.

6.13 The additional FTEs requested for regulatory work, customer service and billing appear commensurate and linear with the expected level of customer growth and therefore we propose allowing the increase in costs that FES has requested.

Note: In their initial submission FES originally asked for Manpower costs to increase by 1% above inflation. We propose not to allow this as it would be inconsistent with the treatment of salaries in the gas distribution controls. The Manpower figures in Table 2 have the proposed 1% increase removed.

Other Manpower Costs

6.14 Entertainment - We propose to accept FES' submission as it is in line with HMRC recommendations and SPC20.

6.15 Training - We propose to allow this cost which is in line with historical spend, and commensurate with training norms.

6.16 Travel and subsistence (including Fleet Costs) - We propose to allow this cost which is in line with historical spend, and commensurate with expected travel norms.

6.17 Recruitment Costs Contract staff - We propose to forecast the SPC23 costs based on the historic recruitment costs.

Operation Costs

Table 3 Operation Costs (£000)

Tariff Costs	Actuals/Forecast			Initial Submission				Consultation Proposals			
	2020 (Actual)	2021 (Actual)	2022 (Forecast)	2023	2024	2025	2026	2023	2024	2025	2026
Office Costs including stationery, telephone and postage	46	43	47	48	49	51	52	48	49	51	52
Rates	4	5	5	5	5	5	5	5	5	5	5
Professional and Legal Fees	55	81	71	78	85	92	98	71	71	71	71
Insurance	32	42	43	45	47	49	51	45	47	49	51
Information Technology	186	187	206	227	246	265	284	227	246	265	284
CAPEX	485	434	333	13	14	64	17	13	14	64	17
Licence Fee	2	2	2	2	2	2	2	2	2	2	2
Network Maintenance including safety inspections	51	77	98	108	117	127	136	108	117	127	136
Call Centre	40	37	40	43	47	51	55	43	47	51	55
Advertising, Website and Sales Development	6	5	7	7	8	8	9	7	8	8	9
Supplier of Last Resort	0	0	0	20	20	20	20	0	0	0	0
Total	**907**	**914**	**852**	**597**	**642**	**734**	**729**	**570**	**608**	**694**	**682**

IT OPEX and CAPEX

6.18 IT costs make up the majority of the operation costs incurred by FES. The new billing system implementation is the IT solution replacing firmus energy's current IUS system.

6.19 The IT costs submitted for SPC23 are broken down into an OPEX and CAPEX element. OPEX costs relate to the ongoing maintenance and support of the various IT platforms/systems and other general IT and telecoms costs. We propose that these are based on existing OPEX costs increasing in line with customer growth. The CAPEX costs of the new billing system were previously captured in the current Price Control SPC20. The CAPEX costs going forward are thus very small in comparison to the current control. We propose to allow these small costs for SPC23 including an extra allowance in 2025 to cover the need for lifecycle replacement laptops, PCs, monitors and meter reading tablets due in 2025.

Professional and Legal Fees

6.20 In both its SPC20 and SPC23 submissions, FES has forecasted costs for Professional and Legal fees to be driven by the forecast increase in customer numbers. After review, we believe this methodology does not accurately reflect how Professional and Legal spend will change. In reality, this spend decreased from 2021 to the forecast in 2022 despite rising customer numbers. Therefore, for the four years of SPC23 we propose that the forecast for 2022 be used to set a fixed allowance. 2020 is considered an outlier due to COVID and will not be used in this calculation.

Advertising, Website and Sales

6.21 FES included a fixed amount in its submission of £25k for 2022 and £50k for each year from 2023-2026 in anticipation of entry into the Ten Towns market by other domestic gas suppliers. The supplier stated that if this entry were to occur FES would have to adopt a new competitive operational strategy.

Note: It is our view that the customers of a regulated company—which is also the commissioning supplier and in a dominant position in the market and a monopoly position in the domestic sector—should not bear the costs of advertising. We therefore removed the £25K from the 2022 forecast and the £50K for each year from 2023-2026.

6.22 Therefore, we propose that FES be provided no additional advertising and marketing allowance. This would be consistent with the price control treatment of both Power NI and SSE Airtricity, neither of which were provided a marketing allowance under their respective price controls when their regulated businesses first faced competition. FES is still the monopoly domestic supplier and faces no competition in the Ten Towns market. However, we will keep this under review as the market develops and observe whether FES' domestic market share deteriorates should competition emerge.

Other Operations Costs

6.23 Office Costs (including stationery, telephone and postage) - We propose to allow this cost which is in line with historical spend, and commensurate with increases in FTEs.

6.24 Rates - FES submitted costs for Rates which increase with FTEs. We see this as an inappropriate driver for rates as they will not be impacted by additional FTEs, but rather the size of Land and Property Services (LPS) increases. We therefore propose that Rates forecasts are set at the 2021 level, as per SPC20 (i.e. the cost observed in the most recent LBE).

6.25 Insurance - We propose to allow this cost which is in line with historical spend, and commensurate with forecast volumes for the price control period. FES provided proof for the increases in overall insurance costs stating that insurance costs had been highly impacted by COVID.

6.26 Licence Fee – We propose to allow the costs for licence fees.

6.27 Network Maintenance (including safety inspections) - We propose to accept the FES submission as the unit rates for maintenance items and safety inspections are set by the network company and the volumes are retrospectively adjusted.

6.28 Call Centre - FES' submission had forecasts based on the average of previous 3 years. The forecasts are inflated by customer numbers throughout SPC23 and this is reasonable.

6.29 Supplier of Last Resort - FES also submitted costs of £20k for each year of the price control to cover Supplier of Last Resort (SoLR) costs. We propose to exclude this as SoLR costs are captured as part of the SoLR process.

Billing Costs

Table 4 Billing Costs (£000)

Tariff Costs	Actuals/Forecast			Initial Submission				Consultation Proposals			
	2020 (Actual)	2021 (Actual)	2022 (Forecast)	2023	2024	2025	2026	2023	2024	2025	2026
Bad debt	27	32	74	85	96	107	117	49	56	62	68
Paypoint costs	497	523	568	616	663	709	754	616	663	709	754
Credit Check Costs	0	1	1	2	2	2	2	2	2	2	2
Bank and Interest Charges	7	6	7	7	7	8	8	7	7	8	8
Meter reading	156	251	276	303	329	355	380	303	329	355	380
Customer Information Bill Processing and Postage	115	192	211	232	252	272	291	232	252	272	291
Total	**802**	**1006**	**1137**	**1245**	**1350**	**1452**	**1552**	**1209**	**1309**	**1407**	**1503**

Bad Debt

6.30 FES state that Bad Debt costs are calculated directly upon the principle of applying 0.25% to credit revenue. This is aligned to the UR determination for SPC20, and as FES' historic figures support this percentage, FES have continued this assumption for SPC23. However in addition to this FES have also weighted the split of bad debt to tariff and non-tariff credit revenue differently to ensure they say, a more accurate provision of debt to each sector.

6.31 FES submit that historically, contract customers are less likely to default on payments, whereas tariff domestic customers and, in particular, IC1 customers are more likely to do so. Whereas the overall debt provision is approximately 0.25%, FES analysis indicates that tariff bad debt is closer to 0.5% whilst non-tariff bad debt is approximately 0.15%

6.32 The submission details an overall forecast of a 0.25% debt provision, as per SPC20, however FES have applied a weighting of 0.5% allowance on tariff revenue with the remainder (approximately 0.15%) applied to non-tariff revenue.

6.33 From analysis of the supplier's financial accounts and responses to numerous UR Information Requests, we determined that FES' calculation of 0.5% of credit revenue for bad debt for the regulated business was based on a methodology using bad debt provision as opposed to actual bad debt. We calculated an actual bad debt level (actual written off debt as opposed to bad debt provision) for regulated customers of 0.29% of credit revenue.

6.34 We propose that Bad Debt is based on the actual write-offs rather than bad debt provisions. This average is calculated at 0.29% of tariff credit revenue based on the average of 2019 - 2021 and this calculation is used to forecast 2022 write offs (the last year of the current control) and then the allowances for SPC23 (0.29% of credit revenues). The 2022 forecast is more than double the 2021 actual as credit revenues in 2022 have more than doubled.

Bad debt will be retrospectively adjusted and allowed as 0.29% of tariff credit revenue.

Note: the figures for Bad Debt in the table above (Actuals/Forecast, Initial Submission and Consultation Proposals) relate to tariff customer debt only.

Bill Processing and Postage

6.35 Bill processing is a major cost that is subject to retrospective adjustment relating to actual bills, invoices, Pay as You Go (PAYG) statements and other literature sent out to tariff customers such as direct debit change confirmations, tariff changes, credit control / debt reminders, property handover letters. The rates are set by the UR for the control period and the costs adjusted for the volumes of letters sent.

6.36 In its submission FES detailed the expected mailing requirements for 2022 (i.e. number of tariff changes; number of bills sent; etc). FES then based its forecasts on increasing this cost with customer growth.

6.37 From analysis of the supplier's financial accounts and responses to numerous UR Information Requests, we determined that FES' forecast costs for Customer Information Bill Processing and Postage were reasonable. The forecasts are based on actual 2021 costs uplifted for customer numbers. The large increase from 2020 to 2021 is due to FES incurring higher costs as 47,000 PAYG customers are now receiving PAYG statements bi-annually which equates to an increase of £60k a year. This is part of the consumer protection programme.

Other Billing Costs

6.38 Paypoint Costs (including PAYG cards) - We propose to accept the FES submission as the rates are agreed and numbers are retrospectively adjusted.

6.39 Credit Check Costs - We propose to accept the FES requested allowances as the costs are based on 2021 costs and are uplifted for increases in customer numbers for SPC23.

6.40 Bank and Interest Charges - These costs will be allowed as they are based on the average of 2019-2021 and thereafter increase in line with forecast volume.

6.41 Meter reading - We propose to accept the FES submission as the rates are set and numbers are retrospectively adjusted.

7. Gas Costs

7.1 Gas Costs relate to the cost of wholesale gas as well as the costs for transporting gas through Great Britain (GB) to the SNIP. These transportation costs are published by National Grid[8]. Previous controls have determined that these costs are pass through which means that FES is allowed to recover the actual cost of gas. Therefore, where wholesale gas costs increase or decrease, the difference in costs is passed on to customers.

7.2 In the Information Paper, we proposed to allow wholesale gas costs and the related transportation costs as pass through costs. Wholesale gas costs will be allowed as pass through at the level purchased at the National Balancing Point (NBP).

Energy Balancing

7.3 In reviewing the gas costs we consider it appropriate to set an additional allowance for energy balancing. The energy balancing amount is a figure included within the tariffs to account for the cost of buying gas within the month as opposed to on the forward curve. The actual wholesale cost of the gas remains pass through, this figure is to ensure the tariff reflects the impact of the timing of purchasing the gas. FES will hedge the majority of their purchases before the month but some gas will remain to be purchased within the month to match the actual consumption profile.

7.4 We will set the energy balancing figure in the tariff as follows:

- Where FES has 40% or less of their gas requirements for the month remaining to be secured, there will be a 10% premium applied to the remaining gas to be purchased.
- Where FES has more than 40% of their gas requirements for the month remaining to be secured, there will be a 10% premium on 40% of the total purchases for the month.

7.5 This is in line with the energy balancing figures currently within the FES tariff. We will discuss the parameters of the energy balancing element of the tariff with FES during the consultation period.

Credit Support

7.6 FES submitted details of credit arrangements in place to cover transmission, distribution, and gas costs and other relevant costs. Currently credit cover

8 http://www2.nationalgrid.com/uk/Industry-information/System-charges/Gas-transmission/Current-charges/

costs are allowed at an agreed pence per KWh.

7.7 The submission for the supplier's credit costs are reasonable when benchmarked to other suppliers in the energy supply industry. We therefore propose to allow these costs.

8. Margin

8.1 During SPC17, we conducted a complete review of margin in line with the methodology used for the previous Power NI supply price control using a notional supply business capital base (made up of core capital and contingent capital) and the cost of capital to calculate an appropriate margin.

8.2 The SPC17 Final Determination approved a margin of 2% of allowable turnover. This was determined to strike an appropriate balance between the calculations of the CMA, UR external consultants and both FES and SSE Airtricity and their advisors, whilst at the same time taking account of other benchmarks in the energy industry.

8.3 We outlined in our Information Note[9] in November 2021 that we did not believe that market conditions have changed sufficiently to warrant any amendment to this level of margin. FES retains a dominant position in supply to price regulated customers (and is the monopoly supplier to domestic customers) in the Ten Towns area and has associated market power. This is one of the principal reasons for the continuance of the price control, and FES still has more market share and fewer competitors than Power NI had when the 2.2% was set for that supplier.

8.4 However FES engaged with consultants Frontier Economics on the issue of margin and, alongside their business plan submission, submitted to the UR a paper from Frontier that outlined a retail supply margin proposal which refreshed the numbers used in the calculations for the SPC17 margin. This again was based on the methodology of a notional supply business capital base (made up of "core" and "contingent" capital) and the cost of capital. It also compared the result of that methodology to relevant benchmarks such as the GB price cap and the Power NI margin to calculate a range within which the FES margin should come. The range suggested by Frontier was 2.2% - 3% of allowable turnover.

8.5 The UR engaged consultants First Economics to assess the Frontier analysis. Both consultants engaged and the UR also met with FES and both sets of consultants in April. Alongside some minor differences in approach, principally to do with the value of the customer base, the main area of disagreement was the cost of capital for that portion of the capital base which is contingent capital i.e. trading collateral requirements and risk capital.

8.6 Whilst Frontier felt that this contingent capital should receive the full rate of return (pre-tax nominal WACC 8.6% – 10.9%), First Economics are of the

[9] https://www.uregni.gov.uk/news-centre/gas-retail-supply-price-controls-2023-information-note

view that it should receive a return of 2%. First Economics sited the CMA decision in its energy market enquiry when it calculated the cost of letters of credit at 2%, alongside observed cost for letters of credit and PCGs of 2%.

8.7 First Economics concluded that whilst these did not provide a definitive answer to the question of what is the cost of contingent capital, the evidence did point clearly in the direction of a costing of around 2%, and that is what the CMA had decided was appropriate in its findings to the enquiry.

8.8 First Economics also compared the result of its own methodology to relevant benchmarks such as the GB price cap and the Power NI margin to calculate an appropriate FES margin and their conclusion was that there is no justification for an increase to the current 2%.

8.9 The UR therefore at this stage proposes no change to the current margin of 2% of allowable turnover.

9. Reconciliation

9.1 This section sets out how the price control will be reconciled to actual allowed costs on an annual basis.

Reconciliation

9.2 On an annual basis we will reconcile the forecast costs that are allowed in the price control with the actual allowed costs (i.e. the retrospectively adjusted allowed costs) to determine a reconciliation amount. This amount will then form part of the k factor.

9.3 The reconciliation will take into account:

- Costs which are retrospectively adjusted
- Ring-fenced allowances (if any)
- Inflation
- Rate of interest applicable
- Possible Other items (to be confirmed)

9.4 In addition to the information required to complete this reconciliation, we will also require from FES annual cost reporting to show their actual costs on a line-by-line basis reconciled with regulatory accounts.

Inflation

9.5 All costs presented in this paper are in October 2021 prices. These costs will be adjusted to account for inflation where appropriate. Inflation will be treated as a pass through. The costs used to make up the tariff at each tariff period will be adjusted to reflect the current price base. For reconciliation purposes the inflation figure will be the average figure for the year being reconciled. The inflation index used will be Consumer Prices Index Including Owner Occupiers' Housing Costs (CPIH).

Rate of Interest

9.6 We propose that any reconciled amounts, whether under or over recovered, will be rolled forward at an interest rate of Bank of England Base Rate plus 1.5%. The Bank of England Base Rate will replace LIBOR which was previously used. The proposed rate of interest reflects the cost to the suppliers of financing the under recovery or the benefits to them of holding any over recovery.

10. Responding to the consultation

10.1 Your response may be made public by the Utility Regulator. If you do not want all or part of your response or name made public, please state this clearly in the response by marking your response as 'CONFIDENTIAL'.

10.2 Therefore you want other information that you provide to be treated as confidential, please be aware that, under the Freedom of Information Act 2000, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential.

10.3 Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 and the Data Protection Act 2018.

10.4 As stated in the GDPR Privacy Statement for consumers and stakeholders, any personal data contained within your response will be deleted once the matter being consulted on has been concluded though the substance of the response may be retained.

10.5 This is an open consultation. We have not posed any specific questions in this paper. Instead we invite stakeholders to express a view on any particular aspect of the paper.

10.6 Responses should be received by 4pm on 29 July 2019 and should be addressed to:

Daniel Squires
The Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED
Daniel.Squires@uregni.gov.uk

Annex 1

Apportionment Cost Drivers

Cost	Driver
Manpower	FTEs
Entertainment	FTEs
Training	FTEs
Travel and subsistence including Fleet Costs	FTEs
Recruitment Costs Contract staff	FTEs
Office Costs including stationery, telephone and postage	FTEs
Rates	FTEs
Professional and Legal Fees	Customer number
Insurance	FTEs
IT OPEX	Customer bills
IT CAPEX	Customer bills
Licence Fee	Load in therms
Network Maintenance including safety inspections	firmus care customers[10]
Call Centre	Customer number
Advertising, Website and Sales Development	Customer number
Supplier of Last Resort	Customer number
Bad debt	Credit Revenue[9]
Paypoint costs incl PAYG cards	PAYG customers[9]
Credit Check Costs	Customer number
Bank and Interest Charges	Load in therms
Meter reading	Customer numbers[9]
Customer Information Bill Processing and Postage	Customer numbers[9]

[10] This is how this cost line is apportioned for this consultation. This cost is then retrospectively adjusted to actual numbers.