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

March 2017



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, proportional, accountable, and targeted.

Be a united team.

Be collaborative and co-operative.

Be professional.

Listen and explain.

Make a difference.

Act with integrity.

Abstract

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

We commenced a review of the maximum average price with feSL in January 2017. We have scrutinised the submission provided by firmus to ensure that the maximum average price approved is not more than the sum of the costs allowed under the price control determination. This ensures that customers pay no more than the costs of purchasing and supplying gas plus a pre-determined allowance for the operating costs of the business and an agreed profit margin.

The maximum average price for feSL's domestic and small business customers in the Ten Towns area will increase to 129.56 pence per them from 31 March 2017.

Audience

Customers and customer groups, industry and statutory bodies.

Consumer impact

feSL's domestic and small business customers in the Ten Towns area will see an average increase of 12.2% increase in their annual bill. The change will take effect from 31 March 2017.

The impact of the tariff change on a domestic customer with average consumption of 12,500 kWh per annum will be an increase of approximately £66 per annum (including VAT) on their gas bill.

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

Summary

On 13 January 2017 the Utility Regulator, in consultation with firmus energy (Supply) Limited (**feSL**), the Department for the Economy (**DfE**) and the Consumer Council began a review of the feSL maximum average price for domestic and small business customers using less than 25,000 therms per annum. This covers approximately 30,000 customers within the Ten Towns area.

We carry out formal reviews of the feSL maximum average price on a bi-annual basis (in advance of April and October). The Utility Regulator can also initiate a further review at any stage should the wholesale cost of gas change significantly such that it would result in an increase or decrease of at least 5% to the maximum average price.

We initiated the formal review to establish the new maximum average price to become effective from 31 March 2017. The review is a formal process agreed by the UR, feSL, DfE and the Consumer Council. It is set out within the feSL price control[1] and details the processes to be followed and the timescales for the review process.

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

The maximum average price for domestic and small business customers will be 129.56 pence per therm from 31 March 2017. The new maximum average price has been modelled and forecast over a period of 12 months however it will be kept under constant review and adjusted within that time period if required. We will complete another formal review in advance of 1 October 2017 and will continue to monitor gas prices to identify if an additional review is required before that date.

From 31 March 2017, the unit rates of tariffs for feSL's customers in the Ten Towns area will increase by 12.2% on average. These unit rates are detailed in Table 4 later in this paper.

[1] Price Control for SSE Airtricity Gas Supply (NI) Ltd and firmus energy (Supply) Ltd Final Determination 29th November 2016: https://www.uregni.gov.uk/sites/uregni/files/media-files/SPC%2017%20Final%20Determination%20v1.0.pdf

Background

In Northern Ireland, there are three distinct distribution areas for natural gas. These are the Greater Belfast area, the Ten Towns area and the West area. Phoenix Natural Gas Limited (PNGL) own and operate the distribution network in the Greater Belfast area, firmus energy (Distribution) Limited own and operate the distribution network in the Ten Towns area while Scotia Gas Networks (SGN) own and operate the distribution network in the West area.

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

From 1 April 2015, the supply market in the Ten Towns area opened to competition from new entrant suppliers in all customer sectors. However feSL are currently the only supplier for domestic consumers in this market. feSL currently supply around 30,000 domestic and small business customers (referred to as "tariff" customers) in this area.

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

Control over charges

> "The Licensee shall take all reasonable steps to secure that in any Relevant Year the average price per unit of gas supplied by it to Regulated Premises shall not exceed the maximum price calculated in accordance with Condition 2.4.2"[2].

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

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

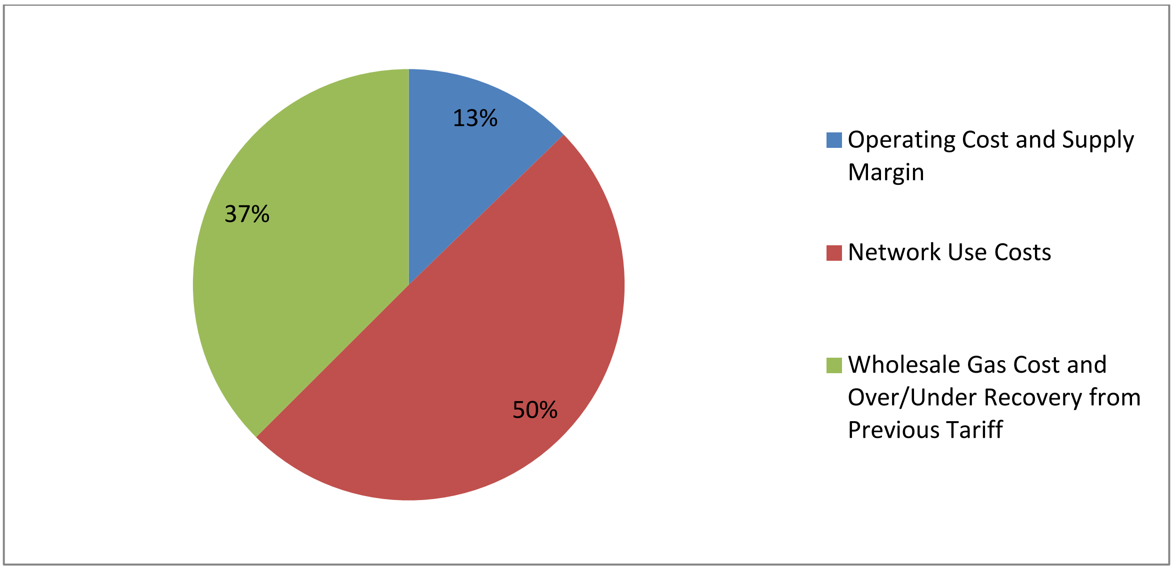
Elements of Maximum Average Price

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

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

The breakdown is shown in figure 1 below.

Figure 1 – Makeup of the maximum average price from April 17



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

Operating Costs and Supply Margin

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

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

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

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

Network Costs

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

The feSL price control determined that the transmission and distribution system charges will be treated as pass through charges which means that the customer pays for the actual cost of the network charges.

The costs for the transmission system are those costs involved in bringing gas from Scotland to Northern Ireland, via the Scotland to Northern Ireland Pipeline, and all the transmission pipelines within Northern Ireland. These costs are published on the Premier Transmission website at http://www.premier-transmission.com/ and on the Gas Networks Ireland website at http://www.gasnetworks.ie/en-IE/Gas-Industry/Northern-Ireland/Transportation-services/Postalised-Tariffs/.

The costs for the distribution system are those costs associated with moving gas throughout the Ten Towns area to homes and businesses. On the 15th September 2016 the final determination on the price control for Northern Ireland's gas distribution networks for 2017-2022 (GD17), and associated licence modifications for consultation, were published. GD17 is the distribution price control for Phoenix Natural Gas Limited (PNGL), firmus energy (Distribution) Limited and SGN Natural Gas Limited which will run from 1 January 20174. The distribution price control determines the amounts that firmus energy Distribution can charge for suppliers to use the Ten Towns network. These can be found on the feDL website http://www.firmusenergy.co.uk/about_us.aspx?dataid=507590.

[3] Price Control for SSE Airtricity Gas Supply (NI) Ltd and firmus energy (Supply) Ltd
Final Determination 29th November 2016: https://www.uregni.gov.uk/sites/uregni/files/media-files/SPC%2017%20Final%20Determination%20v1.0.pdf

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

Wholesale Gas Costs

- ***Wholesale Gas Costs***

The feSL price control determined that the gas cost element of the maximum average price incorporates the wholesale cost of gas as well as charges for transporting gas through Great Britain and costs for securing credit.

The price control determines that gas costs are treated as pass through which means that the customer pays for the actual cost of gas. Therefore, where wholesale gas costs decrease or increase, the resulting savings or additional costs are passed on to the customer.

feSL has a gas purchasing strategy in place which means that they purchase a percentage of their forecast sales volumes in advance on an ongoing basis. This limits the exposure to fluctuations in wholesale gas prices and therefore aims to create more stability in the gas price for final customers.

When setting the maximum average price, the overall cost of gas is estimated based on a combination of actual gas purchases that have already been secured, along with forecast volumes of gas required, and the wholesale cost of gas from the forward curve. Buying gas in advance (hedging) can help to reduce any over/under recoveries building up as the price of the hedged gas in the maximum average price is known when the price is set.

- ***Over/Under Recovery from Previous Tariff Periods***

Wholesale gas costs make up a large component of the final maximum average price and as these costs can be volatile there will always be a difference between the outturn cost of the wholesale gas compared to the forecast costs that are included in the maximum average price.

Where the wholesale gas costs out turns less than was forecast in the maximum average price, feSL will ‘over recover’, this means that they have recovered more money from customers than they spent on gas costs and they will subsequently refund the over recovered difference to customers in the following tariff periods.

Or, where the wholesale gas costs turn out higher than forecast in the maximum average price, feSL will ‘under recover’, this means they have spent more on gas costs than they recovered from customers and they will therefore be able to recharge the under recovered difference to customers in the following tariff periods. This ensures that customers only pay for the actual cost of gas.

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

The maximum average price effective from 31 March 2017 includes an amount of £476k which feSL has over recovered previously and will now be returned to customers.

Both feSL and the Utility Regulator will strive to keep the over/under recovered amount as low as possible in order to reduce volatility in the tariff. This will be carried out through ongoing monitoring and tariff changes being put through when over or under recoveries are increasing to such an extent that a tariff change is required.

Why is the Maximum Average Price for feSL increasing?

The maximum average price for feSL's tariff customers in the Ten Towns area will increase to 129.56 pence per therm from 31 March 2017. Table 1 below shows the movement in the regulated maximum average price from April 2015 (the first regulated tariff) to date.

Table 1 - Historic maximum average price

Effective from date	Approved Maximum Average Price (pence per therm)
01-Apr-15	130.85
01-Oct-15	125.16*
01-Apr-16	115.51
31-Mar-17	129.56

**This figure has been restated to take into account updated volume forecasts. Previously the approved Maximum Average Price was 124.44 per therm).*

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

- the increase in the cost of wholesale gas;
- a slight increase in overall supply operating costs.

It should be noted that the increase in the maximum average price is primarily due to the increase in the cost of wholesale gas.

These are both explained in the section below.

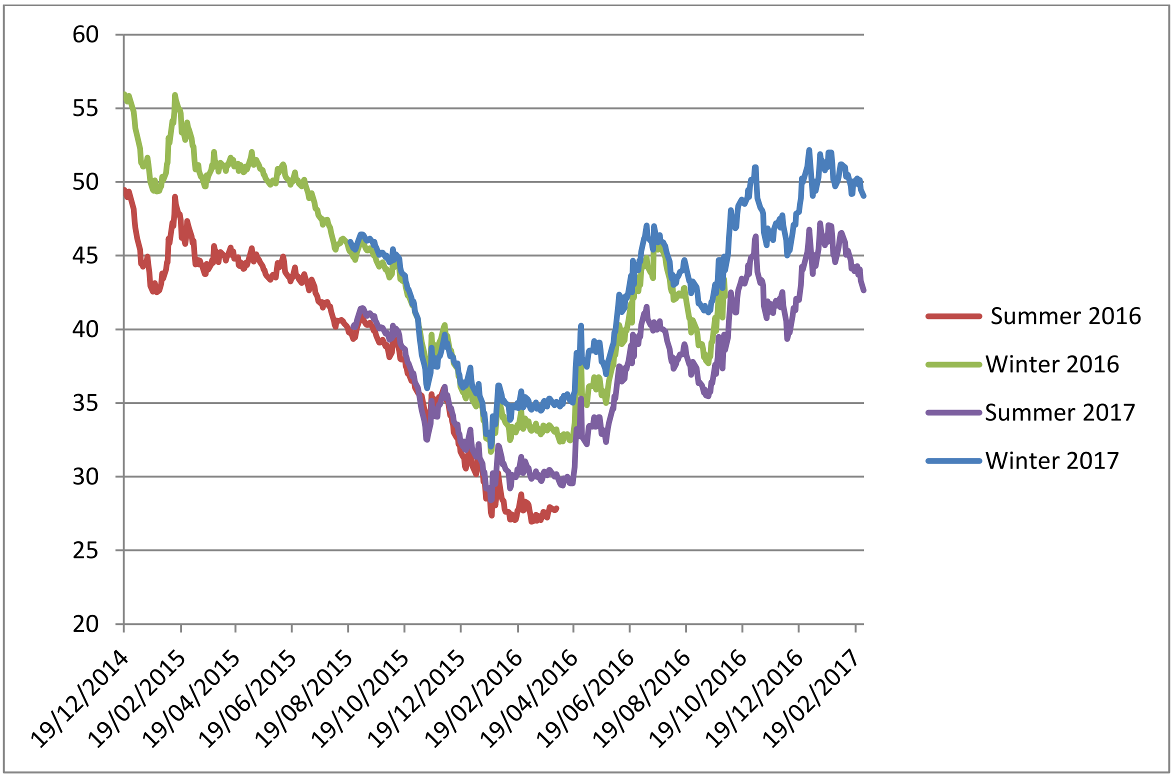
- ***Increase in Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods***

The main driver for the increase in the maximum average price is the increase in the forecast wholesale cost of gas.

Wholesale gas costs on the forward curve have increased over the last number of months. This means that the forecast cost of wholesale gas included in the April 2017 maximum average price is higher than the cost included in their previous tariff when it was set in April 2016.

Overall forecast gas costs on the forward curve have increased over the last number of months. This is shown in the graph below.

Figure 2 – Movement in forward curve of wholesale gas cost



Source: Platts McGraw Hill Financial

Table 2 below shows that the forecast cost of gas within the maximum average tariff has increased from 37.25 pence per therm in the April 2016 tariff to 52.37 pence per therm in the April 2017 tariff.

It is important to note that an element of the gas price included within the maximum average price is a forecast cost and the actual outturn prices may be higher or lower.

If the actual gas prices turn out lower than those forecast then feSL will over recover, and if actual gas prices turn out higher than those forecast then feSL will under recover. Any amounts that are over or under recovered will be returned to customers or recovered from customers in the following tariff period.

The maximum average price coming into effect from 31 March 2017 will include an over recovery. This acts to offset some of the increase in wholesale gas costs in the maximum average price as feSL return this previous over recovery to customers within this new tariff. A forecast over recovery position of £476k at 31 March 2017 (estimated up until the point of the maximum average price change) has been reported. The impact of this in the over recovery on the maximum average price is shown in Table 2 below.

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

Elements within Maximum Average Price	April 2016 (pence per therm)	April 2017 (pence per therm)
Wholesale Gas Cost	37.25	52.37
Over/Under Recovery	0.47	-3.79
Total Wholesale Gas Cost and Over/Under Recovery from Previous Tariff Periods	37.72	48.58

- ***Increase in Operating Charges***

There has been an increase in supply operating costs and supply margin to facilitate costs of billing, meter reading and IT systems etc. The operating costs were determined under the price control carried out by the Utility Regulator and published on 29 November 2016. The price control allowed feSL the costs needed to replace their moribund billing system and this is the principal reason for the increase in operating costs.

Breakdown of Tariff

Figure 3 below shows the breakdown of the feSL maximum average price which will come into effect from 31 March 2017.

Figure 3 – Breakdown of April 2017 maximum average price compared with previous maximum average price

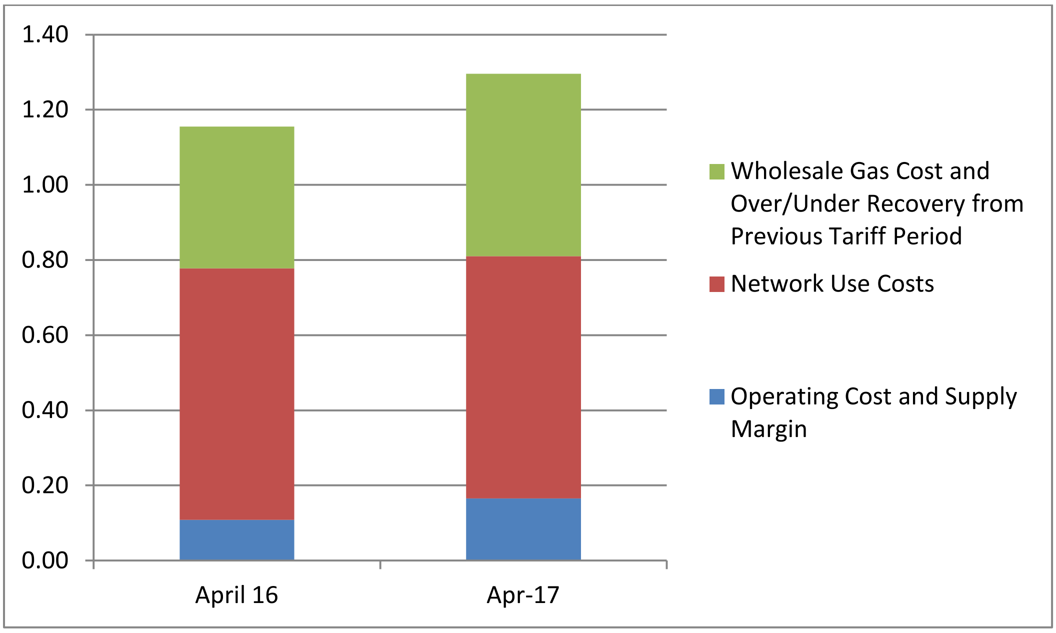
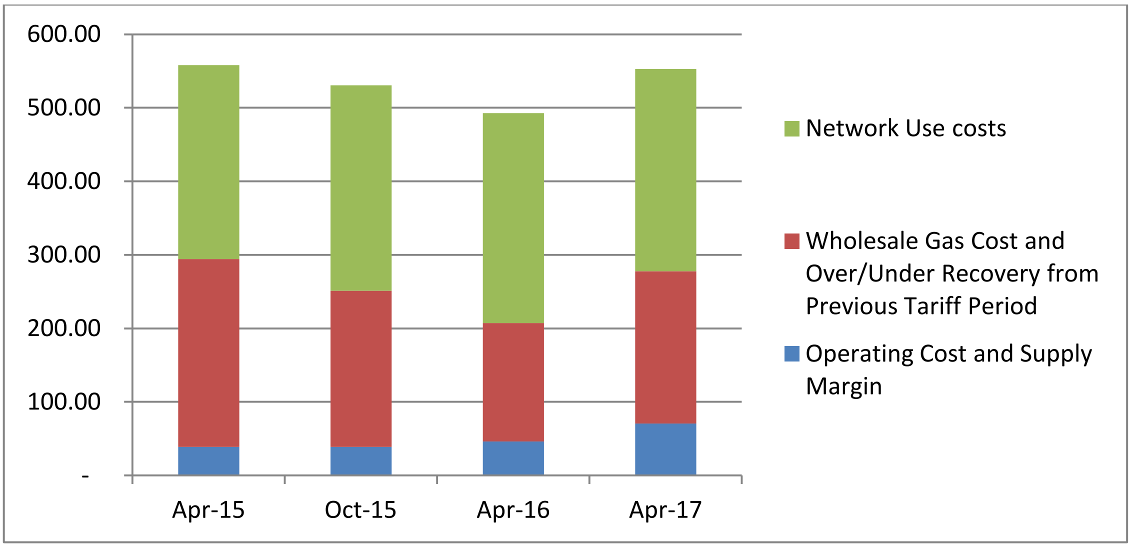


Figure 4 below shows the breakdown in the average annual bill for feSL tariff customers compared with the previous tariff review and illustrates the variation caused by different components of the maximum average price. It can be seen that the increase in the maximum average price is mostly driven by changes in the wholesale cost component.

The average annual bill amounts in this graph have been calculated based on the maximum average price set at each review (which excludes VAT) and are based on average annual consumption of 12,500kWh[5].

[5] 12,500 annual usage estimate is based on the figure published by Ofgem on their website at https://www.ofgem.gov.uk/gas/retail-market/monitoring-data-and-statistics/typical-domestic-consumption-values;

Figure 4 - Graph to show breakdown of average annual bill



Impact on Tariff

As stated earlier, feSL uses the maximum average price to set the actual tariffs charged to customers. The tariffs are calculated on a weighted average basis, based on average usage and the number of customers on each tariff. feSL cannot charge more than the maximum average price overall. From 31 March 2017, the unit rates of tariffs for feSL's customers in the Ten Town area will increase by 12.2%.

The new unit rates for tariff customers that will apply from 31 March 2017 are shown in Table 4 below. Table 5 shows the percentage increase for each individual unit rate of the domestic and small business tariffs.

Table 4 – feSL's tariff unit rates from 31 March 2017 (shown in pence per kWh including VAT)

	Domestic inc 5% VAT	**PAYG inc 5% VAT**	**IC1 ex VAT**	**IC2 ex VAT**
Up to 2,000 kWh	6.690	4.637	6.843	6.843
Over 2,000 kWh	4.511		4.544	4.544
Over 73,200 kWh				4.206
Direct Debit discount	£22.00			

The change in the feSL maximum average price from 31 March 2017 equates to an increase in domestic customer bills of £66 per year (including VAT) based on a domestic customer with an average consumption of 12,500 kWh per annum (rounded to nearest pound).

Table 5 – Percentage Increase in feSL's tariff unit rates from 31 March 2017

	Domestic	PAYG	IC1	IC2
Up to 2,000 kWh	12.2%	12.2%	12.2%	12.2%
Over 2,000 kWh	12.2%		12.2%	12.2%
Over 73,200 kWh				12.2%

Comparison with GB and Ireland

Figure 5 below, shows the average annual bill of a domestic customer for feSL in the Ten Towns compared to the "Big 6"[6] supply companies in GB, Bord Gais in Ireland and SSE Airtricity Gas Supply (NI) Ltd in NI.

This comparison is based on the latest available information on the standard domestic credit tariffs[7] of each company. The average annual bill amounts in this graph have been calculated based on actual tariff unit rates (including VAT) and are based on average annual consumption of 12,500kWh[8].

This graph shows the feSL tariff that will become effective on 31 March 2017 and also takes account of any tariff changes for supply companies in NI, GB and Ireland which have been published, even if the tariff change has not yet taken effect.

This graph illustrates that the feSL tariff for an average domestic standard credit customer in the Ten Towns area will be around the same as the GB average standard tariff and around 10% cheaper than the Bord Gais standard tariff in Ireland[9].

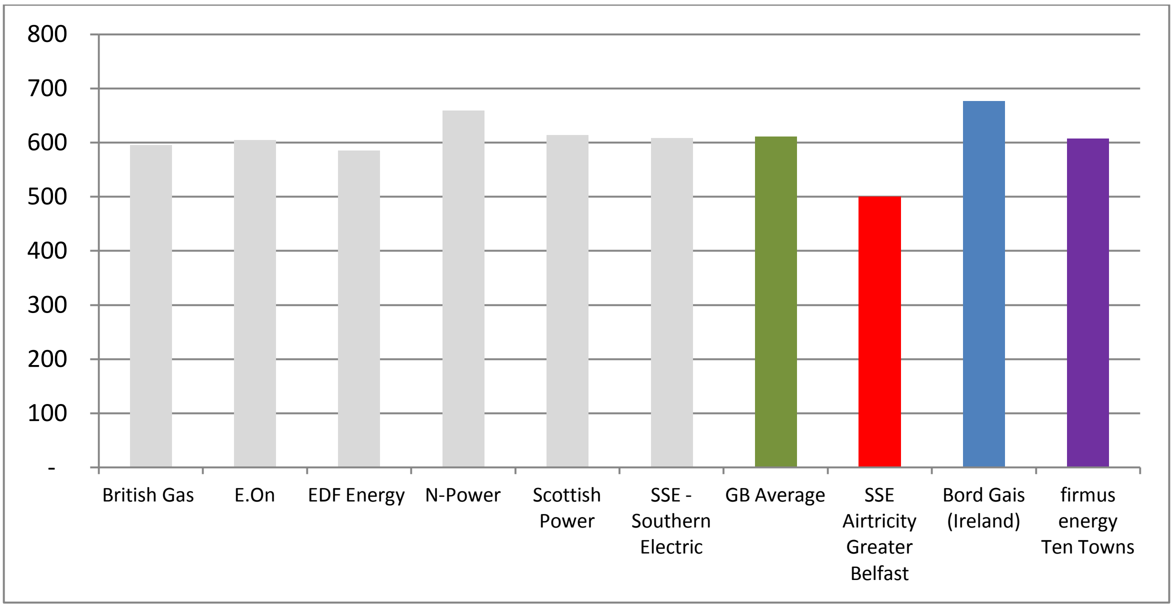
[6] The Big 6 companies are British Gas, SSE, Scottish Power, npower, E.on UK and EDF Energy.

[7] The tariffs used for comparison purposes are the standard tariff rates for domestic credit customers excluding any discounts available for payment by direct debit, viewing bills online etc.

[8] 12,500kWh annual usage estimate is based on the figure published by Ofgem in their Decision:

[9] VAT rates in GB and NI are equal. Comparison of RoI and NI exclusive of VAT shows that firmus is 3% cheaper that Bord Gais in RoI. Exchange rates as of 28/02/17.

Figure 5 - Comparison of average annual domestic bills (based on standard domestic credit customers with estimated usage 12,500kWh per annum including VAT)



The GB comparisons include any recent tariff change made by the Big 6 energy providers

Outcome

The Utility Regulator has reviewed the maximum average price submission provided by feSL and reviewed the feSL forecasts against its own market analysis. The Utility Regulator is satisfied that it is appropriate to set a maximum average price of 129.56 pence per therm for tariff customers in the Ten Towns for one year. This represents an average increase of 12.2% in the actual tariff unit rates that feSL uses to charge domestic and small business customers in the Ten Towns.

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