



Price Control for SSE Airtricity Gas Supply (NI) Ltd 2020-2022

30 August 2019

1 Introduction

- 1.1 The Consumer Council is a non-departmental public body (NDPB) established through the General Consumer Council (Northern Ireland) Order 1984. Our principal statutory duty is to promote and safeguard the interests of consumers in Northern Ireland.
- 1.2 The Consumer Council has specific statutory duties in relation to energy, postal services, transport, and water and sewerage. These include considering consumer complaints and enquiries, carrying out research and educating and informing consumers.
- 1.3 UR must ensure that the consumer voice informs and helps deliver an efficient, economic and co-ordinated gas industry in Northern Ireland with adequate levels of consumer protection. The Consumer Council believes that the Consumer Principles framework can be an effective tool to help inform the development of this and future price controls.
- 1.4 In order to inform our response to this consultation, The Consumer Council procured the services of SLG Economics (SLG) to provide technical expert advice. We ask UR to consider the content of SLG’s note as an integral part of The Consumer Council response to this consultation. The note is included as Annex 1 in this response.



2 Executive Summary

- 2.1 The Consumer Council supports the promotion and ongoing development of natural gas in Northern Ireland. Natural gas offers consumers a choice of fuel that provides consumer protection through its regulatory framework, is cleaner than other fossil fuels and provides payment methods that help consumers manage their spending on energy.
- 2.2 The SSE Airtricity Gas Supply NI Ltd (SSE Airtricity Gas Supply) SPC20 Price Control is an opportunity for the Utility Regulator (UR) to continue to provide price protection to gas consumers in Greater Belfast and North-East Down while facilitating the further development of competition in this retail market. The interests of consumers must be at the heart of the Final Determination.
- 2.3 We acknowledge the work carried out by UR and SSE Airtricity Gas Supply in delivering this price control draft determination. The main points in our response are:
- Continued work is required to develop competition within the domestic Greater Belfast and North-East Down market;
 - We would like UR to identify best practice organisations, if necessary outside Northern Ireland, in order to benchmark SSE Airtricity Gas Supply's performance and help identify efficiencies; and
 - Costs should be properly identified and allocated to SSE Airtricity Gas Supply's regulated and unregulated gas and electricity businesses.
 - We believe that where costs are adjusted retrospectively, any up front allowance should reflect, as closely as possible, what the actual spend will be.
 - IT costs (excluding Capex) must be subject to proper scrutiny.
 - UR should analyse the impact that SSE Airtricity Gas Supply's hedging and wholesale gas purchasing strategy has on the regulated tariff and consider introducing measures that help deliver a more efficient regulated price.
 - As the hedging risk to wholesale gas purchases falls entirely to consumers, we would question if 2% margin is too high a reward for the risk involved.

3 Consumer Context

3.1 Research from Asda highlights that the discretionary income of Northern Ireland households is £100 per week lower than in the rest of the UK¹ and that the median gross weekly earnings in Northern Ireland are lower than in GB, £521 and £569 respectively².

3.2 The Consumer Council's own research in 2019 shows that:

- Half of Northern Ireland adults have £300 or less to spend after essential outgoing each month, with this figure significantly higher for C2DEs (59%), those not working (62%), those with an income of <£20,000 (68%), renters (69%) and those with a disability (62%)³.
- Around 33% of natural gas consumers using a prepayment meter struggle at times to pay for their gas and around 20% of could heat their homes in the last 12 months because they couldn't afford to top up⁴.

3.3 Therefore, with incomes stretched, especially for the most vulnerable, it is important that this price control provides consumers in Northern Ireland with a fair and efficient price settlement.

4 Scope and Duration

4.1 SSE Airtricity Gas Supply remains the dominant supplier in the End User Category 1 retail market segment in Greater Belfast, therefore we agree that the price control must remain domestic and Industrial and Commercial (I&C) consumers using up to 73,200kWh of natural gas per annum.

5 The Regulated Tariff and Network Costs

5.1 The cost of energy is a primary concern for Northern Ireland consumers⁵. We strongly support proposals for bi-annual tariff reviews and a trigger mechanism to monitor the tariff closely and maintain the k factor at a minimal level. However, we believe that where costs are adjusted

¹ Source: Asda Income Tracker July 2019.

² Source: NISRA ASHE report- published 25 October 2018.

³ Source: The Consumer Council Consumer Insight Survey 2019, 15 May 2019.

⁴ Source: The Consumer Council Research on the Consumer Experiences of Electricity & Gas Prepayment Meters, July 2019.

⁵ Source: The Consumer Council Consumer Insight Survey, February 2019.

retrospectively, any up front allowance should reflect, as closely as possible, what the actual spend will be so that the K factor does not have a distorting effect on SSE Airtricity Gas Supply's tariffs.

- 5.2 With regards to network costs, we recognise that these are outside the control of SSE Airtricity Gas Supply. Therefore we support UR's proposal to set them as a pass through element of the regulated tariff. However, we also recognise UR's role in monitoring of efficient costs of both gas distribution and transmission companies in Northern Ireland.

6 Supply Operating Costs

- 6.1 In this section of our response we comment on the key elements from a consumer perspective of SSE Airtricity Gas Supply's operating costs. Where we do not comment on proposals about specific cost items, we implicitly show our support for UR's proposals, provided up-front allowances reflect as closely as possible what SSE should efficiently spend.

- 6.2 The consultation sets out the apportionment cost drivers between SSE Airtricity Gas Supply's regulated and unregulated businesses, but does not provide any explanation for the choice or level of those cost drivers. This is important to ensure that customers of the regulated business are not cross-subsidising the unregulated business. The same explanation should be provided when apportioning cost drivers between the SSE Airtricity Gas Supply SSE Airtricity electricity supply businesses.

Manpower Costs

Salaries

- 6.3 The Consumer Council notes that UR's proposal to allow an increase of six Full Time Equivalent (FTE), down from the 14.5 FTE that SSE requested (three to provide long term sickness and maternity cover).

- 6.4 UR explains the increased allowance on forecasted customer growth and business needs to meet regulatory requirements. However, UR has not provided any customer growth figures or forecasts nor factored in the possibility of a new entrant to the domestic gas retail market during the SPC20 period. Therefore, The Consumer Council cannot assess whether the proposed increased salaries allowance is justified. With regards to the additional staff needed to meet regulatory requirement, we ask UR to outline

what improvements in service delivery can consumers in Northern Ireland can expect as a result of SSE Airtricity Gas Supply's improved regulatory compliance.

- 6.5 Our main concern is that that there is no evidence of any benchmarking of SSE Gas Supply NI's FTE current and proposed levels per number of customers against SSE's unregulated business or suppliers in GB. We note also that UR has not set any efficiency targets and that UR seems to accept a higher overall FTE per 1,000 customers compared to Firmus Energy and Power NI as per point 6.18 of the consultation. We would request evidence that this is an efficient allocation.
- 6.6 We recommend that UR benchmarks SSE Airtricity Gas Supply's manpower costs with a reasonable pool of comparable efficient suppliers in GB and ROI to identify whether there are opportunities to achieve further efficiencies in manpower costs.
- 6.7 We note that salaries for the FTE's are not broken down by different grades or salary bands. We would expect that salaries, given its significance, should be allocated based on Full Time Equivalents (FTE) at different grades or within different salary bands to ensure that if the unregulated business has a higher proportion of staff on higher salaries, that they pay their fair share, rather than an average rate per employee. The same principle should apply to staff working on SSE Airtricity Gas Supply's non regulated supply businesses.
- 6.8 Another factor that UR ought to consider is the fact that 60% of SSE Airtricity Gas Supply regulated customers are on pay as you go tariffs⁶. The ratio is unlikely to change during the SPC20 period. These customers do not receive bills nor require account management. In addition there is no bad debt costs or management. We ask UR to clarify whether it has considered this when proposing the increase of FETs and if so to explain the methodology used to ensure consumers are receiving the most economically efficient price control.
- 6.9 UR's does not seem to have considered when setting the salaries allowance the efficiencies that SSE Airtricity Gas Supply has gained from the IT expenditure in SPC17 and the IT CAPEX that UR and SSE are considering for SPC20. For example, we note Point 7.3.35 of UR's SPC17 Final Determination set out a reduction of manpower by 0.5 FTE in 2018, and 1 in 2019 in

⁶ The Consumer Council calculations using UR's Quarterly Transparency Report Q1 2019.

recognition of the efficiencies that SSE Airtricity Gas Supply IT projects would deliver. We ask UR to carry out a similar efficiency analysis for SPC20.

- 6.10 It is not clear from the consultation paper whether UR has adjusted the non-salaries elements of SSE Airtricity Gas Supply's Manpower costs to reflect UR's proposed decision to increase of six FTE, down from the 14.5 FTE that SSE requested. It would be useful if UR could clarify this in the decision paper.
- 6.11 These are areas that The Consumer Council believes deserve further analysis by UR to ensure SSE Airtricity Gas Supply delivers good value for money to consumers and satisfactory levels of customer service.

Operations Costs

IT OPEX and CAPEX

- 6.12 The Consumer Council overall supports the investment in a high functioning IT system if the evidence demonstrates that it will deliver more accurate bills and a better consumer experience. However, we are of the opinion that before agreeing any additional cost, any benefits to consumers must be evidenced and quantifiable.
- 6.13 We agree that if the current IT provider would no longer be efficient, or in the long term interests of customers, the previously allocated costs should be deducted and the efficient cost of the new billing system included. We look forward to seeing UR's proposals in respect of SSE Airtricity Gas Supply's IT CAPEX for SPC20.
- 6.14 As previously mentioned, we have engaged SLG Economics to review this consultation. They are of the opinion that UR does not appear to have properly scrutinised SSE Airtricity Gas Supply's submission for IT (excluding Capex) or the costs allocated via the service level agreement⁷. Therefore, we are particularly concerned with UR's proposal to approve an increase of SSE Airtricity Gas Supply's IT allowance for SPC20 (excluding CAPEX). UR's paper explains that this would cover costs that "were not yet identified following transition to group IT from PNG" that "supported many IT services under a Service Level Agreement until SSE Airtricity Gas Supply relocated to their own office and IT infrastructure." We have listed below the main reasons for our concern:

⁷ See Annex 1 of this response for more information.

- SSE Airtricity purchased Phoenix Supply Ltd (PSL) in 2012 and moved to its current office at Millennium House in September 2014. SSE Airtricity Gas Supply could have identified these costs at an earlier price control.
- UR increased SSE Airtricity Gas Supply's IT allowances significantly in SPC17 to fund "specific projects and ongoing operational costs" that were deemed necessary for new and upgraded IT systems.
- Despite setting efficiency targets, SSE Airtricity Gas Supply's actual IT costs for the SPC17 period are projected at £2,091k compared to the allowance of £1,779k in UR's SPC17 Final Determination.
- UR has not provided any information about the methodology used to apportion the SSE Airtricity's group IT costs between its regulated and unregulated electricity and gas supply businesses.
- We have not seen any evidence in the SPC20 Consultation Paper that shows or quantifies how SSE Airtricity Gas Supply's IT system will make its operations and billing processes more efficient and cost effective, particularly in areas such as billing and manpower costs.

6.15 The Consumer Council asks UR to address each of our concerns to consider whether UR's proposed IT allowances are appropriate.

6.16 We support UR's proposal to apportion IT OPEX and CAPEX between SSE Airtricity Gas Supply's regulated and unregulated businesses by customer bills as this seems a fairer and more cost reflective methodology given that 60% of the SSE Airtricity Gas Supply customers on the regulated tariffs are on prepayment meters⁸. On this point, we are interested to find out how SSE Airtricity Gas Supply intends to pass through the IT OPEX and CAPEX allowance to its regulated customers given that it is the bill customers who will benefit from this expenditure.

Customer Engagement

6.17 The Consumer Council agrees with UR's assessment of the importance of supplier's customer engagement and information. However, we are of the opinion that SSE Airtricity Gas Supply can undertake any such engagement at a low marginal cost if it maximises the use of existing scheduled communications and maximises the use of low cost online and digital technologies and tools. The Consumer Council believes that there is scope to further reduce SSE Airtricity Gas Supply's allowance to the level of the actual and Latest Best Estimate for SPC17.

⁸ Idem

- 6.18 We recognise the model of consumer engagement within Ofgem's and Ofwat's price control process and would request that similar processes are put in place to ensure SSE Airtricity Gas Supply is reflecting correctly consumer needs in a cost effective manner.

Office Costs

- 6.19 With regards to Office Costs, SSE Airtricity Gas Supply operates its regulated supply businesses from the same premises as its unregulated gas and electricity supply businesses and many costs may be common or jointly incurred. SSE Airtricity Gas Supply will have an incentive to favour allocation to its regulated business. Therefore it is particularly important that costs are properly identified and allocated to the relevant business. We would request further transparency in relation to this.
- 6.20 We are interested also to see whether SSE Airtricity Gas Supply moves towards a more sustainable office environment during SPC20 and whether this has any downward pressure on office costs rather than accepting the yearly increase that UR is proposing to accept.

Rates

- 6.21 The Consumer Council believes that the rates element of the SPC20 should be pass-through of the Lands and Property Services (LPS) bill. However, we would expect SSE Airtricity Gas Supply to seek advice to minimise its rates bill or mitigate any planned increases efficiently.

Professional and Legal Fees

- 6.22 We believe UR's approach and rationale to Professional and Legal Fees to be fair in principle. However, given that the 2019 figures represent SSE's forecast, The Consumer Council believes that it would be prudent to use SSE Airtricity Gas Supply's fees for 2017 and 2018. This should give a more accurate reflection of the fees that SSE Airtricity Gas Supply is likely to pay during SPC20.
- 6.23 It is not clear from the consultation paper whether UR has adjusted the proposed Professional and Legal Fees to reflect UR's proposed decision to increase FTEs by six, down from the 14.5 FTE that SSE Airtricity Gas Supply requested. It would be helpful if UR could clarify this in the decision paper.

Insurance

6.24 UR has not clarified whether this insurance covers the regulated and unregulated SSE Airtricity Gas Supply business and if so how the £27k will be apportioned between the two. If the allowance only applies to SSE Airtricity Gas Supply's regulated business, we would be interested to know for comparison purposes whether SSE has procured a similar insurance for its unregulated supply business and if so how much this amounts to.

CAPEX (non-IT)

6.25 We note that in SPC17 UR benchmarked SSE Airtricity Gas Supply's non-IT CAPEX against Power NI's figures. We ask UR to extend this benchmarking exercise to other suppliers in GB and ROI.

Network Maintenance

6.26 We note that UR's GD17 Final Determination in respect of Phoenix Natural Gas (PNG) set out an allowance for Network Maintenance of £10.2 per weighted connection. When setting the GD17 allowance, UR identified clearly the activities that PNG would undertake and the cost involved.

6.27 In the SPC20 consultation paper we note though that there is a separate allowance for Network Maintenance under Operation Costs in addition to the pass through Network Costs.

6.28 We ask UR to identify what activities are included under the SPC20 Network Maintenance allowance and compare those to the same allowance in GD17 to determine whether or how they should be accounted for in SPC20 and to help identify synergies and efficiencies.

Billing Costs

Bad Debt

6.29 The Consumer Council believes that the methodology to set SSE Airtricity Gas Supply's Bad Debt allowance should be based around the following principles:

- Being cost reflective;

- Requiring SSE Airtricity Gas Supply to have processes and systems in place to reduce risk of bad debt;
- Providing an incentive to increase SSE Airtricity Gas Supply's efficiency;
- Reflecting investment in other areas such as IT systems that may have a positive impact on debt management; and
- Being reflective of its prepayment customer base.

6.30 With regards to UR's proposals in respect of Bad Debt for SPC20, we note the gap between the allowance in UR's SPC17 Final Determination and SSE Airtricity Gas Supply's actual Bad Debt costs for 2017 and 2018. SPC17 set out SSE Airtricity Gas Supply's bad debt at 0.9% of total credit revenue in addition to two credit control FTEs period resulting in and annual allowances of £234k for 2017, £237k for 2018 and £242k for 2019. However, SSE Airtricity Gas Supply's actual and Latest Best Estimate figures for 2017, 2018 are £173k and £168k. Based on this evidence, The Consumer Council believes that SSE Airtricity Gas Supply's Bad Debt SPC20 allowance should be no higher than the current target of 0.45%. The Consumer Council is of the opinion also that UR should benchmark the bad debt rate with the level set for energy suppliers in GB and ROI, as well as Firmus Energy in Northern Ireland.

Bank & Interest Charges

6.31 The Consumer Council believes that SSE Airtricity Gas Supply has a degree of control over the Bank and Interest Charges that it incurs. For example, it can promote cheaper payment methods such as direct debit. We note that the company benchmarks unfavourably with other energy suppliers. It is important for consumers that SSE Airtricity Gas Supply reduces its Bank and Interest Charges, therefore we support UR's proposals. We would add though that the target should be to reduce the number of card transactions as much as possible, ideally exceeding the benchmarks.

Customer Information/Bill Printing and Postage

6.32 The Consumer Council believes that communications with consumers can be undertaken at a very low marginal cost by including non-billing customer information such as energy theft or energy efficiency with scheduled mail shots. Furthermore, SSE Airtricity Gas Supply can avail increasingly of low cost digital and online tools that make print runs obsolete.

6.33 The emerging evidence from SPC17 seems to prove this point. For example, in 2017 SSE Airtricity Gas Supply spent £257k on stationary and postage

compared to an allowance of £521k. The LBE for 2018 of £420 is still significantly lower than the £542 SPC17 FD allowance.

- 6.34 Furthermore, The Consumer Council believes that rather than increasing or even staying constant during the control period, there is a strong argument that the average cost per customer should be declining as more customers move to online and digital methods for receiving customer information and billing. We ask UR to consider this point when preparing its SPC20 Final Determination.

Paypoint Costs incl. PAYG Cards

- 6.35 At present SSE Airtricity Gas Supply pay as you go (PAYG) customers can only top up on PayPoint outlets. From the perspective of the PAYG users it would be a positive development to have a greater choice of outlet options to top up. We ask UR and SSE Airtricity Gas Supply to consider assessing the feasibility during the SPC20 period. Also, given that that this allowance is mostly a pass-through of the charges that PayPoint applies, we would encourage SSE Airtricity Gas Supply to negotiate a lower cost if possible.

Meter Reading

- 6.36 The Consumer Council notes UR's proposals for SSE Airtricity Gas Supply's meter reading allowance. It is our understanding that gas suppliers are responsible for taking meter readings from their customers. However, UR's consultation paper states that SSE Airtricity Gas Supply's meter reading rates "are set" without any explanation or evidence about the methodology used or how UR has scrutinised or benchmarked the rates with Firmus Energy's and suppliers outside Northern Ireland. We ask UR to provide a detailed analysis on this issue in the final determination.
- 6.37 We note also that SSE Airtricity Gas Supply's website advises customers that it "will endeavour to ready your meter at least once a year" and it encourages consumers to provide meter readings, offering a number of easy options⁹ including an online form¹⁰. We are interested in finding out how UR monitors the actual number of meter reads that SSE Airtricity Gas Supply carries out each year to ensure the company is only paid for the actual visits carried out. Also, it would be useful to have information on whether SSE Airtricity Gas Supply's initiatives to promote customer meter readings have reduced the

⁹ <https://www.airtricitygasni.com/at-home/help-and-advice/tariffs-and-payment-options/>

¹⁰ <https://airtricitygasni.com/at-home/my-account/submit-a-meter-reading/>

number of visits that SSE Airtricity Gas Supply has had to undertake for its regulated and unregulated businesses. We ask UR to consider any data available to assess whether the SPC20 meter reading allowance can be reduced.

7 Gas Costs

Energy Balancing

- 7.1. The Consumer Council believes that UR should ensure efficient gas purchasing and benchmark both aspects of the energy balancing cost against gas suppliers in GB and consider whether a 10% premium is required to fund the extra cost of gas purchased in the month.

Credit support

- 7.2. UR's consultation paper indicates that it has benchmarked SSE Airtricity Gas Supply's credit costs against other energy suppliers. We ask UR to specify which suppliers it has benchmarked against and to ensure the list includes suppliers outside Northern Ireland.

Hedging and Purchasing Strategy

- 7.3. Northern Ireland gas consumers must receive the best possible regulated natural gas price. This is only possible if all the components of the domestic tariff are the lowest that they can be, including the wholesale gas costs that suppliers incur. However, at present suppliers pass-through their commodity costs to consumers at no risk to themselves and they do not have an incentive to ensure this cost element of the tariff is efficient. The Consumer Council believe there is an unfair balance of risk, as all the risk and cost falls to consumers.
- 7.4. The Consumer Council understands that gas suppliers put in place their own unique hedging and gas purchasing strategies. We have been told that the main objective is to minimise the impact of price volatility in the wholesale gas markets, but no UR analysis is undertaken as to the efficiency of the strategies, therefore the risk lies with the consumer.
- 7.5. The Consumer Council is concerned that suppliers' wholesale gas hedging and purchasing strategies can have a profound impact on the price that consumers pay. Despite this, suppliers' strategies do not seem to be subject

to a level of regulatory scrutiny that reflects its importance for consumers. Furthermore, suppliers are not incentivised to be efficient in their purchasing strategy therefore there needs to be a recognition that this risk is falling entirely on the consumer.

- 7.6. To reduce this risk, we believe that Northern Ireland consumers can benefit if UR analyses this issue in detail and uses expertise and ample evidence to assess what measures can be introduced to deliver even better regulated natural gas prices for consumers at lower risk. The evidence that we have outlined in this section of our response was not available at the time of the Firmus Energy Supply SPC20 consultation. Therefore we ask UR to consider this proposal also for the Firmus Energy Supply SPC20 final determination.

8 Margin

- 8.1 In our response to UR's SPC17 consultation¹¹, The Consumer Council suggested that UR should not increase SSE Airtricity Gas Supply's margin at the time, 1.5%. UR's SPC17 Final Determination set SSE Airtricity Gas Supply NI's margin at 2% and UR is now proposing to set the same level for SPC20.
- 8.2 We agree with UR's assessment that the regulated retail market conditions in Greater Belfast have not changed sufficiently during the first two years of the SPC17 period. However, as the hedging risk to gas purchases falls entirely to consumers, we would still question if 2% is too high a reward for the risk involved.

9 Reconciliation Costs

Inflation

- 9.1 UR proposes using the Retail Price Index (RPI) as their measure of inflation. The RPI has been widely discredited as an appropriate measure of inflation. However, we note that Paul Johnson in his report to the UK Statistics Authority on the use of consumer price indices concluded: "RPI is not a credible measure of consumer price change ... Taxes, benefits and regulated prices should not be linked to RPI ... Government and regulators should work towards ending the use of RPI as soon as practicable"¹². Other regulators such as Ofcom, Ofwat and Ofgem have already moved partially or completely to

¹¹ https://www.uregni.gov.uk/sites/uregni/files/media-files/CCNI%20Final%20Response_0.pdf

¹² <https://www.statisticsauthority.gov.uk/news/uk-consumer-price-statistics-a-review-2/>

using the Consumer Price Index (CPI) or are considering its use in their current regulatory reviews.

- 9.2 Since vulnerable consumers rely on pensions and benefits that are linked to the CPI, there is a significant risk of these consumers being disadvantaged if the CPI and RPI measures diverge (as for example occurred in 2008-09) and the price-adjustments in their incomes do not rise in line with their gas costs. We therefore believe that it is strongly in consumers' interests to move to using CPI rather than RPI for indexing SSE Airtricity Gas Supply's regulated tariffs.

Rate of Interest

- 9.3 The Consumer Council believes that SSE Airtricity Gas Supply should have an incentive to under or over recover as little as possible. We therefore propose that the rate of interest for over recovery is slightly lower than the rate of interest for under recovery so that accurate forecasting of costs and revenues is incentivised.

10 Conclusion

- 10.1 The Consumer Council aims to strike a balance between the growth and development of natural gas whilst ensuring the interests of consumers are protected. In our view many aspects of this price control do achieve this balance.

- 10.2 We have sought to offer views on how we believe consumers can be better protected and receive the best possible natural gas price. Specifically we would welcome work to introduce benchmarking against industry best organisations, consider efficiencies that help minimise SSE Airtricity Gas Supply's costs and review the impact of suppliers' hedging and gas purchasing strategies.

- 10.3 The Consumer Council remains committed to working in partnership with the Regulator and the gas industry to develop natural gas and its accessibility, to promote competition and most importantly, to protect the interests of consumers.

- 10.4 If you would like further information or to discuss any issues in this paper, please contact Paulino García on 028 9025 1645 or Paulino.Garcia@consumercouncil.org.uk.

Annex 1. SLG Comments on UR's Consultation on the SSE Airtricity Gas Supply NI SPC20 Price Control.

The SSE Airtricity Gas Supply SPC20 Price Control Comments on the Utility Regulator's Consultation

Introduction

The Consumer Council Northern Ireland (CCNI) have asked SLG Economics to provide a short note considering the consumer impacts and benefits of the Utility Regulator's (UR) proposals in their July 2019 consultation on the SPC20 price control for SSE Airtricity Gas Supply¹³. This note considers the following issues:

- Network Costs,
- Supply Operating Costs,
- Gas Costs, and
- Reconciliation.

SLG Economics

SLG Economics is an economics consultancy set up in 2011 by Stephen Gibson providing specialist micro-economic policy advice to regulated companies, regulators, consumer bodies and government. Mr Gibson has over 25 years' experience as a professional applied economist, working on regulation and competition cases from both sides of the regulatory fence.

Mr Gibson has been Interim Chief Economist at Ofwat, Chief Economist at Postcomm, Principal Economist at Ofcom and Head of Economics at Network Rail as well as a number of other senior economics positions.

Mr Gibson is a member of the Government's Regulatory Policy Committee (RPC), which is the independent body responsible for scrutinising and assessing the quality of all government departments' and regulators' Impact Assessments. Mr Gibson is also on the CAA's H7 Advisory Panel, advising on the new regulatory framework for Heathrow and the third runway expansion.

Mr Gibson has been a lecturer at City University, London on their MSc in Competition and Regulation and is a lecturer at Birkbeck University on their postgraduate Industrial Economics courses.

Network Costs

¹³ <https://www.uregni.gov.uk/sites/uregni/files/consultations/SSE%20Airtricity%20-%20SPC20%20Consultation%20v1.1.pdf>

We note that network costs are outside the control of SSE Airtricity and subject to their own price control, therefore we agree that these costs should remain as a pass through to consumers.

Supply Operating Costs

The consultation sets out the apportionment cost drivers between Airtricity's regulated and unregulated businesses, but does not provide any explanation for the choice or level of those cost drivers. This is important to ensure that customers of the regulated business are not cross-subsidising the unregulated business. We do not believe that the UR's consultation provides sufficient evidence for stakeholders to properly respond on the appropriate allocation metrics, but we make the following observations:

- We would expect that manpower (given that it is so significant) should be allocated based on FTEs at different grades or within different salary bands to ensure that if the unregulated business has a higher proportion of staff on higher salaries, that they pay their fair share, rather than an average rate per employee;
- Similarly if the unregulated business is responsible for more training or travel and subsistence, it should pay a higher contribution to reflect this;
- It is unclear why bank and interest charges are allocated based on Load in therms – we see no reason why a higher load should be directly related to the level of bank or interest charges; and
- Professional and legal fees may be better allocated by customer bills than customer numbers – so that they are allocated in proportion to the amount spent by different customers which is likely to be a better driver of professional and legal costs.

Given that SSE Airtricity operates from the same premises as its unregulated domestic and industrial and commercial electricity and natural gas I&C supply businesses and many costs may be common or jointly incurred, it is particularly important that costs are properly identified and allocated to the relevant business. SSE will have an incentive to favour allocation to its regulated business and it is important that UR properly oversee the cost allocation.

Manpower costs – salaries

It is in customers' interests that UR have recognised that SSE Airtricity have claimed for an excessive number of additional staff when benchmarked against other regulated supply companies. However this assumes that the benchmarked companies that are used as comparators are themselves efficient – if this is not the case then there may be the opportunity for still further efficiencies in manpower costs, we would therefore recommend that UR extends its benchmarking studies to compare costs with gas supply in England & Wales and Scotland as well as in Ireland.

Other Manpower Costs

We believe that these costs should be reduced in line with the reduction in manpower numbers discussed above.

Operational Costs

IT (excluding Capex)

We agree that if the current provider would no longer be efficient or in the long term interests of customers then the previously allocated costs should be deducted and the efficient cost of the new billing system included. However we are concerned that the UR does not appear to have properly scrutinised SSE Airtricity's submission for IT (excluding Capex) or the costs allocated via the service level agreement. We recommend that given the size of IT costs (excluding capex) they are subject to proper scrutiny.

Customer Engagement

We believe that customer engagement is important, but can be undertaken at a very low marginal cost to the company by including communications about energy theft, back-billing, energy efficiency and vulnerability with existing communications rather than requiring extra postings. Communications can also increasingly be undertaken more economically by online and digital means (see discussion of customer information provision below) rather than necessarily requiring the costs of a separate print run. Therefore the £61,000-£65,000 annual allowance seems high.

Billing Costs

Bad debt

We agree that the allowance for bad debt should be no higher than the current target of 0.45%, however as well as benchmarking this with the level set for Firmus, we believe that the UR should also compare the medium-term target with the level set for energy companies in England & Wales, which could lead to a lower figure by the end of the control period.

Bank & Interest charges

We believe that SSE Airtricity should not be remunerated for more expensive payment methods that they have directly promoted over cheaper payment methods. However the target should not just be to achieve the same percentage of card transactions as the benchmarks, but to reduce this as far as possible – which is likely to exceed those benchmarks. In addition moving to payment by direct debit provides an additional advantage in reducing the amount and cost of bad debt that SSE Airtricity should remunerated for.

Customer Information, Bill Printing and Postage

We believe that rather than increasing or even staying constant during the control period, there is a strong argument that the average cost per customer should be declining as more customers move to online and digital methods for receiving customer information and billing – particularly since SSE Airtricity is actively incentivising e-billing in their domestic electricity tariff¹⁴, we would expect an efficient company to follow a similar approach in its approach to gas pricing.

Gas Costs

Energy Balancing

We believe that UR should consider further whether:

- a full 10% premium is required to fund the extra cost of gas purchased in the month, and
- whether full pass through of the premium is required up to 40% of the gas requirement, or whether by more effective demand forecasting SSE Airtricity should be able to forecast actual demand with greater accuracy and therefore have an active incentive to purchase a greater proportion of their gas in advance.

We believe that both of these aspects of the energy balancing cost should be benchmarked against gas companies in England, Wales and Scotland.

Reconciliation Costs

Inflation

The UR propose using the Retail Price Index (RPI) as their measure of inflation. The RPI has been widely discredited as an appropriate measure of inflation. Paul Johnson in his report to the UK Statistics Authority on the use of consumer price indices concluded: *“RPI is not a credible measure of consumer price change ... Taxes, benefits and regulated prices should not be linked to RPI ... Government and regulators should work towards ending the use of RPI as soon as practicable”*¹⁵. Other regulators such as Ofcom, Ofwat and Ofgem have already moved partially or completely to using the Consumer Price Index (CPI) or are considering its use in their current regulatory reviews.

Since vulnerable consumers rely on pensions and benefits that are linked to the CPI, there is a significant risk of these consumers being disadvantaged if the CPI and RPI measures diverge (as for example occurred in 2008-09) and the price-adjustments in their incomes do not rise in line with their gas costs. We therefore believe that it is strongly in consumers’ interests to move to using CPI rather than RPI for indexing SSE Airtricity’s tariff.

¹⁴ <https://www.sseairtricity.com/assets/Terms/ElecNI/Oct-18/CR-RET-15-24HR-TARIFF.PDF>

¹⁵ <https://www.statisticsauthority.gov.uk/news/uk-consumer-price-statistics-a-review-2/>

Rate of interest

We believe that SSE Airtricity should have an incentive to under or over recover as little as possible. We therefore propose that the rate of interest for over recovery is slightly lower than the rate of interest for under recovery so that accurate forecasting of costs and revenues is incentivised.

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