Gas Retail Supply

Price Controls 2020 (SPC 20)

UR Information Note

1 November 2018



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

This information paper sets out the Utility Regulator's (UR) approach to the supply price controls for both price regulated gas companies. The next price controls for the gas supply companies, firmus energy (supply) Ltd (firmus) and SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) are due to begin 1 January 2020 and 1 April 2020 respectively.

This is the first of a series of documents which the UR will publish relating to the price controls under this SPC20 project. This paper outlines the UR's proposed approach in relation to examining 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

Consumers and consumer groups; industry; and statutory bodies.

Consumer impact

This paper sets out the UR's intended approach for the gas supply price controls from 2020 onwards. The price controls establish the permitted costs and profit margin for each regulated company for the duration of the control period. Subsequent regulated tariffs will have to operate within these limits.

The price control decisions will therefore impact on the bills of price regulated customers.

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1. CONTEXT

Background

1.1 In relation to gas the principal objective of the UR is *"to promote the development and maintenance of an efficient, economic and co-ordinated gas industry in Northern Ireland" whilst having regard to "the need to ensure a high level of protection of the interests of consumers of gas".*

1.2 In Northern Ireland there are three distinct distribution network areas for natural gas. These are the 'Greater Belfast area', the 'Ten Towns' area and the 'West'. The Greater Belfast area is served by Phoenix Natural Gas Ltd, the Ten Towns area is served by firmus energy (Distribution) Ltd and the West is served by SGN Natural Gas Ltd.

1.3 There are two price regulated gas supply companies in NI:

- SSE Airtricity Gas Supply (NI) Ltd (SSE Airtricity) in the gas supply sector in 'Greater Belfast' and the 'West'; and
- firmus energy (supply) Ltd (firmus) in the gas supply sector in the 'Ten Towns area'.

1.4 The Greater Belfast market has been open to competition since 2007. There are approximately 209,000 customers in the market[1]. Currently there are six active suppliers in the market. However only two companies supply to domestic consumers. SSE Airtricity is the incumbent supplier in this area and is subject to price control. Their current price control lasts for a period of three years from 1 April 2017 to 31 March 2020.

[1] https://www.uregni.gov.uk/sites/uregni/files/media-files/2018-08-31%20Transparency%20Report%20Q2%202018%20FINAL.pdf

1.5 The Ten Towns gas market is a relatively small market; there are approximately 40,000 gas customers[1]. The market for I&C customers using less than 732,000 kWh per annum has been open since April 2015, currently there are four suppliers operating in the market. However firmus is currently the only supplier for domestic customers. Their current price control lasts for a period of three years from 1 January 2017 to 31 December 2019.

UR strategic approach to NI energy gas retail markets

1.6 Where competition is not sufficiently developed or effective, the UR protects customers by regulation and this applies to the relevant areas of the electricity and gas supply markets as much as to other sectors of the energy industry. In both electricity sectors, the UR retains price controls on those supply companies with dominant market positions in relation to household and small business customers.

1.7 The UR previously commissioned Cornwall Energy to review the condition of energy supply competition in NI.

1.8 The report[2] concluded that the requirement for some form of price regulation is likely to continue for the foreseeable future; and that the current form of regulation should co-exist with the ongoing development of competition. The Cornwall paper stated *"the NI experience strongly suggests that regulation and competition can successfully co-exist".*

1.9 The UR approach to the supply price controls is set within this context. At this time, we envisage that the controls will remain in place for both price regulated gas suppliers at 2020, given their market dominance especially in the household sectors, and thus we need to prepare the controls via SPC20. Other issues relating to the scope/coverage of the planned controls are discussed further below.

[2] https://www.uregni.gov.uk/news-centre/competition-retail-energy-markets-northern-ireland-report-published

About this document

1.10 The purpose of this document is to outline the approach and timetable the UR is taking in relation to setting the next price controls for the gas supply companies.

1.11 This paper marks the start of the process within which the new controls will be set. It is anticipated that the work will be completed by the end of 2019 with the view to having the controls in place for the relevant start dates.

1.12 We intend for this process to be transparent and structured. To that end this paper highlights the main issues likely to affect the control, as well as our initial thoughts on how those issues may be addressed or looked at further. We also present the timetable for the process. Given the need for timely delivery to meet licence requirements, we intend to stick closely to that timetable and the milestones set out therein.

1.13 The UR plans to issue a consultation for the end of May 2019. That paper will include our proposals in relation to the supply businesses' operating costs and profit margin as well as the scope of the controls and their durations. These will be fully consulted upon prior to final decisions being made in the late autumn.

2. STRUCTURE AND FORM

2.1 The details of the operation of firmus energy and SSE Airtricity's supply price control are set out in each Licence. At present, the maximum allowed unit price of gas ($\mathbf{P}_{st}$) for customers subject to price control is made up of a number of components:

$$\mathbf{P}_{st} = \mathbf{G}_t + \mathbf{U}_t + \mathbf{S}_t + \mathbf{M}_t + \mathbf{E}_t - \mathbf{K}_{st}$$

2.2 In any given year t,

2.3 $\mathbf{G}_t$ refers to the cost of the "wholesale" gas which the supply company purchases and so long as they comply with its Economic Purchasing Obligation, this will be passed directly through to customers via the regulated tariff.

2.4 $\mathbf{U}_t$ covers the costs of using the gas distribution network; these costs are regulated for all Suppliers through the Gas Transmission and Distribution (T&D) price controls.

2.5 $\mathbf{S}_t$ means the allowed operating charge in pence per unit of gas supplied by the Licensee to Regulated Premises in Relevant Year t

2.6 $\mathbf{M}_t$ means the applicable margin to be applied to each unit of gas supplied by the Licensee to Regulated Premises in Relevant Year t

2.7 $\mathbf{K}_{st}$ is a correction facility whereby under or over-recoveries in the previous year can be collected by the business (under-recovery) or given back to consumers (over-recovery).

2.8 $\mathbf{E}_t$ is associated with costs which are uncontrollable and are passed through to customers via the regulated tariff on a 100% basis. These costs include licence fees; IT projects required in order to put in place the systems and processes to comply with licence obligations and pension deficit costs.

2.9 The $\mathbf{E}_t$ element of the control is reviewed and amended in the licence as part of each price control setting process.

2.10 Operating costs and profit margin are discussed later in this paper.

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

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

2.13 The price control sets out the treatment of each cost element which makes up the tariff. The elements which make up the maximum average price are

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

2.14 In both current gas supply price controls the cost elements of the tariff are the same and the treatment of these costs are the same.

2.15 The current controls set network costs and wholesale gas costs as pass through costs, meaning that the companies are allowed to recover the actual level of these costs.

2.16 Operating costs are set at a fixed amount, with the exception of some billing costs which are adjusted on the basis of actual customer numbers and various other drivers.

2.17 Margin is set within the control at a percentage of allowed revenue, that being 2%. This was set at this level after in-depth consideration at the time of the last price controls.

3. SCOPE AND COVERAGE

3.1 This section of the paper covers the scope and coverage for both gas price controls.

SSE Airtricity

3.2 Currently SSE Airtricity are subject to price control in the market for those consumers using less than 73,200kWh per annum (EUC1 tariff), this includes all domestic consumers and small industrial and commercial consumers (I&C).

3.3 The SSE Airtricity gas supply licence states that the company must apply a maximum average price where consumers '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)…'

3.4 There is currently only firmus energy competing as a supplier in the domestic market in Greater Belfast, however SSE Airtricity hold 75.6% market share. In addition, the latest quarterly transparency report published[3] by the UR shows that SSE Airtricity currently hold 64.6% market share in the small I&C market[2].

3.5 There are currently no competing suppliers in the domestic market in the West, and therefore SSE Airtricity hold 100% market share in that area.

firmus energy

3.6 Currently firmus are subject to price control in the market for those consumers using less than 73,200kWh per annum (EUC1 tariff), this includes all domestic consumers and small I&C consumers.

[3] https://www.uregni.gov.uk/sites/uregni/files/media-files/2018-08-31%20Transparency%20Report%20Q2%202018%20FINAL.pdf

3.7 There are currently no competing suppliers in the domestic market in the Ten Towns, and therefore firmus hold 100% market share. In addition, the latest quarterly transparency report published[4] by the UR shows that firmus currently hold 79.8% market share in the small I&C market.

UR Approach

3.8 Given the large market shares of both SSE Airtricity and firmus in the domestic and small business markets the UR is unlikely to propose any change to the scope of the current price controls.

[4] https://www.uregni.gov.uk/sites/uregni/files/media-files/2018-08-31%20Transparency%20Report%20Q2%202018%20FINAL.pdf

4. DURATION

4.1 The duration of the controls have varied previously from a one year control to a five year control depending on the circumstances of the company, the market and the industry.

4.2 The current price control for both firmus energy and SSE Airtricity have durations of three years. We believe that the present market conditions have not changing significantly since the last price controls and will therefore likely proceed with a further three year price controls for each company. However the UR will be consulting on this and we will invite views from stakeholders as to whether it may be in customers' interests to extend the period to beyond three years.

4.3 We are of the view that a control of one year is too short. This is based on the rationale that any efficiencies which are achieved by the company during that one year will be taken back when setting the next control. This short period in which the companies can retain the out performance reduces the incentive on the companies to make efficiencies which are ultimately passed back to customers in subsequent price controls. In addition there are also negative resource implications for both the company and the UR.

4.4 Five or even seven year controls are common in network controls as these are stable and fairly 'steady state' businesses, however the presence of competition (or the threat of new entrant competitors) in the retail markets and the resultant potential movement in market shares can cause difficulty in forecasting of costs and volumes in the longer term.

4.5 Therefore, we will consider duration as part of this price control process.

5. TREATMENT OF COSTS

5.1 This section of the document will discuss the proposed approach to the treatment of costs within the gas supply price controls.

5.2 The gas supply price control determines the treatment of each of the costs which make up the maximum average price. These costs are:

- Network Costs
- Wholesale Gas Costs
- Supply Operating Costs

Network Costs

5.3 Network costs cover the charges for the use of the Northern Ireland transmission and distribution systems. These charges are reviewed and approved by UR.

5.4 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 (SNIP), and all the transmission pipelines within Northern Ireland.

5.5 The costs for the distribution system are those costs associated with moving gas throughout the three distribution areas to homes and businesses. Transmission and distribution costs are published by the relevant system operator[5].

5.6 In previous controls network costs have been treated as pass through which means that the company is allowed to recover the actual costs incurred. We

[5] System Operators are

- Premier Transmission Ltd http://www.mutual-energy.com/gas-business/
- Phoenix Natural Gas Ltd https://www.phoenixnaturalgas.com/about-us/about-phoenix/network-information/network-charges
- Firmus energy (Distribution) Ltd https://www.firmusenergy.co.uk/publications/category/postalised-capacity-charges
- Gas Networks Ireland http://www.gasnetworks.ie/en-IE/Gas-Industry/Northern-Ireland/Transportation-services/Postalised-Tariffs/

will retain this approach for the forthcoming controls and allow network costs to be recovered on a pass through basis.

Wholesale Gas Costs

5.7 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[6]. 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.

5.8 We propose to continue 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).

Supply Operating Costs (opex)

5.9 There are a number of potential approaches to assessing the opex requirements over the control period:

- 'Bottom up' analysis – Build up the opex on a line by line basis with a detailed review of each cost line (with historical trend analysis);
- 'Top down' analysis – Review of the total opex as a whole (with historical trend analysis); and
- Combination of 'bottom up' and 'top down' analysis (with historical trend analysis).

5.10 We will use a bottom up approach for both companies on the basis that the costs allowances that were set in the last controls were, for many items, new

[6] https://www.nationalgridgas.com/charging/transmission-system-charges

and increased. Actual spend will need to be analysed and compared to these allowances and determinations made on the level of these for the next control period will need to be made. We will focus our analysis on the larger cost areas and those areas which are forecast to increase significantly over the period of the control albeit we will investigate every cost line to some degree.

5.11 For both gas supply companies there are a number of potential opex areas which we may examine in further detail. These include, but are not limited to; bad debt, manpower, billing, and IT costs.

5.12 The gas supply companies will be required to submit forecast costs for a minimum of a three year period (potentially longer), along with historical costs evidencing costs to date. This will include a latest best estimate of the recent year if it has not fully closed. They will also be required to identify any activity which is to be discontinued and where spending will not reoccur. The UR wishes to make it clear from the outset that additional opex allowances will only be given if:

- any net increase in costs is due to exogenous changes in business obligations and are unavoidable and forecast at efficient levels; and
- The company is able to provide compelling evidence for the amounts claimed.

5.13 This means that the burden of proof lies with the company. If the company is not able to justify its claims to the UR's satisfaction then the costs will not be allowed within the control.

Additional Operating Costs

5.14 It is normal regulatory practice to make separate allowances for any incremental expenditure or any reductions in expenditure that result from changes in the scope and nature of business activities.

5.15 We will set a number of items within the control for which additional allowances may be granted through the control period. These will include items such as changes in legislation, licence changes or European Directives. In order to be granted an additional allowance the companies will need to clearly demonstrate that the change places a financial burden on them that was not considered at the time of the control. Furthermore the company will have to justify any amount of new allowance to the UR's satisfaction.

5.16 Any costs arising outside of those allowed within the control and outside of these additional items will not be allowed.

Cost allocation

5.17 The gas supply companies will be required to apportion their costs between businesses and between regulated and non-regulated customers in line with the apportionment methodology set out in condition 1.2.5 of the gas supply licence.

Treatment of Variable Costs

5.18 Within this control we propose to review our treatment of variable costs, that is those costs which vary by customer numbers or volume. We understand that the nature of a gas supply business is such that some costs are dependent on the number of customers and the volume flowed; and that within the gas supply business both these drivers could rise or fall depending on the level of competition, the growth in the gas industry or external factors such as the weather.

5.19 Within the current gas supply price controls the majority of opex costs are set at a fixed allowance. However there are a number of costs which are retrospectively adjusted, these costs relate to the costs for billing, meter reading, printing and posting bills and transaction costs for prepayment customers. Currently these costs are allowed on the basis of the actual cost drivers (meters read, bills posted etc.).

5.20 We will review these costs to determine if it is appropriate to retain these costs as retrospective costs or to introduce a methodology to determine fixed and variable costs. It is important to note that this methodology may differ between the two companies due to their relative size.

6. MARGIN

6.1 This section of the report discusses the approach to setting a margin for each of the price regulated energy supply companies.

6.2 Both SSE Airtricity and firmus currently operate with an allowed margin of 2% of revenue.

6.3 SSE Airtricity and Firmus Energy's current price controls are fixed using the formula as defined in both supply licenses[7]:

$$\mathbf{M}_t = \mathbf{(}(\mathbf{G}_t + \mathbf{U}_t + \mathbf{S}_t + \mathbf{E}_t + \mathbf{K}_{st})/0.98\mathbf{)} - (\mathbf{G}_t + \mathbf{U}_t + \mathbf{S}_t + \mathbf{E}_t + \mathbf{K}_{st})$$

6.4 During the last price control, we conducted a complete review of margin in line with the methodology used for the previous Power NI price control using the capital base and the cost of capital to calculate an appropriate margin.

6.5 We have no specific intentions at present to modify this formula or to put in place an alternative level of allowed margin.

[7] https://www.uregni.gov.uk/gas-licences

7. TIMEFRAME AND NEXT STEPS

7.1 The following timetable highlights the various stages of the price control review process and (approximately) when the UR expects each milestone to be achieved for both regulated suppliers.

Table 1: Price Control Review timetable

Date	Milestone
October 2018	UR engages with price controlled suppliers
November 2018	Utility Regulator information note published
November 2018	Utility Regulator to send business efficiency questionnaire (BEQ) to SSE Airtricity and Firmus Energy.
End January 2019	Submission of completed BEQ by price controlled suppliers
February - April 2019	BEQ Analysis and iteration with the price controlled suppliers & consultation proposals developed.
May 2019	Utility Regulator to publish price control proposals consultation paper
July 2019	End of consultation period
September 2019	Utility Regulator to publish final decision
Sept 2019	Utility Regulator to consult on licence modifications to implement price control decisions – 28 days
October 2019	End of licence modification consultation period Publish licence modification Decision

7.2 As shown the timetable envisages that we will publish two further documents between now and October 2019:

- a price control proposals paper by the end of May 2019, which will contain provisional calculations of the SSE Airtricity and Firmus Energy operating costs and margin which are included in the $\mathbf{S}_t$ formula of the price cap formula; and
- a final decision paper in September 2019.

7.3 We envisage that the entire process will be an iterative one and we will engage with SSE Airtricity, Firmus Energy and other stakeholders throughout.