Price Control for SSE Airtricity Gas Supply (NI) Ltd and firmus energy (Supply) Ltd

Draft Determination

10 June 2016



About the Utility Regulator

The Utility Regulator is the independent non-ministerial government department responsible for regulating Northern Ireland's electricity, gas, water and sewerage industries, to promote the short and long-term interests of consumers.

We are not a policy-making department of government, but we make sure that the energy and water utility industries in Northern Ireland are regulated and developed within ministerial policy as set out in our statutory duties.

We are governed by a Board of Directors and are accountable to the Northern Ireland Assembly through financial and annual reporting obligations.

We are based at Queens House in the centre of Belfast. The Chief Executive leads a management team of directors representing each of the key functional areas in the organisation: Corporate Affairs; Electricity; Gas; Retail and Social; and Water. The staff team includes economists, engineers, accountants, utility specialists, legal advisors and administration professionals.

Our Mission	Value and sustainability in energy and water.
Our Vision	We will make a difference for consumers by listening, innovating and leading.

Our Values

Be a best practice regulator: transparent, consistent, proportionate, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

This document sets out our draft determination for price controls on SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) in the Greater Belfast market and firmus energy (Supply) Ltd (firmus energy) in the Ten Towns gas supply market. The SSE Airtricity price control will come into effect on 1 April 2017. The firmus energy control will come into effect on a January 2017. This consultation also sets out our proposal to implement a supply price control in the West area.

This consultation follows our Approach to Supply Price Controls consultation published in October 2015. This paper outlines the proposed decisions in relation to the main areas within the controls: 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 in terms of price by setting a maximum limit on the average price that the regulated gas suppliers can charge for gas in their relevant markets.

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Glossary

Name	Definition
Capex	Capital Expenditure
CCNI	Consumer Council for Northern Ireland
CMA	Competition and Markets Authority
EED	Energy Efficiency Directive
EUC	End User Category
firmus	firmus energy (Supply)Ltd
firmus distribution	firmus energy (Distribution) Ltd
FTE	Full Time Employee
GB	Great Britain
HMRC	Her Majesty's Revenue & Customers
IT	Information Technology
LBE	Latest best estimates
NI	Northern Ireland
PNGL	Phoenix Natural Gas Ltd
PSL	Phoenix Supply Limited
Power NI	Power NI Energy Ltd
Q	Quarter
REMM	Retail Energy Market Monitoring
SEM	Single Electricity Market
SGN	SGN Natural Gas Limited
SSE Airtricity	SSE Airtricity Gas Supply (NI) Ltd
TSO	Transmission System Operator
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 draft decisions for the price control for the two price-regulated gas supply companies.

- SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) in the Greater Belfast area

- firmus energy (Supply) Ltd (firmus) in the Ten Towns area

1.3. This consultation also sets out our proposal for a supply price control in the West gas distribution area for SSE Airtricity as Commissioning Supplier in that new area.

1.4. The controls will apply from 1 April 2017 for SSE Airtricity and 1 January 2017 for firmus. The discrepancy in dates is due to different accounting periods for the two companies.

1.5. This document sets out the proposed decisions and principles that will form the basis for the price control and provides background information on the gas markets in Northern Ireland.

1.6. This draft determination follows the Approach to Supply Price Controls consultation published in October 2015[1] which set out our high level proposals for the price controls. We received five responses to this consultation which are published alongside this draft determination and addressed where relevant within this consultation.

1.7. We consider that our approach has been consistent with the principles of better regulation[2] which the Utility Regulator continues to apply: transparent, consistent, proportionate, accountable and targeted.

1.8. All costs presented are in October 2015 prices. These prices will be adjusted within the tariff for inflation as discussed in section 11.2.

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1 Approach to Supply Price Controls consultations: http://www.uregni.gov.uk/uploads/publications/Approach_Consultation_v_2_2015.pdf

2 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 there are three distinct distribution areas for natural gas. These are the Greater Belfast area, the Ten Towns area and the West area. The Greater Belfast area is served by Phoenix Natural Gas Ltd (PNGL) and the price-regulated supplier is SSE Airtricity. The Ten Towns area is served by firmus energy (Distribution) Ltd (firmus distribution) and the price-regulated supplier is firmus. The West area is served by SGN Natural Gas Ltd (SGN). This is a new gas area where development is currently underway. As yet there are no connections to the gas network. We discuss our views on a price-regulated supplier for this area in section 8.

SSE Airtricity

2.2. The Greater Belfast market includes Belfast, Newtownabbey, Carrickfergus, Larne, Carryduff, Newtownards, North Down and East Down. There are approximately 189,000 connections to the network (comprising of 177,926 domestic and 10,807 I&C connections) in this area.

2.3. Currently there are six active suppliers in the market. Only two of these companies supply to domestic customers; SSE Airtricity and firmus. One supplier, Electric Ireland, only supplies to very large users and is not included within the tables in this determination.

2.4. SSE Airtricity, as the incumbent dominant supplier (having purchased Phoenix Supply Limited), is subject to price control. The current SSE Airtricity price control lasts for a period of five years from January 2012 to December 2016. This price control can be found on our website[3].

2.5. During 2015 SSE Airtricity formally wrote to the UR to request a change in accounting period from January to December, to April to March. This change was approved and came into force on 1 April 2016.

2.6. The new control will therefore be effective from 1 April 2017.

2.7. We propose to roll over the existing control for a period of three months from 1 January 2017 to 31 March 2017. Section 4 sets out our proposals for this roll over.

3 Utility Regulator Determination on Phoenix Supply Price Control 2012-2016, November 2011: http://www.uregni.gov.uk/uploads/publications/PSL_PC03_Determined_to_Position_Table_26_blanked_for_website2.pdf

firmus

2.8. 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).

2.9. The Ten Towns Market is a relatively small market, there are currently approximately 29,000 gas connections (comprising of 2,347 I&C connections and 26,538 domestic connections).

2.10. 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 firmus remains the sole supplier to domestic properties.

2.11. The current firmus price control runs from April 2015 to December 2016. This control can be found on our website[4].

2.12. firmus 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, GD14[5] ends on 31 December 2016 and a new control, GD17 is currently being drafted.

2.13. We note that the GD17 draft determination[6] imposes upon firmus distribution greater connection targets than included within the firmus submission. For the draft determination we have used the firmus submission given to us for this supply price control, however, we propose for consistency that we will use the GD17 determined targets for the final determination of this supply control.

2.14. Where relevant proposed decisions are in line with our treatment of costs within GD17.

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4 Final Determination on Price Control for firmus energy (Supply) Ltd 1 April 2015 – 31 December 2016, 15 December 2014: http://www.uregni.gov.uk/uploads/publications/2014-12-15_Supply_Price_Control_final_determination.pdf

5 GD14 Price Control for Northern Ireland's Gas Distribution Networks for 2014-2016 Final Determination, 20 December 2013: http://www.uregni.gov.uk/uploads/publications/2013-12-20_GD14_Price_Control_for_NI_GDNs_2014-2016_Final_Determination.pdf

6 Price Control for Northern Ireland's Gas Distribution Networks GD17 Draft Determination, 16 March 2016: http://www.uregni.gov.uk/uploads/publications/2016-03-16_GD17_Draft_Determination_-_Final.pdf

3. Scope and Duration

Scope

3.1. The current SSE Airtricity and firmus price controls for apply to customers using less than 25,000 therms (732,000 kWh) per annum (typically domestic properties and small to medium sized businesses).

3.2. This scope includes two customer categories,

- those using less than 2,500 therms (73,200 kWh), known as End User Category (EUC) 1, typically domestic and small commercial properties and
- those using between 2,500 and 25,000 therms (73,200 and 732,000 kWh) per annum known as EUC 2, typically small to medium sized industrial and commercial properties

3.3. As part of the approach paper we stated that we would review whether it was appropriate for the scope to remain at this level.

SSE Airtricity

3.4. The following table shows the current market shares by connection numbers and consumption in the Greater Belfast market.

Table 1: Market share by connection numbers and consumption Greater Belfast

		SSE Airtricity	firmus	Go Power	Flogas	Vayu
Market share by Connection Numbers	EUC1 - Domestic	73%	27%	0%	0%	0%
	EUC1 – I&C	70%	14%	8%	7%	0.2%
	EUC1 - Domestic & I&C	73%	27%	0%*	0%*	0%*
	EUC2 I&C	40%	20%	21%	18%	0.4%
Market share by consumption	EUC1 - Domestic & I&C	70%	29%	0.4%	1%	0.01%
	EUC2 I&C	38%	31%	11%	19%	0.3%

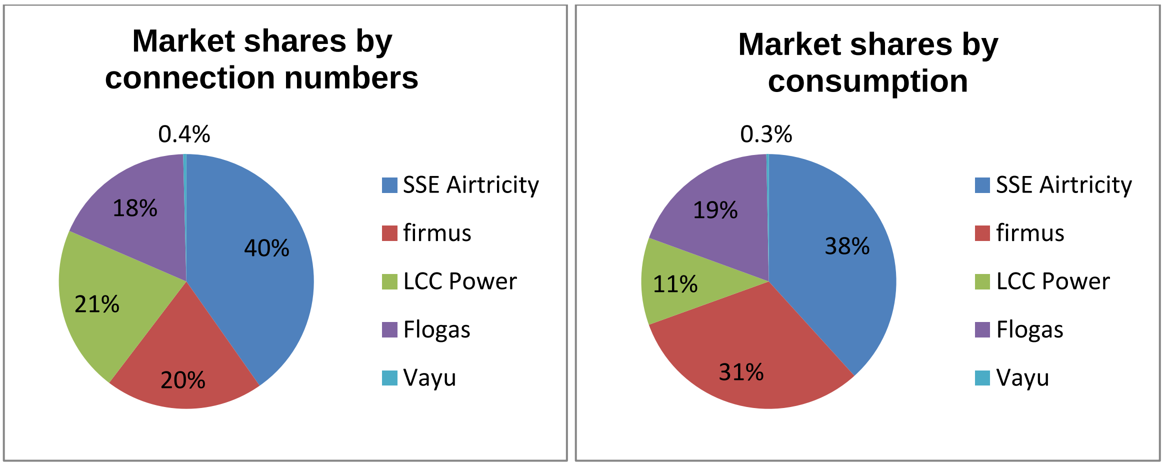
*While Go Power, Flogas and Vayu each hold shares in the EUC1 I&C market the number of domestic properties reduces their share of the overall EUC1 market to 0.3% each for Go Power and Flogas and to 0.01% for Vayu.

3.5. The table shows that SSE Airtricity are dominant in the EUC1 category for domestic and small I&C properties with 73% of market share by connection numbers (made up of 73% of domestic properties and 70% of small I&C properties) and 70% by consumption. There are nearly 186,000 customers in this category.

3.6. There has been little movement in market shares in this category since Q1 2014.

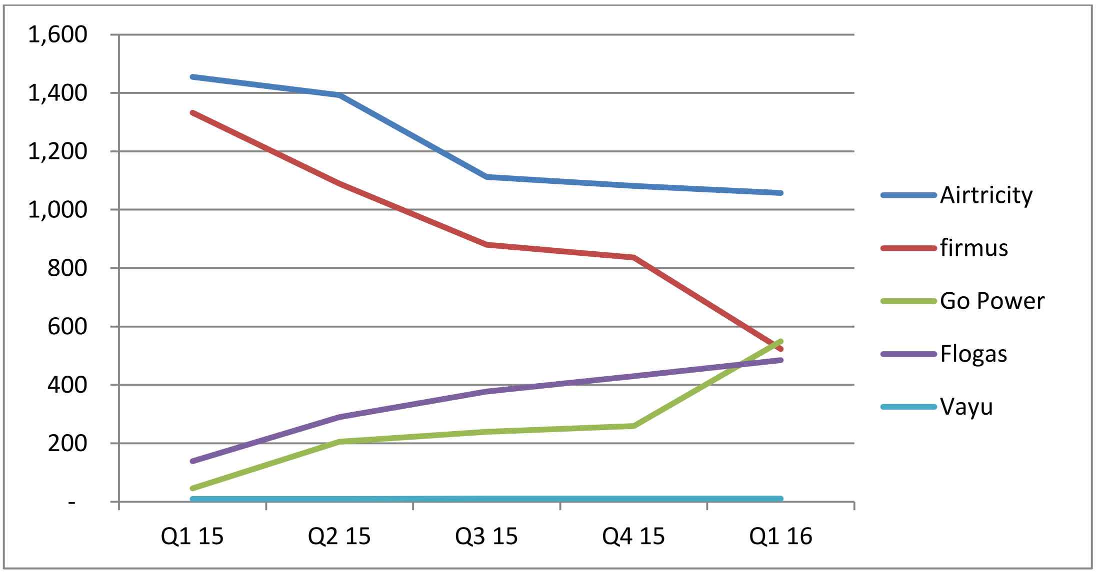
3.7. There are around 2,600 customers within the EUC2 market. SSE Airtricity hold 40% of the market by connection numbers with three of the other suppliers holding around 20% each. By consumption SSE Airtricity hold 38% of the market, with firmus holding 31%. This is reflected in the pie charts below.

Chart 1: Market share in Greater Belfast EUC2 category by connection numbers and consumption



3.8. The graph below shows the movement in connection numbers in the EUC2 category in Greater Belfast from Q1 2015 to Q1 2016 and demonstrates that competition is active in this market as customers are switching and suppliers are gaining and losing market share.

Chart 2: Movement in connection numbers in EUC 2 category in Greater Belfast



3.9. Given that SSE Airtricity now hold less than 50% of the market share and there are four other active suppliers in this market, we propose to remove the EUC2 category from the scope of the SSE Airtricity control. This proposal is consistent with the treatment of Power NI, as the UR removed the price control on that business in the 50-150MWh segment of the electricity market when its share of that segment of the market fell below 50%.

3.10. We therefore propose that the price control for SSE Airtricity will apply only to domestic customers and I&C customers using less than 2,500 therms per annum.

firmus

3.11. The following table shows the market shares by connection numbers and consumption for the Ten Towns area.

Table 2: Market share by connection numbers and consumption Ten Towns

		firmus	SSE Airtricity	Go Power	Flogas
Market share by Connection numbers	EUC1 - Domestic & I&C	100%	0.004%	0.1%	0.3%
	EUC2 I&Cs	78%	0.3%	2%	20%
Market share by consumption	EUC1 - Domestic & I&C	99%	0.01%	0.2%	1%
	EUC2 I&Cs	76%	1%	2%	21%

3.12. firmus are dominant in the EUC1 category, holding almost 100% of the overall market of both domestic and small I&C properties, nearly 28,000 connections in total.

3.13. Within the EUC2 category firmus are also dominant holding 78% of market share by connection numbers. Flogas is the only other competitor with significant market share. There are approximately 900 connections in this market.

3.14. Due to the dominance of firmus in both the EUC1 and EUC2 categories, and the fact that, with the exception of Flogas, other competitors do not hold appear to be very active in this market we propose to retain the scope of the control at customers using up to 25,000 therms per annum. This will cover both the EUC1 and EUC2 categories.

Responses to Approach Consultation

3.15. Overall respondents to the consultation were in agreement with our review of the scope of the control, stating that it satisfied the criteria for deregulation proposed in the Power NI control.

3.16. One respondent stated that while it supported deregulation within the EUC2 category, it would like additional information to be published on the I&C customers within the EUC1 category, as it may be necessary to also deregulate I&C customers within this category.

3.17. From May 2016 we will be publishing EUC1 connections split by domestic and I&C as shown in the table above in the Quarterly Transparency Reports[7]. This information shows that in Greater Belfast SSE Airtricity currently hold 70% of the I&C connections within the EUC1 category and therefore it is appropriate that these customers remain within the control.

3.18. We are currently unable to obtain consumption figures split by domestic and I&C properties. However we will review this as part of the next stage of the Retail Energy Market Monitoring (REMM) project.

Duration

3.19. Within the Approach consultation we stated that we considered a three 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.

3.20. Two respondents to the consultation commented on this question. One stated that they supported the proposal for three years as it was reasonable given the level of industry change and the possibility of further competition developing.

3.21. The other respondent stated that it did not support the duration as it may be necessary to remove the control for I&C customers over this duration. It does not appear likely that the market shares will change significantly over a three year price control to warrant any further deregulation I the Belfast market or to warrant any deregulation in the Ten Towns market

3.22. It is our proposal to apply the control for a period of three years for both price-regulated gas suppliers; from 1 April 2017 to 31 March 2020 for SSE Airtricity and from 1 January 2017 to 31 December 2019 for firmus.

7 Retail Market Monitoring Quarterly Transparency Report, Quarter 1: January - March 2016, Published 31st May 2016: http://www.uregni.gov.uk/uploads/publications/2016-05-31_Transparency_Report_Q1_2016_Final.pdf

4. Rollover of Existing SSE Airtricity Price Control

4.1. The existing SSE Airtricity price control ends on 31 December 2016.

4.2. During 2015 SSE Airtricity formally wrote to the UR and requested a change in financial year in order to align with the financial year of the SSE group.

4.3. In October 2015, following a consultation period we issued a decision paper[8] which stated that the SSE Airtricity financial year would change from a January to December financial year to an April to March financial year. This change came into effect on 1 April 2016.

4.4. As a result of this change the price control will now commence on 1 April 2017 until 31 March 2020.

4.5. We therefore propose to extend the existing control for a period of three months from 1 January 2017 to 31 March 2017.

4.6. The existing control[9] will apply in its entirety to the price-regulated business of SSE Airtricity as it applies in 2016.

4.7. The control will apply to all customers using less than 25,000 therms per annum (both EUC1 and EUC2 categories).

4.8. Network costs and relevant wholesale gas costs will continue to be treated as pass through costs. Operating costs will be allocated on a pro rated basis from 1 January 2017 to 31 March 2017. The table below shows the operating cost allowance for this period in October 2015 prices.

4.9. The ring fenced allowance for bad debt will be allowed at a pro rated amount, the conditions for the allowance as set out in the determination must be met.

This allowance is ring fenced solely for debt management and prevention and PSL will have to evidence to the Utility Regulator how this money has been spent and the benefits achieved from it.

4.10. The efficiency factor of 1% will apply on all operating costs up to 31 March 2017.

8 Decision paper on change in SSE financial year: http://www.uregni.gov.uk/uploads/publications/2015_10_21_SSE_Airtricity_Decision_on_Licence_Mod_to_Financial_Year.pdf

9 PSL Final Determination http://www.uregni.gov.uk/uploads/publications/PSL_PC03_Determined_to_Position_Table_26_blanked_for_website2.pdf

Table 3: Operating costs allocation from 1 January to 31 March 2017

	Allowance for 2016		Pro Rated Allowance 2017
	2010 prices (£000)	2015 prices (£000)	2015 prices (£000)
Manpower	1,534	1,780	445
Human Resources	27	31	8
Fleet Costs	56	64	16
Travel and Subsistence	15	18	4
Office Costs	218	253	63
Rates	44	51	13
Telephone & Postage	35	41	10
Stationery	38	45	11
Advertising, Marketing and PR	119	138	35
Licence Fee	65	75	19
Professional and Legal Fees	123	142	36
Insurance	57	66	16
IT	178	207	52
Capex	13	15	4
Network Maintenance	147	171	43
Billing	2,121	2,461	615
Total	**4,789**	**5,558**	**1,390**
Efficiency factor	1%	1%	1%
Determination	**4,742**	**5503**	**1376**

4.11. The following costs will be treated as retrospective costs as per the control. The allowance will be adjusted on a retrospective basis for the actual costs and cost drivers.

- Licence Fee
- Inflation
- Apportionment of cost

4.12. Billing costs will also be adjusted on a retrospective basis at the rates as agreed in the 2012-2016 final determination, section 6.14 based on the actual level of activity

- Bad Debt at 1% of credit revenue (adjusted for actual credit revenue)
- Transaction costs (adjusted for actual number of transactions)
- Meter reading costs (adjusted for actual number of meter reads)

- Bill printing costs (adjusted for actual number of bills)

4.13. The rate of interest on any amounts to be returned to or collected from the customer will be rolled forward at an interest of LIBOR plus 1.5% as per section 11.3 of the 2012-2016 final determination.

4.14. The correction mechanism as set out in section 11.4 of the 2012-2016 final determination will apply to costs and volumes up to 31 March 2017.

5. The Regulated Tariff

5.1. The gas supply licence confers on the Utility Regulator (the Authority) the power to control charges if deemed necessary:

2.4.1 Control over Charges in the absence of competition

If ….consumers of different cases or classes of cases or for different areas, whose consumption of gas at any premises is reasonably expected not to exceed 2,197,500 kilowatt hours in any given period of twelve months:

(a) do not have the opportunity of taking a supply of gas from another gas supplier (or if there is such an opportunity it does not safeguard the interests of consumers); and

(b) the Authority determines that competition from fuels other than gas is not safeguarding the interests of those consumers;

then the Licensee shall take all reasonable steps to secure that in any period of 12 months the average price per therm of gas supplied to such consumers shall not exceed a maximum price to which the Authority has consented...

5.2. A price control is the mechanism that we use to determine the costs which make up the maximum average price per therm that a price-regulated gas supply company can charge.

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

5.4. 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

5.5. Under the current licence condition the gas supply companies cannot seek to disapply a price control determination unless they apply for consent to a maximum average price which does not comply with the provisions of the price control.

5.6. Although there has to date been no disapplication of a gas supply price control we consider that the current position poses a number of risks;

i. The timeframe between the final determination and the tariff review means that it may be a number of months before the company will challenge a price control decision.

ii. Any challenge to the price control at a tariff review would lead to a delay in a tariff change and to a buildup of over or under recoveries which would impact upon the consumer.

5.7. Therefore, we consider that it would be appropriate to introduce a licence modification as part of the price control process to include the price control within the licence. We have already commenced discussions on this with the two price-regulated gas suppliers.

5.8. The modification would provide the company with the opportunity to challenge the control at the time of a modification to give effect to any new price control and bring the gas supply licence in line with other licences.

5.9. We intend to consult on the proposed modifications alongside the final determination.

K Factor

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

5.11. Within this draft determination 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

5.12. 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.

Retrospective cost line	Determination Basis
Network costs	Pass through cost (see section 6 of this draft determination)
Wholesale gas costs	Pass through cost (see section 9 of this draft determination)
Prepayment transaction costs (within Billing costs)	Retrospective adjustment (see section 7.4 of this draft determination)
Bad debt (within Billing costs)	Retrospective adjustment (see section 7.4 of this draft determination)
Meter reading costs (within Billing costs)	Retrospective adjustment (see section 7.4 of this draft determination)
Customer information (processing & postage (within Billing costs)	Retrospective adjustment (see section 7.4 of this draft determination)
Safety inspections and meter exchanges (within Network Maintenance cost line in Operations Costs)	Retrospective adjustment (see section 7.3 of this draft determination)

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

5.14. The k factor is the term for the difference between actual allowed costs and forecasts for those costs.

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

5.16. At each tariff change the Utility Regulator will publish the k factor to allow for transparency.

Tariff Review

5.17. 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.

5.18. We will review the gas tariffs on a bi annual basis; additionally 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 guard against tariff volatility for consumers.

5.19. We have established a process in consultation with the gas suppliers, CCNI and the Department for the Economy[10] which sets out the timescales and information required in setting the tariff.

5.20. 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. It is important, therefore, that all parties are aware of and in agreement with a formal process.

5.21. This process will provide 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

5.22. In addition to the bi annual tariff reviews we will 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.

5.23. The trigger mechanism will operate to allow the UR to initiate a tariff review should the wholesale cost of gas change, either increase or decrease, so as to change the tariff by 5%.

5.24. 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.

5.25. Where a review is initiated by the trigger mechanism the tariff review group will look at not only the wholesale cost of gas but 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

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

10 Previously the Department of Enterprise, Trade and Investment

Tariff Structure

5.27. The domestic credit tariff for both price-regulated suppliers is made up of two charges, a higher charge for the first 2,000kWh used per annum and a second charge for any usage above 2,000kWh per annum[11].

5.28. Pay as You Go customers pay a flat tariff for each unit used[12].

5.29. Industrial and commercial customers using less than 73,200 kWh (2,500 therms) per annum are charged a tariff with the same structure as the domestic credit tariff.

5.30. Those I&C customers using between 73,200 and 732,000 kWh (2,500 and 25,000 therms) per annum are charged a three tiered tariff, with different charges for usage up to 2,000kWh per annum, between 2,001kWh and 73,200kWh per annum and above 73,200kWh per annum[13]. This will apply only to firmus customers.

5.31. 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.

11 SSE domestic tariff http://www.airtricitygasni.com/fs/doc/Domestic_Tariff.pdf
firmus domestic tariff https://www.firmusenergy.co.uk/home/tariffs-offers/all-tariffs

12 SSE PAYG tariff http://www.airtricitygasni.com/fs/doc/PAYG_Tariff.pdf
firmus PAYG tariff https://www.firmusenergy.co.uk/home/tariffs-offers/all-tariffs

13 SSE business tariff http://www.airtricitygasni.com/fs/doc/IC2_Tariff.pdf
firmus business tariff https://www.firmusenergy.co.uk/home/tariffs-offers/all-tariffs

6. Network Costs

6.1. Network costs are the charges incurred by each supplier for their use of the Northern Ireland transmission and distribution systems. These charges are reviewed and approved by the Utility Regulator.

6.2. The costs for the transmission system are those costs involved in bringing gas from Scotland to Northern Ireland, via the Scotland to Northern Ireland Pipeline, and all the transmission pipelines within Northern Ireland. These costs are published on the Premier Transmission website[14].

6.3. 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 distribution company websites[15].

6.4. Distribution costs are also subject to price control by the Utility Regulator. The current price control, GD14, ends on 31 December 2016 and a new control, GD17, is currently being undertaken. The GD17 draft determination can be found on our website[16].

6.5. Within the previous controls for SSE Airtricity and firmus, the network costs have been treated as pass through costs. This means that the customer pays for the actual cost of the network charges.

6.6. Within the approach consultation we proposed that network costs remained as pass through costs as these as are costs which are outside the control of the supplier. This proposed treatment was welcomed by respondents.

6.7. Network costs will therefore be treated as pass through costs.

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14 PTL tansmisison charges: http://www.premier-transmission.com/

15 PNGL conveyance charge statement: http://phoenixnaturalgas.com/help-and-advice/networks/charges/firmus conveyance charge statement: https://www.firmusenergy.co.uk/home/firmus-energy-network/publications/conveyance-charge-statement-2016

16 GD17 draft determination: http://www.uregni.gov.uk/uploads/publications/2016-03-16_GD17_Draft_Determination_-_Final.pdf

7. Supply Operating Costs

7.1 Background

7.1.1. Supply operating costs are those costs which relate to the day to day operating of the supply business.

7.1.2. In October 2015 the UR provided both gas supply companies with an initial information request for the operating costs wholly and necessarily incurred by the supply business in the provision of gas to customers within their respective network areas.

7.1.3. The submission requested historical actual costs, latest best estimates of current costs and a forecast of costs for the next three years. We stated that we would welcome any evidence to support the submission. Additionally the information request was clear that the burden of proof rests with the companies to justify the cost base set out in the submission.

7.1.4. The costs shown throughout this paper are the total SSE Airtricity Supply costs (including SSE Airtricity Ten Towns Supply business costs); and the firmus Ten Towns Supply business costs (not including the firmus Belfast supply business costs). Cost apportionment to ensure no cross subsidisation between the regulated and unregulated businesses of both SSE Airtricity and firmus is discussed and explained in section 7.5.

7.1.5. In January 2016 the supply companies presented their initial submissions to the UR.

7.1.6. Over the past four months we have engaged with the companies to understand these submissions through meetings and additional information requests. We have analysed the 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 (e.g. IT required spend).

7.1.7. As a result we present below our draft proposals for the price controls for SSE Airtricity and firmus. These proposals are shown against the actual and requested costs of the companies.

7.1.8. In their submissions the companies presented their 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 companies to spend but rather to provide an efficient allowance for them to spend running the price-regulated supply business.

7.1.9. In setting out how we have reached our proposed allowances we will refer to the submissions and detailed cost lines and discuss those areas where our proposals vary from the companies' submissions.

7.1.10. We have not, at this stage, applied an efficiency factor to operating costs for either supplier for 2017–2019, however, we welcome comments on this matter.

7.2 Manpower Costs

Table 4: Manpower costs for SSE Airtricity (£000s)

	Actual Costs		LBE[17]	Submission			Draft Determination		
	2014	2015	2016	2017	2018	2019	2017	2018	2019
Manpower Costs	916	908	1,436	1,870	1,930	2,052	1,254	1,289	1,325
Staff Engagement	9	15	15	26	25	26	9	9	9
Travel and Subsistence	35	63	76	51	50	51	45	45	45
Training	8	44	44	44	46	47	39	39	39
Recharges	502	630	466	470	475	480	376	380	384
Recruitment Costs	142	214	16	47	49	53	16	16	16
Total	**1,612**	**1,874**	**2,053**	**2,507**	**2,575**	**2,708**	**1,739**	**1,778**	**1,818**
Total FTE	**57**	**57**	**56**	**73**	**72**	**74**	**63**	**63**	**63**
Cost per FTE	**28**	**33**	**36**	**34**	**36**	**36**	**28**	**28**	**29**

7.2.1. SSE Airtricity currently operate with 56 full time staff (FTE). In addition there are six temporary staff employed to carry out reconciliations on prepayment systems. These staff are funded under a mechanism in the current control know as the bad debt management allowance (part of billing costs) and therefore are not reported in the most recent actual manpower costs for 2015.

7.2.2. This level does not include the regulation team or corporate services manpower costs such as those for finance, HR, payroll etc which are recharged separately.

7.2.3. SSE Airtricity has requested an increase of 17 staff members to 73 FTE from 2017 onwards.

17 LBE means Latest best estimates

7.2.4. This increase is made up of:

- 6 staff to reconcile prepayment system – transferred to manpower costs from billing costs
- 5 staff to support increased opening hours and Energy EfficiencyDirective support
- 1 training/quality monitoring
- 2 complex complaint handlers
- 1 field operative
- 1 credit controller
- 0.5 SSE rewards administrator
- 0.5 central services return from career break

7.2.5 Having benchmarked SSE Airtricity against both firmus and Power NI we consider that SSE Airtricity currently has a high staff level.

7.2.6 Further we consider that a number of posts requested, such as training/quality monitoring, complex complaint handlers and the post created for the returning staff member would provide internal efficiencies to the company by freeing other staff from undertaking this work.

7.2.7 While we support SSE Airtricity's request to increase the opening hours the request for 5 additional staff appears excessive. The increased opening hours equate to an additional 23 hours per week yet SSE Airtricity have requested 185 man hours. While we understand that more than one person is required to operate during these opening hours we consider that this increase can be met with 3 additional staff alongside changes to shift patterns etc within the existing workforce. This increased staffing level will also provide EED support.

7.2.8 In relation to the prepayment reconciliation we understand that this is necessary ongoing work in order to manage the prepayment system to minimise bad debt and reconcile prepayment statements. However we consider that some of the work undertaken over the last two years in this area has been legacy work and has reduced the backlog of work to be undertaken. As such we propose to allow 4 staff for prepayment reconciliation.

7.2.9 The field operative and credit controller position were requested initially as a bad debt management allowance which has subsequently transferred to manpower costs. There was, however, insufficient information to assess the benefit of these posts to customers.

7.2.10 SSE Airtricity have requested 0.5 FTE in order to administer the SSE rewards scheme for gas customers. This scheme allows customers to avail of priority tickets for the SSE arena in Belfast and in other parts of the country. We consider that this cost is not wholly and necessarily related to the supply of gas to customers and therefore this cost, and all costs relating to the SSE rewards scheme are not allowed within this control.

7.2.11 We propose to allow a total of 63 staff from 2017 for the period of the control. This is made up of the existing 56 staff plus an additional 3 for extra opening hours/EED support and 4 for prepayment reconciliation.

7.2.12 SSE Airtricity has stated in their submission that they utilise the Hays methodology to determine salaries at all grades, and aim to be a median employer in Northern Ireland, not paying either the highest or the lowest salary.

7.2.13 In addition SSE Airtricity has introduced the living wage, which affects the lower salary grades.

7.2.14 SSE Airtricity have also requested salary increases of 5% for lower grades and 1% for all other grades above inflation.

7.2.15 Overall we support the review of salaries undertaken by SSE Airtricity. We agree with the Hays methodology for determining salaries and have benchmarked with other companies and find the salaries to be broadly in line with those companies.

7.2.16 We also support the introduction of the living wage and note the intention for the minimum wage to be increased to £9 per hour by 2020, thereby requiring an increase in salary levels for these grades.

7.2.17 However SSE Airtricity have submitted costs for 2015 (last available actual costs) which show an average salary of £20k per annum, while in 2017 they are requesting costs which equate to an average salary of £26k per annum.

7.2.18 Given that the Hays review took place before 2015 we cannot see justification for the increase in costs. While SSE Airtricity have submitted a breakdown of costs for 2015 these do not reconcile to the average salary level of £20k.

7.2.19 Therefore we propose to use the average salary level from 2015 of £20k per annum. We will allow an increase of 5% per annum in grades 8 and 9 to reflect the increase to the national living wage, but all other grades will increase only by inflation.

7.2.20 SSE Airtricity have requested costs for staff engagement and training which they intend to spend on staff motivation and training and initiatives such as the Great Place to Work scheme.

7.2.21 While we support these endeavours we consider that they will provide efficiencies within the business through staff retention and morale. We therefore propose to allow costs for staff engagement at the HMRC allowance of £150 per employee.

7.2.22 SSE Airtricity have submitted travel and subsistence costs of approximately £710 per FTE per annum. We consider that these costs are high as they include the costs of travel and accommodation to and from SSE Airtricity head offices in Dublin. However we recognise that SSE Airtricity benefits in some cost areas due to being part of the larger SSE group and therefore propose to allow these costs at £710 per person.

7.2.23 Training costs have been requested at £612 per FTE per annum. We have benchmarked these costs against other companies and consider this to be a reasonable level for training costs. Therefore, we propose to allow these costs.

7.2.24 SSE Airtricity have also submitted costs of £0.5m for recharged salaries. These costs relate to services provided by the SSE business as a whole and include regulation, corporate affairs, human resources, finance etc.

7.2.25 SSE have not provided sufficient explanation of these costs at present, or demonstrated how they are allocated between the various different SSE companies. Therefore we propose to reduce the level of recharges by 20% pending a more detailed explanation.

7.2.26 Recruitment costs are allowed at £16k per annum in line with the 2016 estimate in the table above as there is no explanation of the forecast agency costs.

Table 5: Manpower costs for firmus (£000s)

	Actual Costs		LBE	Submission			Draft Determination		
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
Manpower Costs	636	747	823	822	821	821	739	739	738
Staff Engagement	3	3	3	23	23	23	3	3	3
Travel and Subsistence	21	24	25	25	25	25	13	13	13
Training	18	39	41	41	41	41	11	11	11
Recruitment Costs	12	12	12	12	12	12	12	12	12
Total Manpower Costs	**689**	**825**	**905**	**923**	**923**	**922**	**778**	**777**	**777**
Number FTE	**16.3**	**18.4**	**19.3**	**19.3**	**19.3**	**19.3**	**18.3**	**18.3**	**18.3**
Cost/FTE	**42**	**45**	**47**	**48**	**48**	**48**	**42**	**42**	**42**

7.2.27 firmus currently operate with 108 FTE in the overall business, allocated between the distribution business, the Greater Belfast supply business and the Ten Towns supply business. 19 staff are allocated to the Ten Towns supply business, with 12.7 of these currently allocated to the price-regulated sector of the Ten Towns supply business.

7.2.28 firmus has not requested any increase in staff as part of their price control submission.

7.2.29 Having reviewed the current allocations of staff between the businesses we consider that a number of staff are disproportionally weighted towards the price-regulated Ten Towns supply business, particularly in relation to marketing staff.

7.2.30 We therefore propose to allow 11.7 staff for the period of the control.

7.2.31 In addition to reducing the number of FTEs we have used the 2014 actual salaries as these are the last actual costs provided as part of the submission. firmus has increased their salary level to include costs for Executive and Non Executive directors. We consider that these costs should be separately identified and apportioned.

7.2.32 Salary levels for firmus and SSE Airtricity are comparable at the relevant grades. However the lower number of staff in firmus leads to a higher proportion of high grade staff to the overall amount, hence the average staff cost is higher that SSE Airtricity.

7.2.33 firmus have included client entertainment costs of £20k within manpower costs. These costs are not appropriately included within manpower costs and should have formed part of advertising costs within the submission.

7.2.34 The costs relate to the entertainment of I&C customers due to increased competition within the sector. We propose that these costs are not allowed as we consider that advertising costs should be borne by the company as retaining customers provides a reward to the company in terms of the margin from each customer.

7.2.35 We propose that staff entertainment be set at the level allowed by HMRC at £150 per FTE and note that this cost has not increased with inflation as is included within the firmus submission. This approach is consistent with SSE Airtricity allowance and the treatment of costs for GD17.

7.2.36 firmus has requested a training allowance of around £2k per employee. Having benchmarked the training costs we consider this cost to be high. We note that there a number of cost lines included within the training line which we would consider should be included within the professional and legal fees cost line. These include Heron Report data, Met office data and professional subscriptions. We propose to allow the same training costs as SSE Airtricity at £600 per FTE and have moved £25k from training into professional and legal costs as we consider this the appropriate cost line.

7.2.37 Recruitment costs for firmus are allowed at the requested level as this is in line with previous years' figures.

7.3 Operations Costs

Table 6: SSE Airtricity operations costs (£000s)

	Actual Costs		LBE	Submission			Draft Determination		
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
Office Costs	332	337	337	347	349	353	334	343	347
Rates	45	37	38	39	40	41	39	40	41
Professional and Legal Fees	151	146	143	148	145	174	128	131	160
Insurance	61	25	28	26	22	19	26	22	19
Information Technology	193	213	200	1,030	563	502	484	561	563
Capex	22	-	17	21	21	22	-	-	-
Licence Fee	2	2	2	2	2	2	2	2	2
Network Maintenance	244	197	199	231	244	247	177	181	185
Advertising	128	140	198	288	291	315	23	23	43
Total Operations Costs	**1,178**	**1,096**	**1,162**	**2,130**	**1,677**	**1,676**	**1213**	**1303**	**1360**

7.3.1 Operations costs include office costs and rates, professional and legal fees, insurance, information technology (IT), capital expenditure (CAPEX), licence fee, network maintenance and customer engagement. In their submission on operations costs, SSE Airtricity stated that they have not forecast any significant changes from the previous control period with the exception of IT and customer engagement.

7.3.2 SSE Airtricity have stated that the office costs submitted include the costs associated with landlord lease arrangements, service charges, facilities management and services contracts for their offices at Millennium House. SSE Airtricity also provided more detailed information on stationery costs, telephone and postage, parking and storage and subscription costs. Since the last price control, SSE Airtricity has moved to a city centre location, Millennium House, and now shares premises with the SSE electricity business.

7.3.3 Office costs are in line with previous years despite the relocation to city centre premises therefore we propose to allow these costs. We have based the telephone and postage costs on the last actual costs available and included an increase based on increased connections. The requested costs for storage, subscriptions and the office costs for bad debt management have not been allowed due to insufficient evidence of why these costs are required.

7.3.4 In previous price controls, rates have been allowed on a fixed allowance basis. As part of the submission, SSE Airtricity has requested that, as rates can be subject to external factors such as political decisions, they should be retrospectively allowed based on actual costs. We consider that the variance between forecast and actual has not been a material sum in the past and therefore this cost will remain as a fixed allowance.

7.3.5 In their submission, SSE Airtricity noted that although the level of professional and legal fees they requested is in line with the current allowance, they have also requested an increase in 2019 to allow for increased costs associated with a future price control review. In analysing the information provided by SSE Airtricity, we note that a proportion of these costs are recharges for specific professional services through group functions such as corporate legal and taxation. These services are recharged rather than employing individual staff members. In keeping with our thinking in the manpower section, we propose to reduce the recharge aspect of professional and legal fees by 20% pending a more detailed explanation of the makeup of these costs.

7.3.6 SSE Airtricity note that the forecast insurance costs from 2016 onwards are based on SSE group recharge figures and are reduced from previous years. They state that this is a benefit of being part of the SSE group. We propose to accept these costs.

7.3.7 As part of the 2012-2016 Supply Price Control, the UR determined to allow all IT costs requested by Phoenix Supply Ltd (PSL)[18]. These requested costs were to support PSL's IT requirements for running their business including customer switching, billing and day to day operational matters.

7.3.8 As part of this price control submission, SSE Airtricity requested costs for both ongoing requirements to maintain IT systems alongside costs associated with proposals for new and upgraded IT systems. SSE Airtricity state that underinvestment in their legacy IT systems has resulted in a lack of functionality and therefore the system requires significant upgrading during the 2017-2019 control period.

7.3.9 Forecast costs submitted by SSE Airtricity show a substantial increase from the last price control in terms of both specific projects and ongoing operational costs. SSE Airtricity has submitted funding requests for nine projects, ranging from

18 SSE Airtricity purchased Phoenix Supply Limited in June 2012.

customer services such as webchat and improved telephone systems to compliance requirements such as EED and Retail Energy Market Monitoring (REMM) improvements. Given the technical nature of these requests we requested Gemserv to carry out an assessment of, and provide an opinion on, the IT costs submitted.

7.3.10 Gemserv have reported that the new projects have merit and that the optional projects seem to have the potential to improve customer service and reduce costs. However, with regard to the reporting project, Gemserv were not able to substantiate whether the outcome of the project was to benefit customers or to align with SSE corporate systems. We are proposing therefore to disallow the costs for this project. Furthermore, Gemserv have identified that part of the proposed projects, the Hi-Affinity Upgrade[19], was completed in March 2016 yet the costs were submitted as part of the overall submission. Therefore, we propose that this should not be allowed in the 2017-2019 price control.

7.3.11 Gemserv also advised the UR that implementing the IT projects as one suite of projects should attract substantive economies of scale if procured and delivered efficiently, and have therefore recommended a 20% reduction in implementation costs and a 10% reduction in submitted capital costs.

7.3.12 For the draft determination we propose allowing costs for all the IT projects requested by SSE Airtricity with the exception of the Hi-Affinity Upgrade and the reporting project and will apply the economies of scale recommended by Gemserv.

7.3.13 In their submission, SSE Airtricity requested the IT costs in year one of the control, 2017. We propose to spread the allowance over the three years of the control in order to avoid having a significant impact on customers in year one and to better match the likely IT roll out profile.

7.3.14 SSE Airtricity's IT operational costs have also increased to support the new projects. Gemserv reviewed these costs and considers them to be reasonable and suitable for inclusion in the price control. Gemserv recommended that we remove contingency costs of £60k over the control as these costs were not evidenced. Additionally they recommended removing year one costs for three of the proposed projects as they considered that these costs should be included in the overall project development costs. We propose to disallow the contingency costs and the relevant year one costs in line with Gemserv recommendations.

7.3.15 We note that SSE Airtricity has provided no information on the efficiencies that will be realised as a result of these IT projects and we have made no specific assumptions on the impact of these efficiencies on costs. For the final determination we expect SSE Airtricity to submit information on the efficiencies that the introduction of these new projects will bring.

19 Hi-Affinity is a customer management and billing system

7.3.16 SSE Airtricity requested an amount for non IT capex as part of their submission however, they have not provided evidence to account for the amount, therefore, we propose at this stage to disallow it.

7.3.17 Costs for licence fees will be allowed.

7.3.18 Network maintenance costs relate to metering costs for which the supplier is responsible such as meter exchanges (where the supplier is charged by the Distribution Network Operator for the exchange) and safety inspections for vulnerable customers, tampered meters and disconnections.

7.3.19 In their submission, SSE Airtricity stated that their forecast network maintenance costs were similar to those in the previous control. They noted the increase in drivers for items driven by an increase in the cost drivers linked to customer growth but also noted how they had been able to reduce overall costs in meter tampering. SSE Airtricity also proposed establishing a Boiler Replacement Scheme for vulnerable households.

7.3.20 We propose to allow the network maintenance costs at the submitted levels which are in line with historic levels. However, we propose to set safety inspections and meter exchanges as a retrospective cost as these activities are a requirement placed on the company. We propose to allow the costs for each activity on a pass through retrospective basis and allow the supplier the costs for the volume of activity carried out. For the avoidance of doubt, the supplier will not be allowed to recover this rate for any meter exchanges where the supplier did not incur a cost (i.e. where the Distribution Network Operator completes a meter exchange for the supplier that is not chargeable by the Operator then the supplier will not be entitled to recover any costs).

7.3.21 We are proposing to disallow the proposed Boiler Replacement Scheme as there are existing schemes which provide funds for these activities to various categories of customer. Further, we propose to disallow the warrant access costs as there is not sufficient evidence on the requirement and benefit of these costs.

7.3.22 SSE Airtricity's submission highlighted specific customer engagement initiatives that they have requested costs for as part of the 2017–2019 supply price control. The cost allowance for customer literature has been moved to the customer information line in billing costs as a retrospective cost. We propose that the costs for SSE Rewards are not allowed as we consider that this cost is not wholly and necessarily related to the supply of gas to customers and therefore unjustifiable. We do propose to allow costs for customer research and other publications as these will bring benefits to consumers however, we do not propose allowing costs for public relations (£10k p.a.), sponsorship (£10k p.a.) and brand recharge (£15k p.a.).

Table 7: firmus operations costs (£000s)

	Actual Costs		LBE	Submission			Draft Determination		
	2014	2015	2016	2017	2018	2019	2017	2018	2019
Office Costs	58	66	69	69	69	69	58	58	58
Rates	5	5	6	6	6	6	5	5	5
Professional & Legal Fees	79	131	84	82	82	82	82	82	82
Insurance	40	30	31	31	31	31	31	31	31
Information Technology	157	261	88	441	141	88	205	170	175
Licence Fee	2	2	2	2	2	2	2	2	2
Network Maintenance	48	75	85	109	118	128	110	116	124
Call Centre	18	21	24	27	30	33	16	17	19
Advertising	74	88	88	88	88	88	33	10	10
Supplier of Last Resort				20	20	20			
Total Operations Cost	**481**	**678**	**477**	**875**	**587**	**547**	**542**	**491**	**506**

7.3.23 In their submission, firmus forecast their future office costs in line with future tariff FTEs. We propose to retain costs at the 2014 levels as these are the most recent actual costs and there is no increase in staffing levels. This is consistent with the treatment of office costs in GD17.

7.3.24 firmus submitted costs for rates with an increase based on an increased forecast on FTE numbers. We believe this is an inappropriate driver for rates as rates will not be affected by extra FTEs but rather the size of buildings/Land & Property Services (LPS) increases. We therefore propose to retain costs at the 2014 levels as these are the most recent actual costs. This is consistent with the treatment of costs in GD17.

7.3.25 The professional and legal fees submitted by firmus are in line with previous years. We propose to accept these costs. As stated before, we note that there are a number of cost lines included within the training line which we would consider should be included within the professional and legal fees cost line. These include Heron Report data, Met office data and professional subscriptions. We have moved £25k from training to professional and legal costs as we consider this the appropriate cost line.

7.3.26 The insurance costs submitted by firmus are in line with previous years, therefore, we propose to allow these costs. This is consistent with the treatment of insurance costs in GD17.

7.3.27 As part of their submission, firmus requested a substantial increase in IT costs to provide a new billing system and the replacement of the internal system software, IUS. 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 states that their present system is not flexible enough and too expensive for their future needs. firmus said 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.

7.3.28 As with SSE Airtricity, given the technical nature of these requests we requested Gemserv to carry out an assessment of, and provide an opinion on, the IT costs submitted. Initially, Gemserv reported that firmus had not provided sufficient information to agree, or to disagree, with the proposal to replace the existing billing system. However, following substantial engagement with firmus, Gemserv have stated that the information received indicates that a new billing system is required and recommended that we allow the costs for the billing system and the associated operational costs.

7.3.29 firmus initially allocated the costs for the new system equally between the Belfast and Ten Towns markets. However we consider that this allocation is not reflective of costs and therefore propose to allocate on the basis of customer numbers.

7.3.30 As with the SSE IT spend, we have split the IT costs evenly over the three year control period to minimise the impact on customers. We have included the requested capex costs within the IT line. This is in line with SSE Airtricity IT costs

7.3.31 We note that although firmus has stated that the development of new systems will improve productivity, the submission does not highlight any efficiencies resulting from the new systems. We expect firmus to submit information on the efficiencies that the introduction of this new system will bring during this consultation period.

7.3.32 Costs for licence fees will be allowed.

7.3.33 Network maintenance costs relate to metering costs for which the supplier is responsible such as meter exchanges (where the supplier is charged by the Distribution Network Operator for the exchange) and safety inspections for vulnerable customers, tampered meters and disconnections.

7.3.34 As with SSE Airtricity, we propose to allow the firmus costs at the submitted levels which are in line with historic levels. We propose to set safety checks and meter exchanges as retrospective costs as these activities are a requirement on the company. We propose to allow the costs for each activity on a pass through retrospective basis and allow the supplier to recover the costs for the volume of activity carried out. This is of particular relevance to the firmus control as the number of connections is forecast to increase by 46%. For the avoidance of doubt, the supplier will not be allowed to recover this rate for any meter exchanges where the supplier did not incur a cost (i.e. where the Distribution Network Operator completes a meter exchange for the supplier that is not chargeable by the Operator then the supplier will not be entitled to recover any costs).

7.3.35 firmus have also requested additional allowance for unrecoverable gas costs relating to tampered and faulty meters. We consider this is a part of bad debt allowance and therefore propose to disallow this amount.

7.3.36 firmus submitted increased costs for the call centre which they stated was to account for the projected increase in customer phone calls resulting from growth in customer numbers. We propose to allow these costs at 2014 levels, increasing based on customer numbers.

7.3.37 firmus have submitted costs for advertising, website and sales development stating that they are a key cost for the supply business and are essential to be in line with the UR objective to ensure that suppliers do not use a distribution company as a marketing vehicle. This item comprises website development, advertising, sponsorship, market research and corporate events. The website development costs are being requested in order to ensure distribution and supply website functions are separate.

7.3.38 We propose the website development costs are allowed in 2017 only as firmus have failed to evidence why these costs would be ongoing for the duration of the price control. In keeping with our proposal for SSE, we propose that costs relating to corporate events and sponsorship are not allowed.

7.3.39 firmus have also submitted costs of £20k for each year of the price control to cover Supplier of Last Resort costs. They have not provided any evidence for these costs. We propose to disallow these costs. Any costs arising from a Supplier of Last Resort event will be recoverable by the company through a licence modification.

7.4 Billing Costs

7.4.1 For both SSE Airtricity and firmus, the majority of billing costs are treated as retrospective costs as these costs are driven by actual volumes of gas burned and actual customer numbers and can therefore be affected by factors outside of the control of the company (e.g. weather).

7.4.2 In the case of retrospective costs we will include a forecast allowance in the price control determination; however the final allowed costs will be calculated based on actual cost drivers.

7.4.3 The costs affected are:

- Prepayment transaction costs – adjusted for actual customer numbers and number of transactions
- Bad debt – adjusted for actual credit revenue
- Meter reading – adjusted for actual number of meters read
- Customer information (processing & postage)– adjusted for actual number of bills

Table 8: SSE Airtricity billing costs (£000)

	Actual Costs		LBE	Submission			Draft Determination		
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2017**	**2018**	**2019**
Prepayment Transaction/ Commission costs	365	408	418	437	444	450	437	444	450
Bad Debt	284	404	263	254	258	261	195	198	201
Bad Debt Management Allowance	107	116	116	-	-	-	-	-	-
Meter Reading	554	546	652	678	703	728	678	703	728
Customer Information Processing and Postage	173	319	399	521	542	565	521	542	565
Bank Charges	60	89	97	104	112	120	104	112	120
Prepayment Cards	-8	1	7	9	8	7	9	8	7
Credit Check Charges	8	9	9	10	10	11	10	10	11
Tracing costs	35	47	51	52	55	56	52	55	56
Text alerts	1	2	2	4	5	6	4	5	6
Total Billing Costs	**1,580**	**1,940**	**2,014**	**2,068**	**2,136**	**2,205**	**2,009**	**2,077**	**2,145**

7.4.4 Prepayment transaction costs are the transaction and commission costs relating to the pay as you go meters. We propose to retrospectively adjust these costs based on the actual rate charged to the company and the actual volume of activity.

7.4.5 During the current price control period, we can see that SSE Airtricity has made considerable improvement in its management of debt and that credit checks and tracing costs are important in allowing debt to remain at a low and stable level.

We propose to allow these credit checking and tracing costs.

7.4.6 The existing SSE Airtricity price control includes a bad debt level of 1% of credit revenue. This was a challenging target set to Phoenix Supply Ltd (PSL) on the basis of their poor record with debt. SSE Airtricity has made considerable changes to the processes surrounding debt and have seen significant improvement in the bad debt levels, (bad debt levels in 2014 were 0.81% of credit revenue).

7.4.7 SSE Airtricity has requested a bad debt level of 1% of credit revenue for the three years of the control. We consider that the changes made by SSE Airtricity will bring further reductions to the bad debt level and propose a bad debt level of 0.75% of credit revenue. However we do not propose to allow any additional fixed bad debt management allowance in this control, the existing allowance has been added to the manpower cost line.

7.4.8 The meter reading service used by SSE Airtricity is a standalone business operating within the legal entity of SSE Airtricity Gas Supply. We propose to allow the meter reading rate submitted by SSE Airtricity as this rate is in line with that allowed in the previous control. The meter reading costs will therefore be retrospectively adjusted based on the rate submitted by SSE Airtricity and the actual number of meter reads undertaken.

7.4.9 The GD17 approach paper[20] indicated that the UR may consider undertaking a meter reading review in the future to establish if it is appropriate for the responsibility for meter reading to remain with gas suppliers, or if the responsibility should it be transferred to the distribution network operators. If the UR does complete this review during this price control period any impact of the review will be applied retrospectively to this price control.

7.4.10 The customer information processing and postage cost line includes the postage and printing costs for all customer literature, including bills, statements, and any information the company must provide to its customers under licence requirements. These costs will be retrospectively adjusted at an allowed rate (the rate submitted by SSE Airtricity) for printing and postage adjusted for the actual volume. This cost also includes the non-licence requirement customer literature, moved from advertising and customer engagement under operation. We propose, that costs to provide customer information on SSE Rewards are not allowed.

7.4.11 SSE Airtricity submitted appropriate information on their bank charges. We propose to allow this cost as it is in line with previous costs.

7.4.12 We propose that the other billing costs (i.e. prepayment cards, credit check charges, tracing costs and text alerts) will be allowed as fixed cost allowances as

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set out in the table above.

Table 9: firmus billing costs (£000)

	Actual Costs		LBE	Submission			Draft Determination		
	2014	2015	2016	2017	2018	2019	2017	2018	2019
Prepayment transaction costs	197	231	264	301	335	370	301	335	370
Bad debt	122	129	114	108	104	104	86	83	83
Meter reading	121	130	203	226	252	274	226	190	192
Customer Information Processing and Postage	45	63	158	123	135	209	123	135	209
Bank and Interest Charges	11	11	11	10	10	10	10	10	10
Prepayment Cards	8	7	9	8	8	8	8	8	8
Credit Check Costs	6	7	9	11	13	16	11	13	16
Virtual terminal	0	1	1	1	1	1	1	1	1
Total Billing Costs	**511**	**578**	**768**	**788**	**858**	**992**	**766**	**776**	**889**

7.4.13 Prepayment costs are the transaction and commission costs relating to the pay as you go meters. These costs will be retrospectively adjusted based on the actual rate charged to the company and the volume of activity.

7.4.14 firmus currently have an excellent bad debt level with the current bad debt level within the existing control at 0.2% of credit revenue. firmus have requested an allowance of 0.25% of credit revenue, however they have failed to evidence why the level should be increased. Based on the historic performance to date and on the high percentage of prepayment meters installed in the Ten Towns area we propose to retain the current level of bad debt at 0.2% of credit revenue.

7.4.15 Bad debt levels for the two suppliers differ due to SSE Airtricity's legacy debt issues. There are currently over 12,000 customers repaying debts on a quantum meter much of which was accrued on credit meters before the customers where then switched to prepayment meters to recover the debt. As the total bad debt is apportioned over credit revenue this leads to a higher percentage for SSE Airtricity. Additionally with no competition in the Ten Towns area customers cannot switch to avoid repaying debt or leave final bill debt when they switch.

7.4.16 firmus tender for their meter reading services and have a contract in place until April 2018. We benchmarked the costs against SSE Airtricity and firmus' forecast costs are higher than those for SSE Airtricity. We consider that firmus should be achieving better meter reading rates from either a supplier or in-house facility. We propose a glide path from their existing rates in 2017 to reduced rates in 2019. We consider that meter reading costs may be higher within the Ten Towns area due to the geographical location and rurality of the properties and therefore have set a proposed rate above that allowed for SSE Airtricity. The allowed rates, however, will decrease over the duration of the control to implement the glide path mentioned above.

7.4.17 The GD17 approach paper[21] indicated that the UR may consider undertaking a meter reading review in the future to establish if it is appropriate for the responsibility for meter reading to remain with gas suppliers, or if the responsibility should it be transferred to the distribution network operators. If the UR does complete this review during this price control period any impact of the review will be applied retrospectively to this price control.

7.4.18 The customer information (processing and postage) costs are the costs of all customer literature, including bills, statements, and any information the company must provide to its customers under licence requirements. These costs will be retrospectively adjusted based on the allowed rate for printing and postage adjusted for the actual volume.

7.4.19 We propose to allow bank and interest costs as a fixed allowance as they are in line with previous costs.

7.4.20 We propose to allow credit check and tracing costs as fixed allowances to maintain the excellent bad debt levels that firmus maintains.

7.4.21 Virtual terminal is a cost to cover a web-based platform that allows customers to make bill payments over the phone. We propose to allow this cost as a fixed allowance.

7.5 Apportionment

7.5.1 The apportionment allocation of costs allocates the appropriate level of costs to the tariff sector of each business (i.e. the price regulated sector of each business). This ensures there is no cross-subsidisation between the tariff and non-tariff businesses of firmus and SSE Airtricity. 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 cost drivers can be found in Annex 1.

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8. Gas to the West

8.1. The West distribution area covers Strabane, Omagh, Enniskillen, Derrylin, Dungannon, Coalisland, Cookstown and Magherafelt.

8.2. SGN Natural Gas Limited (SGN) are the distribution network operator for the West area.

8.3. It is intended that the first large I&C customer in the West area will be connected during quarter 4, 2016 with the first domestic connections being made during 2018 (possible end 2017).

8.4. SGN issued a formal invitation for suppliers to make a submission for the role of Commissioning and Default Supplier for the West Licensed Area.

8.5. The UR has previously stated that it may consult on a proposal that the commissioning/default supplier will have a price control placed on it for domestic and small I&C properties

8.6. Once SGN issued the invitation to apply for commissioning/default supplier, the two existing commissioning/default suppliers were invited to submit potential costs for the West for consideration as part of the 2017-2019 supply price control process.

8.7. In the event, only SSE Airtricity applied to be commissioning/default supplier in the West. We have scrutinised their proposed operating costs for the West area alongside their submission for operating costs for the Greater Belfast area.

8.8. SGN have appointed SSE Airtricity as commissioning/default supplier within the West area. The UR therefore proposes to apply a supply price control to SSE Airtricity in the West area for domestic and small business customers.

Scope and Duration

8.9. We are proposing that the scope of the price control on SSE Airtricity in the West area will be domestic and small I&C customers using up to 2,500 therms per annum. This will align the scope of the West control to the scope of the Greater Belfast control. SSE Airtricity is the commissioning/default supplier in both areas.

8.10. We propose to commence the price control on SSE Airtricity in the West area from 1 April 2017. The price control will apply for three years and therefore it will apply from 1 April 2017 to 31 March 2020. This will align the duration of the price control on SSE Airtricity in the West area with the duration of the price control on SSE Airtricity in the Greater Belfast area.

Network Costs

8.11. In line with our proposal for the treatment of networks costs in the supply price controls for SSE Airtricity in the Greater Belfast area and firmus in the Ten Towns (as set out in section 6 of this paper), we are proposing that network costs will be treated as a pass through cost for the price-regulated supplier, SSE Airtricity, in the West area.

Gas Costs

8.12. We are proposing to align the treatment of gas costs for SSE Airtricity in the West area with the treatment of gas costs in the Greater Belfast and Ten Towns supply price controls. Therefore we propose that gas costs will be treated as a pass through cost. In addition an energy balancing allowance will be included in SSE Airtricity's tariffs in the West in the same way as it is included in SSE Airtricity' tariffs in Greater Belfast.

8.13. SSE Airtricity will need to put credit arrangements in place to cover transmission and distribution costs in the West area. We propose these costs will be treated in the same way as the SSE Airtricity price control.

Supply Operating Costs

8.14. SSE Airtricity have submitted a request for set up and operations costs of £230k for the duration of the three year price control as seen in the table below. SSE Airtricity forecast that by 2019 1,500 domestic and 87 I&C properties will be connected. This is a more conservative forecast of customer numbers than the targets forecast for SGN.

Table 10: West costs for SSE Airtricity

	Initial Submission			Draft Determination		
Summary	2017	2018	2019	2017	2018	2019
Manpower - Meter Reading	181	19,392	46,562	181	19,392	46,562
- Contact Centre	600	3,000	7,000			
- Back Office	600	3,000	7,000			
Customer Billing and Engagements	224	987	2,425	224	987	2,425
Network Maintenance	1,992	2,697	4,025	500	1,000	1,500
Geocoding Data	3,543	3,685	3,832	3,543	3,685	3,832
Brand Awareness		15,000	15,000			
Setup Costs	85,000			25,000		
Total Costs	92,140	47,761	85,844	29,448	25,064	54,319

8.15 Due to the previous uncertainty regarding the commissioning/default supplier and price control arrangements for the West area these costs have only been recently submitted and we have been unable to fully analyse these as yet.

8.16 Within the draft determination we propose to allow costs of £109k for the duration of the price control. These costs are total costs for the West area and will be apportioned between tariff and non tariff customers.

8.17 SSE Airtricity has submitted costs for manpower for contact centre and back office. We accept that new connections may lead to increased manpower costs for SSE Airtricity; however we propose that these costs are funded from the efficiencies gained from the allowed IT projects mentioned in paragraph 7.3.15.

8.18 We note that SSE Airtricity has included meter reading costs within the manpower costs. We would propose that at some stage meter reading costs will need to be treated as a retrospective cost so that it is consistent with our treatment of meter reading costs in the Greater Belfast control. We will seek to work with SSE Airtricity during the consultation period to agree when West meter reading cost will need to be reported separately as opposed to being included in manpower which is a separate cost item from meter reading.

8.19 The GD17 approach paper[22] indicated that the UR may consider undertaking a meter reading review in the future to establish if it is appropriate for the responsibility for meter reading to remain with gas suppliers, or if the responsibility should it be transferred to the distribution network operators. If the UR does complete this review during this price control period any impact of the review will be applied retrospectively to this price control.

8.20 Customer engagement costs relate to the postage and printing costs for all customer literature, including bills, statements and any information the company must provide to its customers under licence requirements. These costs will be treated as retrospective costs as per the Greater Belfast control.

8.21 Safety inspections and meter exchanges within the network maintenance costs will be treated as retrospective costs as per the Greater Belfast control. We have reduced the costs for network maintenance as we have not received sufficient evidence to support these costs. While SSE Airtricity state that they have used the same assumptions as for the Greater Belfast area we would question if these assumptions are appropriate in a new gas area with a new network operator.

8.22 We propose disallowing £50k for brand awareness and advertising (£30k as set out above and an additional £20k within set up costs). As commissioning/default supplier, SSE Airtricity will not be required to increase its brand awareness in order to attract customers.

8.23 In relation to set up costs, SSE Airtricity presented a list of costs equating to £85k in total. These costs relate to professional and legal costs, as well as costs for setting up new systems and processes for the West area. Again we consider that there is insufficient information to allow a number of these costs.

8.24 Additionally we consider that some of the activities presented by SSE Airtricity are already covered by existing regulatory activities or do not require the forecast level of costs. For the draft determination, we propose to allow £25k for set up costs and we will review these costs on the receipt of further information from SSE Airtricity during the consultation period.

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9. Gas Costs

9.1. Gas Costs relate to the cost of wholesale gas as well as the costs for transporting gas through Great Britain to the SNIP. These transportation costs are published by National Grid[23]. Previous controls have determined that these costs are pass through which means that the company is allowed to recover the actual cost of gas. Therefore where wholesale gas costs increase or decrease, the additional costs, or resulting saving are passed on to customers.

9.2. In the Approach consultation, 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).

9.3. Respondents to the consultation welcomed the proposal to treat wholesale gas costs and related transportation costs as pass through, therefore we propose to continue this approach.

Energy Balancing

9.4. In reviewing the gas costs for the final determination 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. SSE Airtricty and firmus 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.

9.5. We will set the energy balancing figure in the tariff as follows

- where SSE Airtricity or firmus 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 SSE Airtricity or firmus 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.

This is in line with the energy balancing figures currently within the SSE Airtricity and firmus tariffs. These costs will form part of the tariff costs.

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

Credit Support

9.6. Both suppliers submitted details of credit arrangements in place to cover transmission, distribution and gas costs and other relevant costs. Currently credit cover costs are allowed at an agreed pence per therm/KWh.

9.7. The submissions for credit costs from both companies are reasonable when benchmarked to Power NI credit costs and those costs seen generally in the energy supply industry. We therefore propose to allow these costs however any allowance is inter-dependent on the margin allowance and their inclusion in the regulated tariff is predicated on agreement to the level of margin proposed in the next section.

10. Margin

10.1. In its approach paper the UR committed to carrying out a review of the level of margin allowed for both firmus and SSE Airtricity. This review was in parallel to the Competition and Markets Authority (CMA) investigation into the GB Energy market, which looked at the issue of appropriate energy retail margins, and we have needed to be cognisant of the findings of that review as any appeal against a UR decision on margin would be referred to the CMA.

10.2. The UR further recognises that the benchmarks of the Power NI allowed margin and also the previous margin allowed (i.e. the current margin that both firmus and SSE Airtricity receive), are relevant to the calibration of an appropriate percentage of turnover figure to calculate the amount of the margin for both companies.

10.3. The UR has sought to use the above benchmarks to come to a fair proposal on margin using four points of reference, including the capital base x cost of capital calculation mentioned in the approach paper of October 2015. These are:

- The range of margin for a supply business operating in competitive markets as outlined by the CMA in its recent GB investigation

- The range of margin as calculated by First Economics using the capital base x cost of capital methodology

- The benchmark of Power NI allowed margin

- The benchmark of the current allowed price-regulated gas supply businesses margin

Each of these is discussed in turn below.

<u>CMA Margin Range</u>

The CMA found in its investigation that "*Low margins are consistent with energy retail being a low capital business as retailers do not own or operate any of the physical assets required for the delivery of gas or electricity...... We consider that energy retailers face low demand risk because energy is an essential good and is largely non-cyclical, particularly for domestic customers...... However, we note that the calculation of the competitive EBIT margin is very sensitive to the level of capital employed in such an 'asset light' business. We would therefore caution against inferring a precise estimate for the competitive EBIT margin from this analysis.* ***Margins in the range of 1 to 3% would appear to provide a guide to***

the competitive EBIT margin based on current business models.

10.4. The UR puts considerable weight on this range as it has been calibrated after a protracted and extensive piece of analysis carried out by CMA under intensive scrutiny. We also note that the CMA is cognisant of the fact that the calculation is sensitive to the amount of capital employed and this can be influenced greatly by the efficiency with which a business manages its working capital throughout a given financial year or business cycle.

10.5. Also we need to be particularly aware of the CMA findings as any appeal by the regulated licensees against a UR decision on margin would be referred to the CMA. So it seems sensible that they would find that the margin for the gas supply business in NI, both of which have market power and dominance in the sectors this price control covers, would be within this 1 to 3% range. We cannot see any major differences in the position of NI suppliers to those in GB that would lead to a requirement to increase the NI supply businesses margins above this range. On the contrary we would expect that the dominant positions of each (and firmus' monopoly position in the domestic sector) might lead the CMA to point to the lower end of their own range.

First Economics Margin range

10.6. The UR employed First Economics to carry out a capital base x cost of capital calculation, the same methodology as used by the CMA, but specific to both SSE Airtricity and firmus. The UR asked First Economics to stick rigidly to the CMA methodology and apply the same logic as they did to each part of the calculation. The UR also requested both businesses outline their capital bases and the cost of capital they felt should be applied to those capital bases. First Economics requested various pieces of additional or supporting information from both businesses and an iterative process was commenced. Meetings were held at which the consultancy support of both SSE Airtricity and firmus met with the UR and also First Economics to discuss the submissions of both businesses.

10.7. On the whole a lot of common ground was found, barring the inclusion of the cost of customer acquisition in the overall capital base and the cost of capital to be applied to "contingent" capital. This second issue was the most important and explains most of the disparity between the margin ranges calculated by both firmus and SSE Airtricity and their advisors and First Economics.

10.8. firmus argue that a margin range of 6 to 7.7% of turnover is appropriate and SSE Airtricity felt that a range of 4.1 to 6.1% was correct. The UR disagrees, and has shared the First Economics calculation with both businesses. The range calculated by First Economics was 1 to 2.1%.

10.9. We note that the First Economics range is within the CMA range, but the midpoints of the margin ranges sought by both businesses sit well outside of the CMA parameters. Again the reason for this disparity is because the businesses submissions allowed for a full cost of capital to contingent capital, whereas the CMA allowed a rate of 2% on this type of capital - which is the rate used by First Economics in their analysis for UR.

Power NI Margin

10.10. At the last review of the Power NI price control for the Power NI control currently in place the UR employed both Economic Consulting Associates (ECA) to calibrate an appropriate margin for Power NI. The final result of that review, accepted by Power NI, was a margin of 2.2% of turnover. It was noted during that review and in previous reviews that Power NI would have a higher capital commitment relative to turnover than price-regulated gas supply businesses, because the payment terms in the electricity wholesale market are more frequent and at closer intervals than in the gas market. There is also less liquidity and ability to fully hedge demand in the electricity market. These factors adversely affect working capital requirements. Taking this into account it seems reasonable that a margin slightly below that of the Power NI 2.2% would adequately reward the gas supply businesses for the capital employed in their businesses.

Current Gas Margin

10.11. The margin currently allowed to both SSE Airtricity and firmus is 1.5% of turnover. This has been the margin allowable for the past number of years and dates back to when SSE Airtricity faced a lot less competition in the price-regulated sector than it does today and to before the domestic gas market in the Ten Towns area was open to competition. Whilst there is this increased competition and new threat of entry in the domestic Ten Towns market, both businesses still enjoy a very dominant position in supply to price-regulated customers and have associated market power. Indeed this is one of the principle reasons for the continuance of the price control on these two entities, and both businesses have more market share and fewer competitors than Power NI had when the 2.2% was set for that business.

10.12. However despite this relatively advantageous market position held by both gas supply businesses in terms of market share, it is a fact that the UR allowed a margin of 1.5% when there was less competition in both their markets, so it again seems reasonable that an uplift of some sort should be applied to account for this, albeit that that uplift would need to keep the margin within the ranges of both the

CMA and Fist Economics, and be less than the 2.2% margin of Power NI.

<u>Industry and Regulatory Benchmarks</u>

Below is a table showing all the relevant benchmarks that need to be looked at when setting the margin for this upcoming 3 year price control period.

Table 11: Benchmarks – Margin on Turnover

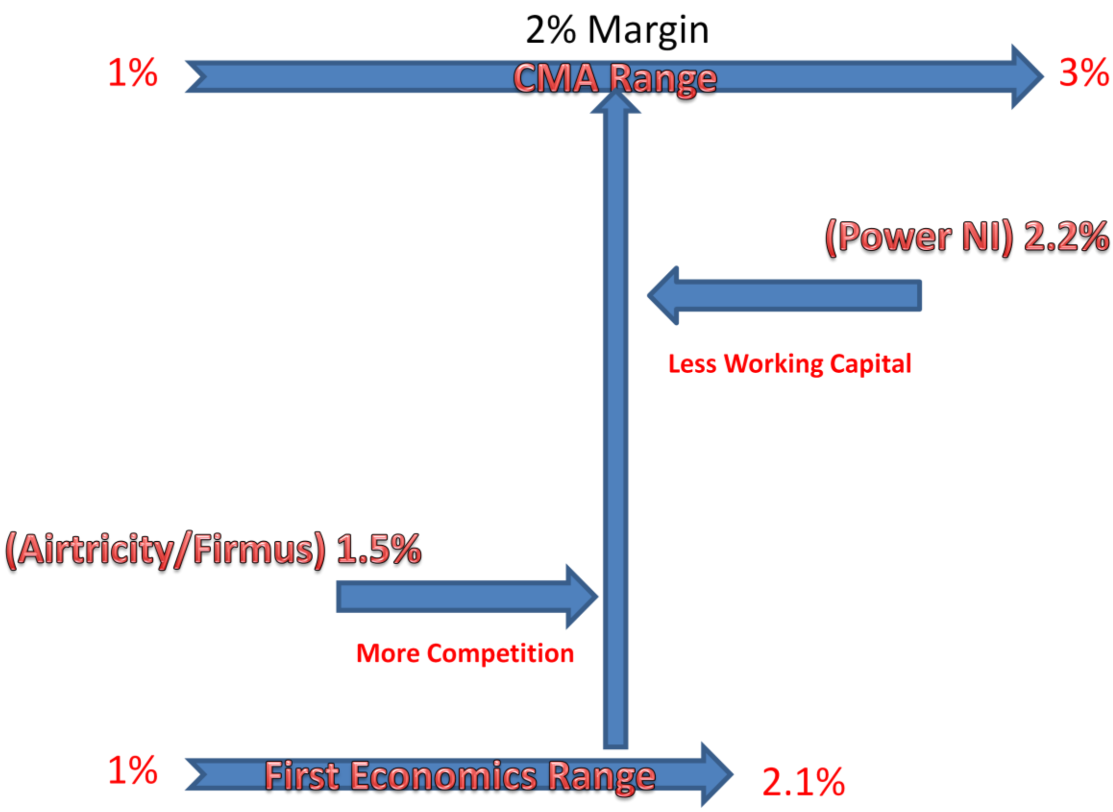
0.5%	Low end of regulatory precedent for energy retail price controls
1.0%	Ofwat's profit margin allowance for household water retail businesses
1.0%	Profit allowances in rail franchises with no cost or revenue risk
1.5%	Ofgem profit margin allowance at the point when the GB market was fully opened to competition
1.5%	Utility Regulator profit margin allowance in current gas supply controls
2.2%	Utility Regulator's profit margin allowance for Power NI's current price control
2.5%	Ofwat's profit margin allowance for non-household water retail businesses
2% to 3%	Average pre-2008 margin for GB energy retail businesses
3%	Ofgem calculation of the profit margin for a hypothetical GB energy retail business facing volume risk but no upstream price risk
1% to 3%	CMA guide to appropriate supply margin range for competitive energy businesses

10.13. As can be seen the benchmarks for companies in markets with some competition run from 1% to 3% and this includes the actual margins earned by GB retail energy businesses pre 2008. These businesses were non price controlled operating in a competitive market. This set of benchmarks further assures the UR that the 1-3% range is where we should be looking when setting an appropriate return for a price-regulated, former incumbent and dominant retail energy business.

<u>UR Proposal on Margin</u>

10.14. Given all the above and after due consideration, the UR proposes that the margin for both firmus and SSE Airtricty for the next price control period should be set at 2% of turnover. This strikes an appropriate balance between the calculations of the CMA, First Economics and the two businesses and their advisors, whilst at the same time taking account of other benchmarks in the energy industry.

10.15. The picture below illustrates the central nature of a 2% margin in the CMA range but also why it is higher than the current gas margin (more competition) and lower than the current Power NI margin (less working capital). It also is at the upper end of the first economics range.



10.16. Overall the UR view is that given the various sources of information, all indicating that a supplier margin should fall in the 1 to 3% range, the submissions from the businesses seeking margins at levels of 4-8% are unduly high. We are satisfied that our calibration of the margin properly reflects the appropriate benchmarks and sits within the First Economics calculated range. We are therefore proposing a margin that is the midpoint of the CMA range; that sits correctly relative to the Power NI margin and the current gas margins, and allows the companies a return that is fair and appropriate.

11. Reconciliation

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

11.1 Reconciliation

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.

The reconciliation will take into account

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

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

11.2 Inflation

All costs presented in this paper are in October 2015 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 RPI.

11.3 Rate of Interest

We propose that any reconciled amounts, whether under or over recovered, including gas costs, will be rolled forward at an interest rate of LIBOR plus 1.5%. This will apply to both SSE Airtricity and firmus.

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.

12. Responding to the consultation

As a public body and non-ministerial government department, the Utility Regulator is bound by the Freedom of Information Act which came into effect on 1 January 2005. According to the remit of the Freedom of Information Act, it is possible that certain recorded information contained in responses can be put into the public domain.

Hence it is possible that all responses made to consultations will be discoverable under Freedom of Information Act, even if respondents asked the Utility Regulator to treat responses as "confidential".

It is therefore important that respondents note these developments and in particular, when marking responses as "confidential" or asking the Utility Regulator to treat responses as confidential should specify why they consider the information in question to be confidential. Confidentiality disclaimers created automatically by your company's email system will not normally be treated as sufficient in terms of a confidentiality request.

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.

Responses should be received by 4pm on 9th August 2016 and should be addressed to both:

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Annex 1

Apportionment Cost Drivers

Cost	**Driver**
Manpower Costs	Manpower Numbers
Staff Engagement	Manpower Numbers
Travel and Subsistence	Manpower Numbers
Training	Manpower Numbers
Recharges	Manpower Numbers
Office Costs	Manpower Numbers
Rates	Manpower Numbers
Professional and Legal Fees	Customer Number
Insurance	Load in therms
IT	Customer Number
Capex	Manpower Numbers
Licence Fee	Load in therms
Network Maintenance	Tariff
Customer Engagements	Customer Number
Prepayment Costs	Tariff
Credit Check Charges	Customer Number
Meter Reading	Meters Read
Customer Information P+P	Number Bills
Bad Debt	Tariff
Bank Charges	Customer Number