Electricity and Gas Retail Supply Price Controls 2017 (SPC 17)

UR Approach Consultation

October 2015



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 paper sets out the Utility Regulator's (UR) approach to the supply price controls for both the electricity and gas price regulated companies. The next Power NI Price Control is due to begin 1 April 2017. The next price controls for the gas supply companies, firmus energy (supply) Ltd (firmus) and SSE Airtricity Gas are due to begin 1 January 2017. This is the first of a series of documents which the UR will publish relating to the price controls under this SPC17 project. This paper outlines the proposed high level approach 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

Consumers and consumer groups; industry; and statutory bodies.

Consumer impact

This paper sets out the UR's proposed approach for both the electricity and gas supply price controls from 2017 onwards. The price control establishes 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. The number of non-domestic customers who will be able to avail of a regulated tariff will also be examined within these controls.

Contents

1. CONTEXT

Background

1.1 In Electricity, the primary statutory duty of the Utility Regulator (UR) is "*to protect the interests of consumers of electricity supplied by authorised suppliers, wherever appropriate by promoting effective competition*"[1].

1.2 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".*

1.3 There are three price regulated energy supply companies in NI:

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

1.4 The electricity supply market in NI is fully open to competition and there are now a number of competing suppliers in the market. However, Power NI have the majority share of the domestic market and of some segments of the Industrial and commercial (I&C) market. This will be discussed further in the Scope and Coverage section of this paper. There are approximately 780,000 customers in the domestic electricity market and approximately 51,000 in the less than 50 MWh segment of the I&C market (in which Power NI are currently subject to a price control).

1.5 In Northern Ireland there are two distinct distribution areas for natural gas. These are the Greater Belfast area and the Ten Towns area. The Greater Belfast area is served by Phoenix Natural Gas Ltd and the Ten Towns area is served by firmus energy (Distribution) Ltd.

1.6 The Greater Belfast market has been open to competition since 2007. There are approximately 178,000 customers in the market. Currently there are six

[1] Article 12 of *the Energy (Northern Ireland) Order 2003*.

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. The current price control lasts for a period of five years from 1 January 2012 to 31 December 2016.

1.7 The Ten Towns gas market is a relatively small market; there are approximately 27,000 gas customers. 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. The current price control lasts for a period of 21 months from 1 April 2015 to 31 December 2016.

UR/Cornwall Energy's review of NI energy retail markets

1.8 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.

1.9 During 2014 the UR commissioned Cornwall Energy to review the condition of energy supply competition in NI.

1.10 The Cornwall Phase I report[2] laid out the findings in relation to the state of retail competition in the NI electricity and gas retail markets. The primary findings of the report were:

- The NI market has achieved reasonable levels of switching given the context of the market and its maturity.
- The Power NI (former electricity supply incumbent) share of the domestic and small I&C market remains high, with a lot of the pricing strategies of competitors focused on discounting of the Power NI price; The market shares of SSE Airtricity (former gas supply incumbent in the Greater Belfast area) remain similarly high.
- There are limited supply players in the energy supply market and it is highly concentrated.

[2] http://www.uregni.gov.uk/publications/ur_review_of_retail_market_effectiveness_phase_1_next_steps1

- Given the fundamental lack of scale of the NI market, this is unlikely to change and the number of suppliers in the market is unlikely to materially increase.
- Given the structural characteristics of the energy market and the lack of sufficient critical mass to attract a larger number of suppliers, relying on competition is not enough on its own to effectively protect customers. Northern Ireland has only circa 788,000 domestic electricity customers and circa 167,000 domestic gas customers in the greater Belfast Area. Put into context the electricity market in NI has less than 3% of the total number of domestic electricity customers in GB and is only around 70% the size of the market in greater Manchester. The market for natural gas in Northern Ireland is much smaller, making up less than 1% of the total number of natural gas customers in GB.
- Those customers who wish to switch have arguably already done so, and it should not be expected that switching rates will continue as they have up to now.

1.11 The report concluded that the requirement for some form of price regulation is likely to continue for the foreseeable future; and that this 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”.*

1.12 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 all three price regulated suppliers at 2017, given their market dominance especially in the household sectors, and thus we need to prepare the controls via SPC17. Other issues relating to the scope/coverage of the planned controls are discussed further below.

1.13 The Power NI control is due to begin 1 April 2017, with the SSE Airtricity and firmus controls due to begin on 1 January 2017.

1.14 However SSE Airtricity have requested a licence modification to change their accounting period from the current January to December period to an April to March period, We have granted this modification and this will come into effect from 1 April 2016. As a result the start date of the price control will change to 1 April 2017, in line with the accounting period. We propose to extend the existing control for a period of three months from January to March 2017 on a pro rata basis and for the new control to start on 1 April 2017.

About this document

1.15 The purpose of this document is to consult on the Approach the UR should take in relation to setting the next price controls for the energy supply companies set out above.

1.16 This paper marks the start of the process through which the new controls will be set. It is anticipated that the work will be completed by the end of 2016 with the view to having the controls in place for the relevant start dates.

1.17 We intend for this process to be transparent and timely. To that end this paper consults on the main issues likely to affect the control, our initial thoughts on how those issues may be addressed or looked at further and welcomes stakeholder feedback on various questions and issues. We also present the timetable for the controls. Given the need for timely delivery to meet licence requirements, we intend to stick closely to that timetable and the milestones set out therein.

1.18 The UR is seeking feedback from interested stakeholders at this early stage, so that this may help to shape our consultation planned for the end of May/June. That future paper will include details of respondents' feedback to this consultation and 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.

1.19 The document is structured as follows:

- Section 2 outlines the proposed structure and form of the controls;
- Section 3 provides detail on those sectors of the market we consider should fall within the scope of the controls;
- Section 4 outlines our proposals for the duration of the price controls;
- Section 5 sets out the options for assessing operating expenditure ;

- Section 6 discusses the setting of the allowed margin for the price controlled businesses;
- Section 7 asks the key consultation questions on which we are seeking feedback from interested stakeholders; and
- Section 8 reviews the timeframe and how we intend to engage with stakeholders throughout the price control process.

Equality considerations

1.20 As a public authority, the UR has a number of obligations arising from Section 75 of the Northern Ireland Act 1998. These obligations concern the promotion of equality of opportunity between:

i. persons of different religious belief, political opinion, racial group, age, marital status or sexual orientation;

ii. men and women generally;

iii. persons with disability and persons without; and

iv. persons with dependants and persons without.

1.21 The UR must also have regard to the promotion of good relations between persons of different religious belief, political opinion or racial groups.

1.22 In the development of its policies the UR also has a statutory duty to have due regard to the needs of vulnerable customers i.e. individuals who are disabled or chronically sick, individuals of pensionable age, individuals with low incomes and individuals residing in rural areas. Some of the above equality categories will therefore overlap with these vulnerable groupings.

1.23 In order to assist with equality screening of the proposals contained within this consultation paper, the UR requests that respondents provide any information or evidence in relation to the needs, experiences, issues and priorities for different groups which they feel is relevant to the implementation of any of the proposals. Furthermore, the UR welcomes any comments which respondents might have in relation to the overall equality impact of the proposals.

Q1.	***Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?***
Q2.	***Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If so, why and how? Please provide supporting information and evidence.***

Responding to this consultation

1.24 The UR is keen to hear all stakeholder views on the proposed approach to the Supply Price Controls for each of the price regulated energy supply companies.

Responses to this consultation should be forwarded to reach the UR on or before 4pm on Tuesday 8th December 2015 to:

Nicola Sweeney
The Utility Regulator
Queens House
14 Queen Street
Belfast
BT1 6ED
Email: Nicola.Sweeney@uregni.gov.uk

1.25 Your response to this consultation may be made public by the UR. If you do not wish your response or name made public, please state this clearly by marking the response as confidential. Any confidentiality disclaimer that is automatically produced by an organisation's IT system or is included as a general statement in your fax or coversheet will be taken to apply only to information in your response for which confidentiality has been specifically requested.

1.26 Information provided in response to this consultation, including personal information may be subject to publication or disclosure in accordance with the access to information regimes; these are primarily the Freedom of Information

Act 2000 (FOIA) and the Data Protection Act 1998 (DPA). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things with obligations of confidence.

1.27 In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Authority.

1.28 This document is available in accessible formats. Please contact: Nicola Sweeney on 028 9031 6622 or nicola.sweeney@uregni.gov.uk

2. STRUCTURE AND FORM

Power NI

2.1 The details of the operation of Power NI's supply price control are set out in its Licence. At present, Power NI's maximum allowed unit price of electricity (**M_t**) for customers subject to price control is made up of a number of components:

$$M_t = G_t + U_t + S_t + K_t + (J_t - D_t) + E_t$$

In any given year t,

2.2 **G_t** refers to the cost of the "wholesale" electricity which Power NI purchases and so long as Power NI complies with its Economic Purchasing Obligation, this will be passed directly through to customers via the regulated tariff.

2.3 **U_t** covers the costs of using the electricity network; these costs are regulated for all Suppliers through the NIE Transmission and Distribution (T&D) price controls.

2.4 **K_t** 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).

2.5 **J_t** encompasses costs associated with buy-out from the Northern Ireland Renewables Obligation with the **D_t** term representing any savings on the buy-out Power NI achieves.

2.6 **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.

2.7 The E_t element of the control is reviewed and amended in the licence as part of each price control setting process. This will be particularly relevant regarding the pension deficit recovery (which is currently a pass-through item in E_t). The Competition Commission ruled that the treatment of the pension deficit of NIE should be consistent with Ofgem's treatment of pension deficits of distribution businesses in GB during the RP5 referral. The UR decided that it was appropriate to adopt these principles for the other NI regulated energy businesses that seek to pass through pension deficit costs through their regulated tariffs. This is directly relevant to Power NI and their recovery of historic pension deficit. A formal notification of the new arrangements and the cut-off date for the recovery of historical pension deficit was issued December 2014 in the paper *"Pension Deficit Recovery – A Utility Regulator Position Paper*[3]*"*.

2.8 This paper stated that the cut-off date would be March 2015 and that the historical deficit determined at this time would be recovered over no longer than 10 years. The paper stated that "The companies affected by this decision will need to submit calculations of historical and incremental deficits and illustrate compliance with the RIGS methodology for the purposes of setting regulated tariffs." It should also be noted that the UR's intention to apply consistent policy in relation to pension deficit recovery was previously consulted on as part of the 2012-14 Power NI price control.

2.9 As demonstrated above, the majority of Power NI's costs are straight pass-through costs which are subject to other price controls or regulations; and thus this price control review deals principally with the $\mathbf{S_t}$ term of the tariff formula (along with the aforementioned E_t), which is in effect Power NI's own operating costs and margin allowed by the regulator. This amount must be sufficient to finance an efficient business and should comprise the following elements:

- Operating costs;
- Allowed Margin.

2.10 The Allowed Revenue of S_t is currently collected on a ratio of a 70% fixed amount plus a 30% variable amount collected on a per customer basis. This was reviewed as part of the last control and as a result it was determined that the split should be adjusted slightly (moving from 67:33).

2.11 We are proposing that the current structure and form of the Power NI price control remains the same.

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

[3] http://www.uregni.gov.uk/news/view/regulator_publishes_a_pension_deficit_position_paper/

Q3. Do respondents consider that the existing structure and form remains appropriate for the next Power NI price control? If not, please explain what you believe the structure and form should be.

SSE Airtricity and firmus

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

<u>2.4.1 Control over Charges in the absence of competition</u>

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 ensure 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...

2.14 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.

2.15 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.

2.16 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

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

2.18 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.

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

2.20 Margin is set within the control at a percentage of allowed revenue.

2.21 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.

2.22 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;

- 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
- 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

2.23 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 begun to discuss this with the two gas companies. This would provide the company with the opportunity to challenge the control at the time of a modification to give effect to any new control and bring the gas supply licence in line with other licences.

Q4 Do respondents consider that the proposed review of the gas supply licences are appropriate? If not, please explain your reasons.

3. SCOPE AND COVERAGE

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

Power NI

3.2 Power NI are currently subject to price control regulation in the whole of the Domestic market and for I&C customers up to 50MWh per annum consumption (or 50 kVA Maximum Import Capacity (MIC) connection if consumption data is unavailable) in the Non-Domestic market. "Regulated premises" which are those premises covered by price control regulation are defined in Annex 2 of the Power NI licence.

3.3 Power NI remains dominant in the Domestic market with a market share of c.66% by consumption and c.68% by connection.

3.4 Therefore, the UR envisages that price control regulation, i.e. the setting of regulated tariffs offered by Power NI, will continue to apply to the whole Domestic market whilst Power NI remain in a dominant position. However, the UR will continue to monitor the situation as competition develops and in light of our statutory duties.

3.5 In relation to the Non-Domestic market, further deregulation took place at the last control reducing the coverage in the I&C market to its current level (50 MWh/annum). It had previously been at the level of 150MWh annual consumption.

3.6 In assessing market share, the UR will continue to assess the combined share of Power NI and its affiliate Energia as is the normal practice in competition assessment matters. While there may be business separation obligations in the licences of Power NI and Energia, it is recognised that these will only ever be effective to a certain degree. The common ownership and shareholder control of Power NI and Energia is the salient point when thinking about market share and potential dominance.

3.7 Power NI, when taken with their affiliate company Energia, are still the dominant supplier in the Non-Domestic market up to 50 MWh when considered on the basis of joint market shares. We will also consider other indicators/measures of the degree of competition in our assessment of the need for this I&C sector to remain under the price control or not.

3.8 Therefore, UR's consultation on the price control proposals will use market share by consumption and by customer number information, in addition to existing data that the UR already uses to monitor, which includes amongst other things:

- Number of suppliers;
- Market share trends;
- Customer switching rates;
- Substitutability of the product;

Q5. Do respondents agree with the UR proposal to review price regulation in the 0-50MWh sector of the market? Please provide suitable evidence, including legal opinion if applicable, as to why price regulation should or should not remain in this sector.

SSE Airtricity

3.9 Currently SSE Airtricity are subject to price control in the market for those consumers using less than 732,000kWh per annum, this includes all domestic consumers and small to medium industrial and commercial consumers (I&C consumers).

3.10 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)…'

3.11 As part of the price control process we will review this sector of the market, considering whether competition is effective in this sector of the market and offering consumers adequate protection or whether price regulation should remain in this sector.

Q6. Do respondents agree with the UR proposal to review price regulation in the 73,200kWh to 732,000kWh (EUC 2)sector of the market? Please provide suitable evidence, including legal opinion if applicable, as to why price regulation should or should not remain in this sector.

firmus

3.12 Currently firmus are subject to price control in the market for those consumers using less than 732,000kWh per annum, this includes all domestic consumers and small to medium I&C consumers.

3.13 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 over 92% market share in the I&C market.

3.14 In light of Firmus' dominance within the market we intend to retain the scope of the control to cover all customers using less than 732,000kWh. We will continue to monitor the market as competition develops and in light of our statutory duties.

Q7. Do respondents agree that it is reasonable to retain the scope of the price control for firmus at the under 732,000kWh sector of the market?

[4] http://www.uregni.gov.uk/uploads/publications/Transparency_Report_2015_AUG.pdf

4. DURATION

4.1 This section of the paper will look at the options for the duration of the controls for the regulated companies. It will also present an alternative option for Power NI which would result in the current control being "rolled over"; this is discussed in further detail later in this section. The duration of the control has 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 Power NI has a duration of three years. The SSE Airtricity control[5] was set for five years with an option of a reopener after three. The firmus control was set for a period of 21 months in order to align the end of the control with those of SSE Airtricity and Power NI. We have considered three potential options for duration for both the electricity and gas controls. These options are based on the lengths of controls previously set by UR and on good regulatory practice. They are:

1. One year;
2. Three years; or
3. Five 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 can be taken back when setting the next control. In addition there are also negative resource implications for both the company and the UR.

4.4 The current price control for SSE Airtricity is a five year control, set at a time when the market was relatively stable and predictable, with a built in reopener should market conditions, or other agreed factors, change. Five year controls are also common in network controls as these are stable and fairly 'steady state' businesses, however the current 'flux' in the retail market in relation to movement in market shares and new suppliers entering the energy market would cause difficulty in forecasting of costs and volumes in the longer term and for this reason we would deem a five year duration too long.

[5] The SSE Airtricity price control was set for Phoenix Supply Ltd. SSE Airtricity purchased Phoenix Supply Ltd in June 2012

4.5 Therefore, we consider that three years would be the most appropriate duration for both the electricity (if a new control were to be implemented) and gas controls, as it balances the resource implications of carrying out a control with the ability to forecast accurately over the medium term.

Q8. Do respondents agree that a duration of three years for the next price controls for electricity and gas is appropriate?

Power NI Alternative Option

4.6 As mentioned previously in 4.1, there is an alternative option which could be considered in the case of the Power NI price control. The development of the new I-SEM market will impact upon the operating costs of Power NI and may have implications for the margin, as discussed in Section 6 of this paper. However the impact of I-Sem on the Power NI business is difficult to forecast in advance. We are therefore considering the option of rolling over, or continuing, the existing Power NI control parameters until such time as we can make a more informed forecast of the I-SEM impacts on their business and the efficient cost and margin levels which we should allow.

4.7 It is anticipated that the new I-SEM market will 'go-live' in the latter stages of 2017. The market design is still in development and as such makes it more difficult to determine with a degree of certainty what the likely cost impacts on Power NI could be. In this context the UR may consider the roll-over of the current control until there is more clarity in terms of the likely cost impacts.

4.8 The current control could potentially be rolled over for:

- One year – thereby ending March 2018
- Two years – thereby ending in March 2019

4.9 It should be noted that Sections 5 and 6 discuss the approach to the treatment of costs and the margin for Power NI. These sections are based on the assumption that there will be a new price control as opposed to a roll-over of the current control. If the decision to roll over the Power NI price control is taken then some elements of the approach to both cost and margin will not be applicable.

Q9. Do respondents think that a potential roll-over of the current Power NI price control is appropriate to help address the uncertainty in relation to the development of the new I-SEM?

5. TREATMENT OF COSTS

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

Power NI

5.2 One of the main work areas during the price control project will be to estimate the efficient level of Power NI's own costs (part of the S_t term in the price control formula). These costs are mainly the operating expenditures that Power NI incurs in providing retail services to customers, including its staff costs, out-sourced billing and customer service costs, corporate overheads and provisions for bad debt. The E_t of the control has already been covered in Section 2 of this paper, these are the costs which are a straight pass through, as provided for in Annex 2 of the Power NI licence. These categories of costs are identified in the licence, Power NI can make separate submissions for these costs over the course of the control. As discussed previously these costs need to be fully justified by the company and approval for these has to be obtained before any expenditure occurs.

5.3 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).

5.4 The allowance in the current control was determined by examining overall cost lines with a more detailed 'drill down' on cost lines which were large and/or had forecast a significant increase.

5.5 To determine the current control we asked Power NI to supply a detailed one year forecast and once an efficient baseline was established this was then rolled forward for the next two years of the control.

5.6 For the forthcoming control we are proposing to collect three years of financial data submitted by Power NI on their forecast OPEX. This financial information will be submitted through the Business Efficiency Questionnaire (BEQ), as has been the case in previous years. We are proposing to use approach 3 in the assessment of OPEX.

5.7 We will focus our analysis on the larger costs lines (drilling down into these) and on those which are forecast to increase by a significant amount or percentage.

5.8 There are a number of potential areas which we may examine in further detail such as bad debt (in the context of the methodology and level and consistency across price controls); IT/outsourced costs; I-SEM costs; and Pension Deficit costs. This is not a definitive list and at this stage is only a proposal for potential areas we may focus our resource on.

Additional opex

5.9 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.

5.10 It is proposed that Power NI should be asked to submit claims for additional cost items in its response to the UR's business plan questionnaire. It 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
- Power NI is able to provide compelling evidence for the amounts claimed.

5.11 This means that the burden of proof lies with the company. If Power NI is not able to justify its claims to the UR's satisfaction, there will be no allowance for additional opex.

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

Cost allocation and adjustments for loss of market share

5.13 As a final step in the opex analysis, it is necessary to deal with two related tasks:

- allocating Power NI's total opex between price controlled and non-price controlled customers; and
- adjusting price controlled opex for future customer loss.

5.14 Adjusting for future customer loss was reviewed in detail at the last review and therefore the same methodology will be applied at this control (70:30 split). The allocation methodologies were also examined at the last review and it is likely they will be maintained however any new costs lines will have to be apportioned on an appropriate basis. This may be based on the existing cost drivers (which were reviewed at the last controls) or by a new cost driver or mix of cost drivers.

Q10. Do respondents consider the approach outlined for assessing the Power NI opex is appropriate at this price review? If not, please explain what approach you consider the UR should take to assessing opex and the reasons why.

SSE Airtricity and firmus

5.15 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

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

5.17 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.

5.18 The costs for the distribution system are those costs associated with moving gas throughout the Ten Towns area to homes and businesses. Transmission and distribution costs are published by the relevant system operator[6].

5.19 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 propose to retain this approach for the forthcoming control and allow network costs as pass through costs.

Wholesale Gas Costs

5.20 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[7]. 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.

5.21 We propose 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

5.22 Supply operating costs (opex) are the costs necessary for the gas supply companies to run their businesses, for example the costs of billing, meter reading, customer service, offices, salaries and IT systems etc.

[6] System Operators are

- Premier Transmission Ltd http://www.premier-transmission.com/
- Phoenix Natural Gas Ltd http://www.phoenixnaturalgas.com/help-and-advice/networks/charges/
- Firmus energy (Distribution) Ltd http://www.firmusenergy.co.uk/about_us.aspx?dataid=507590
- Gas Networks Ireland http://www.gasnetworks.ie/en-IE/Gas-Industry/Northern-Ireland/Transportation-services/Postalised-Tariffs/

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

5.23 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).

5.24 It is likely that our options for reviewing opex will vary between the two gas supply companies. For firmus we propose to use a top down approach on the basis that the costs have been reviewed in detail for the most recent control which commenced in April 2015. 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.

5.25 For SSE Airtricity we propose to use the combination approach in the third option, on the basis that this is the first control for SSE Airtricity as a business (the previous price control having been completed for Phoenix Supply Ltd which was purchased by SSE Airtricity in June 2012). While the day to day business remains the same this change in ownership has implications for a number of cost lines such as manpower and overhead costs, and for the apportionment of costs between businesses.

5.26 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, meter tampering and IT costs.

5.27 The gas supply companies will be required to submit forecast costs for a three year period, along with historical costs evidencing costs to date. In addition the companies will be asked to submit claims for additional cost items within their submission. 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

- The company is able to provide compelling evidence for the amounts claimed.

5.28 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 opex

5.29 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.

5.30 We propose to 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.

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

Cost allocation

5.32 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

5.33 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.

5.34 Within the current gas supply price controls the majority of 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).

5.35 We propose to 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 similar to that applied in the Power NI control as detailed above. It is important to note that this methodology may differ between the two companies due to their relative size.

Q11. Do respondents consider the approach outlined for assessing the treatment of costs for the gas supply companies if appropriate? If not please explain what approach you do consider to be appropriate and the reasons why.

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.

Power NI

6.2 The other input to the S_t term in Power NI's current price control is an allowance for profit. The margin which was set for the current control 2104-2017 was 2.2%.

6.3 Significant analysis and resource was deliberately put into the margin analysis at the time of the last control by both Power NI and the UR to establish both an appropriate methodology for calculating the margin and the level of the margin itself.

6.4 The margin was derived from using a capital base x cost of capital methodology and verified using an alternative approach developed by ECA consultants. The combination of these two methodologies produced a range of margin levels and 2.2% was deemed to be the logical midpoint of these.

6.5 At the time of the last control it was envisaged, given the detailed analysis and resource that were employed, that this margin would be carried forward to future controls.

6.6 In this context, there are three potential options for the approach to margin:

1. Roll forward the margin of 2.2% from the previous control on the basis of the detailed and robust analysis carried out in the last price control;
2. Roll forward the margin of 2.2% as a baseline with an adjustment delta for any changes to the working capital and collateral requirements of the business whether positive or negative; or
3. Reopen the margin using the same methodology from the previous control but using new inputs (for example updated working capital requirements).

6.7 We are proposing that approach 2 be adopted for assessing the margin which Power NI should earn. The methodology and analysis which set the 2.2% was robust and as such we are of the view that this is the appropriate baseline. However, we are aware that there have been changes in the market since setting the last price control. These include I-SEM which could potentially have some impact on the working capital or collateral requirements of Power NI. Other factors such as the timing of setting tariffs may have positive effects on working capital requirements. However, the overriding principle we will follow is that any delta adjustment will need to be justified by Power NI and they will need to adequately demonstrate that there is a requirement to adjust the margin.

Q12. What are respondents' views on the proposed approach to establishing a margin for Power NI?

SSE Airtricity and firmus

6.8 Both SSE Airtricity and firmus currently operate with an allowed margin of 1.5% of revenue.

6.9 The 1.5% margin has been in place since 2008 for SSE Airtricity (formerly Phoenix Supply Ltd).

6.10 In 2014, while developing the current firmus price control, we carried out a review of the margin for firmus. The review was completed using the Power NI margin of 2.2% as a baseline to determine if the gas supply margin should be greater or lower than the allowed electricity supply margin.

6.11 The review concluded that a retail margin of no greater than 1.5% was appropriate for gas retail companies.

6.12 We propose to carry out a complete review of margin for this price control 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.

6.13 It is important to note that the outcome of this review may lead to a different margin than that granted to Power NI, and may lead to a different margin for the separate gas supply companies.

Q13. What are respondents' views on the proposed approach to establishing a margin for the gas supply companies?

7. CONSULTATION QUESTIONS

7.1. The UR is keen to hear the views of interested stakeholders and invite representations on the following questions:

Q1. Do respondents agree that where this consultation has an impact on the groups listed, those impacts are likely to be positive in relation to equality of opportunity for energy consumers?
Q2. Do respondents consider that the approach needs to be refined in any way to meet the equality provisions? If so, why and how? Please provide supporting information and evidence.
Q3. Do respondents consider that the existing structure and form remains appropriate for the next Power NI price control? If not, please explain what you believe the structure and form should be.
Q4. Do respondents consider that the proposed review of the gas supply licences are appropriate? If not, please explain your reasons.
Q5. Do respondents agree that with the UR proposal to review price regulation in the 0-50MWh sector of the market? Please provide suitable evidence, including legal opinion if applicable, as to why price regulation should or should not remain in this sector.
Q6. Do respondents agree with the UR proposal to review price regulation in the 73,200kWh to 732,000kWh (EUC 2) sector of the market? Please provide suitable evidence, including legal opinion if applicable, as to why price regulation should or should not remain in this sector.
Q7. Do respondents agree that it is reasonable to retain the scope of the price control for firmus at the under 732,000kWh sector of the market?

Q8. Do respondents feel that a duration of three years for the next price controls for electricity and gas is appropriate?
Q9. Do respondents think that apotential roll-over of the current Power NI price control is appropriate to help address the uncertainty in relation to the development of the new I-SEM?
Q10. Do respondents consider the approach outlined for assessing the Power NI opex is appropriate at this price review? If not, please explain what approach you consider the UR should take to assessing opex and the reasons why.
Q11. Do respondents consider the approach outlined for assessing the treatment of costs for the gas supply companies appropriate? If not please explain what approach you do consider to be appropriate and the reasons why.
Q12. What are respondents' views on the proposed approach to establishing a margin for Power NI?
Q13. What are respondents' views on the proposed approach to establishing a margin for the gas supply companies?

TIMEFRAME AND NEXT STEPS

8.1 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 all three regulated suppliers. It should be noted that if the option for a roll-over is taken for the Power NI Price Control this timetable will not be applicable in its entirety. However, we would envisage at this point that all the stages in the timetable up until April 2016 will be the same for the three regulated companies until the a position is taken on whether the Power NI control will be rolled over.

Table 1: Price Control Review timetable

Date	Milestone
October 2015	UR engages with price controlled suppliers
End-October 2015	Utility Regulator consultation paper on price control Approach to be published
November 2015	Utility Regulator to send business efficiency questionnaire (BEQ) to Power NI/Airtricity/firmus
December 2015	End of Approach Consultation
January 2016	Deadline for responses to business efficiency questionnaire
February-April 2016	BEQ Analysis and iteration with the price controlled suppliers & consultation proposals developed.
May 2016	Utility Regulator to publish price control proposals consultation paper
August 2016	End of consultation period
November 2016	Utility Regulator to publish final decision
January 2017	Utility Regulator to consult on licence modifications to implement price control decisions – 28 days
April 2017	Licence Modifications become effective

8.2 In addition to Power NI, SSE Airtricity, and firmus the UR hopes that a wide range of interested parties will actively participate in the review process, including customers/customer representatives and rival retailers.

8.3 Feedback to this consultation from interested stakeholders will help to shape the UR's consultation paper containing proposals which is planned for May 2016 and to last a period of 12 weeks. That consultation paper will include details of respondents' feedback to this consultation and include the UR's proposals with regards to the regulated suppliers operating costs, profit margin, scope of control and duration.