

## By email

Dear Shane

### 1 Introduction

- 1.1 On 3 September 2024, the Electricity Price Control Commissioner (**Commissioner**) consultation on the proposed variation of the electricity price control order (**Consultation**)<sup>1</sup> in response to Sark Electricity Limited's formal request for such a variation sent on 26 June 2024.
- 1.2 The Consultation requested responses from interested parties by 5pm on Tuesday 24 September 2024. This letter constitutes the response of Sark Electricity Limited (**SEL**) in relation to the Consultation.

### 2 Overarching considerations and observations

- 2.1 The Consultation comes at a time of significant uncertainty over the future of Sark's electricity system.
- 2.2 Chief Pleas has announced its intention to tender for a completely new electricity system in Sark, to be developed and operated in parallel to the existing one currently managed by SEL.<sup>2</sup> Even operating on the assumption that such a grid will be built and deployed in an efficient and timely fashion, the Commissioner faces the not insignificant challenge of balancing the need to ensure the safety, resiliency and affordability of the existing grid with the ramp-up of the potential new electricity grid in Sark.
- 2.3 According to the Control of Electricity Prices (Sark) Law (**2016 Law**), in setting a fair and reasonable price for a price control order (**PCO**), the Commissioner shall take into account (among other things)<sup>3</sup>:
  - (a) the cost of generating and distributing the supply of electricity;
  - (b) the replacement cost of plant and equipment;
  - (c) the quality and reliability of electricity supply;
  - (d) a reasonable return to be received by the supplier.

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<sup>1</sup> Office of the Sark Electricity Price Control Commissioner (2024), 'Consultation on proposed variation to the electricity price control order', 3 September, <https://www.epc.sark.gg/consultation-on-variation-request-for-the-2023-25-price-control-order.html> (accessed on 13 September 2024).

<sup>2</sup> BBC (2022), 'Sark government says new electricity system needed', 30 June, <https://www.bbc.com/news/world-europe-guernsey-61982217> (accessed on 5 August 2024).

<sup>3</sup> The Control of Electricity Prices (Sark) Law, 2016, s16(1) and 13(2).

- 2.4 These legal requirements for setting the PCO are consistent with SEL's own stated objective to ensure a safe, reliable and affordable electricity supply for its customers.<sup>4</sup>
- 2.5 The Commissioner's proposals included in the Consultation attempt to keep electricity prices as low as possible by minimising any additional expenditure. According to the Commissioner, this would be consistent with the upcoming roll-out of the new Chief Pleas' grid and the likely resulting discontinuation of SEL's electricity grid.
- 2.6 However, we note that significant uncertainty remains over whether the new electricity grid can and will be successfully financed and built and, if so, when it will become operational. This dual layer of uncertainty poses significant challenges for SEL in terms of operating the existing grid and for the Commissioner in terms of setting the next PCO.
- 2.7 The first key issue is represented by the timings of the new grid development. Taking into account the significant uncertainty over when (and if) the new grid will enter into operation, SEL needs to ensure a safe and reliable network for all its customers over the next two years but also potentially beyond that period.
- 2.8 The second key issue has to do with affordability concerns for SEL's customers, since they would have to simultaneously pay for:
- (a) the management of the existing grid;
  - (b) the costs arising from the regulatory need to mitigate the risk for ramping down the existing grid;<sup>5</sup>
  - (c) the decommissioning costs of the existing grid; and
  - (d) (we assume, in the absence of some public spirited benefactor) the costs associated with the roll-out of the new grid.
- 2.9 These key risks should be taken into account by the Commissioner and balanced carefully to ensure that a service that is both resilient and affordable is provided.
- 2.10 In light of the uncertainty characterising the Sark electricity system, SEL must be equipped from a regulatory perspective to face the different states of the world that could arise. In other words, the Commissioner needs to retain optionality in the design of the new regulatory pricing framework, and we expect the decisions made in the Consultation to acknowledge the potential path dependency that may arise. For example, if a decision to fully wind down the existing grid is made and no additional capital expenditure to ensure health and safety is allowed, it may become impossible to supply safe and reliable electricity over time. Therefore, considering the costs and risks associated with the development of the parallel grid, it is crucial to continue the necessary network CAPEX programme to ensure that the existing grid remains safe and reliable for all customers.

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<sup>4</sup> SEL (2024), 'About Sark Electricity', <https://www.sarkutility.com/> (accessed on 17 September 2024).

<sup>5</sup> As an example, in light of the Chief Pleas' announcement, the Commissioner proposed an accelerated depreciation profile for SEL's investments. Accordingly, the prospective build of competing grid infrastructure and the corresponding (risk of) asset stranding is already implying upward pressure on costs for consumers.

2.11 Similarly, we note that, despite the uncertainty over the development of the future parallel grid and the discontinuation of the existing grid, decommissioning can be pre-funded only while the current grid is still operational. If the need for decommissioning arises once the existing grid is switched off, SEL would face sudden and unfunded costs and associated losses due to the need to dispose of its network assets. However, if decommissioning is prefunded and the need for decommissioning does not materialise, SEL could commit to give back the funds to consumers. On balance, a clear plan and funding for decommissioning would help to retain optionality over the future of the electricity grid on Sark, whether or not the current grid faces substitution by a potential new grid.

2.12 Arguments around the concept of natural monopoly

2.13 Before addressing the Commissioner's proposals included in the Consultation, we would like to highlight the inconsistencies in Chief Pleas' plan to develop a parallel grid. As previously highlighted, Chief Pleas' announcement to build a new grid on Sark is the main driver of the uncertain circumstances in which SEL is currently required to operate.

2.14 From a regulatory standpoint, we note that, in the presence of a natural monopoly, duplicating the network is less economically efficient than operating a single one. We observe that a 'natural monopoly arises when average costs are declining over the range of production that satisfies market demand'<sup>6</sup>, and that this 'typically happens when fixed costs are large relative to variable costs'<sup>7</sup>. Public utilities such as energy networks are textbook examples of a natural monopoly.

2.15 In other words, in the presence of high (sunk) fixed costs, average costs will fall as the number of properties connected to an electricity grid increases. Therefore, in a natural monopoly, one firm is able to supply the total quantity demanded in the market at a lower cost than two or more firms would be able to. Conversely, splitting up the natural monopoly would raise the average cost of production and force customers to pay more.

2.16 This is effectively summarised in the following example:

It would make little sense to argue that a local water company should be broken up into several competing companies, each with its own separate set of pipes and water supplies. Installing four or five identical sets of pipes under a city, one for each water company, so that each household could choose its own water provider, would be terribly costly. The same argument applies to the idea of having many competing companies for delivering electricity to homes, each with its own set of wires.

Source: Dean, E., Elardo, J., Green, M., Wilson, B. and Berger, S. (2016), 'Principles of Microeconomics: Scarcity and Social Provisioning', Open Oregon Educational Resources, '17.3 Regulating Natural Monopolies', <https://openoregon.pressbooks.pub/socialprovisioning/chapter/17-3-regulating-natural-monopolies/> (accessed on 5 August 2024).

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<sup>6</sup> Dean, E., Elardo, J., Green, M., Wilson, B. and Berger, S. (2016), 'Principles of Microeconomics: Scarcity and Social Provisioning', Open Oregon Educational Resources, '17.3 Regulating Natural Monopolies', <https://openoregon.pressbooks.pub/socialprovisioning/chapter/17-3-regulating-natural-monopolies/> (accessed on 5 August 2024).

<sup>7</sup> Ibid.

- 2.17 Regarding this point, we note that the previous Commissioner affirmed that Sark's electricity market can be characterised as a "de-facto" monopoly supplier of an essential service, i.e. the provision of electricity'.<sup>8</sup> Therefore, in the specific case of Sark, it would be economically inefficient to have two parallel electricity grids competing with each other. Indeed, it would be more efficient to enhance the existing network in order to address the 'serious health and safety concerns'<sup>9</sup> mentioned by the government.
- 2.18 Indeed, if SEL were permitted to spend the capex funds requested (and dealt with further in paragraph 5 below), there is a considerable argument that may need for the New Grid other than a political one falls away (and indeed with such New Grid falling away so would any decommissioning costs).
- 2.19 Whilst we acknowledge the decision to pursue such an inefficient course is, or should be, ultimately outside the Commissioner's control, it is in this context, in which a new grid may or may not be built (and on an uncertain timeframe), that the legal requirements for setting the PCO need to be applied. Such application should be consistent with SEL ensuring a safe, reliable and affordable electricity supply for its customers irrespective of whether it will remain in operation or be decommissioned.
- 2.20 Indeed, if the Commissioner accepts that it is SEL's duty to ensure the safety and reliability of the power that it supplies, it follows that the Commissioner would allow SEL to fund the necessary network upgrades to ensure safety in the upcoming period. Additionally, if the Commissioner accepts that investment incentives need to be maintained in order for capital to be attracted and retained for network upgrades—or, indeed, for the development of a new grid—then the Commissioner would need to ensure that there is no asset stranding of the current asset base. This would require that the regulatory regime allows for the orderly unwinding and decommissioning of the assets, including not only the use of accelerated depreciation policies but also the introduction of decommissioning funds.<sup>10</sup>
- 2.21 Any variation of the PCO or new PCO, accordingly, needs to simultaneously accommodate either of the eventualities (continued operations or decommissioning) by allowing for both decommissioning funds to be accumulated in order to unwind the existing asset base, while also allowing for the necessary network upgrades in order to continue safe operations of the grid to the benefit of Sark consumers.

### **3 Specific considerations and responses on the Consultation on the variation of the electricity price control**

In the following sections, we address each aspect of the Consultation specifically. For each section, we first present the Commissioner's position on the matter as we understand it before then providing our view on the same matter. Our broad paragraph numbering is intended to reflect that used in the Consultation.

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<sup>8</sup> Office of the Sark Electricity Price Control Commissioner (2017), 'Consultation on Sark's Electricity Price Control', para. 9.

<sup>9</sup> BBC (2022), 'Sark government says new electricity system needed', 30 June, <https://www.bbc.com/news/world-europe-guernsey-61982217> (accessed on 5 August 2024).

<sup>10</sup> This is a flexible regulatory mechanism in so far as such funds could be returned to customers as future tariff rebates if the existing network is not, in fact, subsequently decommissioned.

## 4 Application of inflation

### 4.1 Commissioner's position

4.2 The Commissioner agreed on retrospectively increasing the allowance for fixed OPEX for 2024–25 by Guernsey inflation in 2023 and granting the recovery of this amount in the remaining months of the PCO. In fact, the Commissioner acknowledges that failing to adjust fixed OPEX on the basis of inflation represented a 'manifest error in the PCO'.<sup>11</sup>

4.3 Moreover, the Commissioner is minded to change the inflation treatment of the RAB financing. We understand that, starting from 1 October 2024, the Commissioner is going to apply the inflation rate to the allowed rate of return rather than to the RAB. According to the Commissioner, incorporating inflation within the rate of return (instead of the RAB) tends to accelerate cash flows compared with applying the inflation adjustment to the RAB amount.

### 4.4 SEL's response—application of inflation to fixed OPEX

4.5 We welcome the Commissioner's decision to apply the inflation adjustment on the OPEX allowance, as this is in line with our PCO variation request. The Commissioner's revised positioning is now also aligned with the original PCO Consultation, according to which the opening RAB as well as the fixed OPEX allowance shall be updated annually on the basis of Guernsey's rate of inflation.<sup>12</sup>

4.6 Considering Guernsey's inflation for 2023 (i.e. 6.3%) and the level of fixed OPEX allowance (i.e. £330,307), the inflation adjustment at the OPEX level would have been equal to c. £20,809. This is broadly in line with SEL's assessment that its 'real world' annual fixed cash costs have increased by £27,000.<sup>13</sup>

4.7 We also welcome the Commissioner acknowledging that it would not be appropriate to expect efficiency gains in fixed OPEX in the second year of the PCO. When asked by SEL why the fixed OPEX allowance had not been adjusted on the basis of Guernsey's rate of inflation in 2023, the Commissioner appeared to justify his decision by stating on an ex post basis that he is applying an (RPI-X) adjustment and, 'in the case of SEL, having X equal to RPI would be consistent with this concept'.<sup>14</sup>

4.8 As highlighted in the PCO variation request, regulators should clarify upfront which efficiency challenges are being applied in their determinations. Such efficiency challenges should focus on aspects that are genuinely within the control of the company and be based on robust evidence regarding what a company is expected to achieve. This is typically derived through: (i) detailed, bottom-up examinations of companies' costs; and/or (ii) comparisons to what similar companies have been able to achieve. The failure to index revenues to general inflation results in an arbitrary and

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<sup>11</sup> Office of the Sark Electricity Price Control Commissioner (2024), 'Consultation on proposed variation to the electricity price control order', 3 September.

<sup>12</sup> Office of the Sark Electricity Price Control Commissioner (2023), 'Consultation On Proposed Price Control Order', 8 February, p. 3, <https://www.epc.sark.gg/consultation-on-proposed-price-control-order.html> (accessed on 5 August 2024).

<sup>13</sup> Ibid.

<sup>14</sup> E-mail from Shane Lynch to Alan Witney-Price and Wayne Atkinson, Re: Inflation effect on Fixed Operating Costs, 3 May 2024.

random efficiency challenge. As an example, if inflation exceeds the rate anticipated by the regulator, the efficiency target facing the company effectively increases, despite there being no new evidence regarding the extent to which a company can deliver efficiency savings. Similarly, if inflation is below what the regulator anticipates, the efficiency challenge is unduly relaxed. Determining the efficiency challenge in such an arbitrary manner would therefore be inconsistent with good practice.

- 4.9 Furthermore, we note that, on a principled basis, the fixed OPEX allowance is not generally increased exclusively on the basis of the general rate of inflation (i.e. RPI in the case of Sark's regulatory framework). Rather, UK regulators typically fine-tune their annual adjustments to reflect Real Price Effects (RPEs). As an example, recently Ofgem has decided to broadly retain its RIIO-2 approach to RPEs for the RIIO-3 price control period. This approach involves making annual adjustments to allowances based on the differences between the CPI (and CPIH) and input price indices. This indexed methodology aims to accurately reflect market conditions and mitigate the risks associated with forecasting errors and volatile input costs.<sup>15</sup> The intent of the RPE regime is to incorporate input price inflation in the allowed revenues, rather than general price inflation.
- 4.10 We note that, in a competitive market, an increase in input price inflation naturally leads to an increase in expenditure and an increase in prices, at least in the medium term. Ideally, the regulator would undertake a detailed assessment of the input price pressure facing the company (i.e. examining the input prices for material inputs such as fuel costs and electricity grid components). Even in regulatory regimes that do not undertake such a detailed assessment of input prices, it would be reasonable to at least index expenditure allowances to increase in line with general inflation.
- 4.11 SEL's response—application of inflation to the allowed rate of return and/or RAB
- 4.12 The Commissioner is minded to apply the inflation rate to the allowed rate of return starting from 1 October 2024 since applying inflation to the rate of return (rather than to the RAB amount) tends to accelerate cash flows recovery.
- 4.13 From the perspective of accelerating cash flows, we welcome the Commissioner's decision to apply the inflation adjustment to the allowed rate of return, instead of inflating the RAB amount while applying a real rate of return. In fact, we agree that, on a principled basis, applying inflation to the real rate of return tends to bring forward the cash flows, provided that the inflation rate is higher than zero. However, we note that it will represent part of the Commissioner's duties to ensure that the change in the inflation approach (from the RAB amount to the allowed rate of return) is going to be Net Present Value neutral for SEL. It is also important that appropriate protections are considered if this change introduces other sources of risk, e.g. inflation forecasting error risk in shifting from ex post indexation of the

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<sup>15</sup> Ofgem (2024), 'RIIO-3 Sector Specific Methodology Decision – Overview Document', 18 July, para. 9.20.

RAB to ex ante inflation allowance in the Weighted Average Cost of Capital (WACC)<sup>16</sup>.

- 4.14 We also consider that the Commissioner needs to consider evidence on revising the underlying (real) WACC rate of return, prior to converting this to a nominal basis by incorporating an inflation allowance. In relation to this, we observe that the real rate of return was set too low, with reference to relevant precedent. This is discussed below.
- 4.15 Specifically, with respect to the real rate of return, we note that the Commission seems to retain a value equal to 5.00%. According to the Commissioner, this value compares with the allowed real rate of return for NIE Networks in Northern Ireland (i.e. 3.18% RPI-real), which he believes to be similar for electricity network companies in other parts of the UK.<sup>17</sup> On these grounds, the Commissioner implicitly considers a risk premium equal to 1.82%, 'in recognition of the additional specific risks which [SEL] faces'.<sup>18</sup>
- 4.16 In this regard, we note that the value indicated by the Commissioner for NIE Networks refers to the sixth regulatory price control ('RP6'), which applies for the period from 1 October 2017. Considering the substantial changes in the macroeconomic environment and capital markets that have occurred since then, it would be more appropriate to use an updated real interest rate.
- 4.17 In particular, as a high-level approximation for an updated Sark-specific rate of return (as the Commissioner has presently done in anchoring the allowance on the preceding NI control), it would be reasonable to look at the following sources.
- (a) If we use the mid-point of the 'early-view' RIIO-3 capital allowances published by Ofgem for transmission operators (i.e. 4.06% CPIH-real),<sup>19</sup> then convert it to the RPI-real basis for comparability with the RP6 precedent by using the RPI-CPIH wedge assumed by Ofgem (0.11%), and then we sum the Sark-specific risk premium implicitly estimated by the Commissioner (i.e. 1.82%), we would obtain an allowed rate of return for Sark equal to 5.77%.<sup>20</sup>
- (b) Alternatively, if we consider the allowed rate of return proposed for NIE Networks RP7 (i.e. 4.79% CPIH-real),<sup>21</sup> converting it to RPI-real basis using the wedge assumed in RP7 Draft Determinations (0.9%)

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<sup>16</sup> WACC is a company's average after-tax cost of capital from all sources, including ordinary shares, preferred shares, bonds, and other forms of debt. It represents the average rate that a company expects to pay to finance its business.

<sup>17</sup> Office of the Sark Electricity Price Control Commissioner (2023), 'Price Control Order for prices charged by Sark Electricity Limited ("SEL") for the period 01st April 2023 – 31 March 2025', 4 April, p. 6, <https://www.epc.sark.gg/price-control-order-01-04-23.html> (accessed on 13 September 2024).

<sup>18</sup> Ibid.

<sup>19</sup> Ofgem (2024), 'RIIO-3 Sector Specific Methodology Decision – Finance Annex', 18 July, Table 1 and Table 13.

<sup>20</sup> The inflation wedge of 0.11% is applied via the Fisher equation, resulting in an RPI-real WACC estimate of 3.95%.

<sup>21</sup> Utility Regulator (2023), 'NIE Networks – Transmission and Distribution 7th Price Control (RP7)', Draft Determination – Main Report, November, Table 13.4, <https://www.uregni.gov.uk/files/uregni/documents/2023-11/RP7%20DD%20Main%20Document.pdf> (accessed on 5 August 2024).

and we add the Sark-specific risk premium (i.e. 1.82%), we would get a real return equal to 5.68%.<sup>22</sup>

- 4.18 We believe that both of these figures would provide a more anchored estimate of Sark's real return compared with the value proposed by the Commissioner, as they better reflect the current macroeconomic environment. We also note that these figures are considerably higher than the 5.00% estimated by the Commissioner in the context of the PCO. We consider that the Commissioner needs to consider such evidence on increasing the underlying (real) WACC rate of return, prior to converting this to a nominal basis, in line with his new proposed change in the inflation methodology.

## **5 New capital expenditure**

### **5.1 Commissioner's position**

- 5.2 In the consultation, the Commissioner has recognised the importance of SEL being able to carry out the necessary investments to operate a safe and reliable electricity grid until the replacement parallel grid is rolled out. Notwithstanding, the Commissioner has decided to reject SEL's request for a £537,426 capital investment programme, which is crucial for maintaining the network service quality. Instead, the Commissioner is minded to allow SEL a project management fee of £31,250 spread over a three-year period, and to accept any investment recommended by an independent technical adviser.

### **5.3 SEL's response**

- 5.4 The Commissioner's decision to not allow the recovery of SEL's CAPEX programme places pressure on SEL's ability to maintain a safe and reliable grid until a replacement grid is operational. In Sark, technical reports by independent engineering consultants, such as Energy People and EIS, had both made negative conclusions about the current grid, leading Chief Pleas to claim SEL's grid to be 'outdated and in a state of repair which does not meet basic British industry standards as used in the UK and Guernsey'.<sup>23</sup>
- 5.5 Whilst SEL challenges a number of the assertions put forwards in those reports, clearly the planned capital investments that SEL has put forward are crucial for ensuring a good service over the next two years, and these would prove to be even more critical in a scenario where the new replacement grid is either delayed or cancelled in the future. Therefore, SEL should be allowed to invest into the grid to improve reliability, health and safety of the network, in line with the British industry standards.
- 5.6 We observe that it is consistent with good regulatory practice to allow for networks to recover expenditure on health and safety.<sup>24</sup> For example, Ofgem allows health and safety costs to be recovered through several avenues—a part of health and safety costs are recovered through the 'Legal and Safety' TOTEX cost category. This relates to expenditure where the primary driver for intervention is to meet safety requirements and protect

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<sup>22</sup> Inflation wedge of 0.9% applied via a Fisher equation, resulting in an RPI-real WACC estimate of 3.86%.

<sup>23</sup> BBC (2022), 'Sark government says new electricity system needed', 30 June, <https://www.bbc.com/news/world-europe-guernsey-61982217> (accessed on 5 August 2024).

<sup>24</sup> Unless there is evidence that expenditure has not been efficiently incurred.

staff and the public.<sup>25</sup> Another source of funding for health and safety costs is through asset replacement allowances. While the primary driver for asset replacement is asset condition, Ofgem also considers safety and environmental factors in its assessment.<sup>26</sup>

- 5.7 In the Northern Ireland electricity regime, the regulator also seeks to allow recovery for all necessary expenditures to ensure that network safety requirements are met.<sup>27</sup> In particular, the regulator highlights that reduction of day-to-day costs of running a network should not be at the expense of safety and reliability of the network.<sup>28</sup>
- 5.8 We note the Consultation repeats the Commissioner's historic assertions that SEL failed to provide its revised proposals as requested. As the Commissioner is well aware, SEL disagrees with this viewpoint, the fact that proposals provided were not to the Commissioner's taste does not mean they were not provided.
- 5.9 In the Consultation the Commissioner asserts that:
- 'In my view, and based on my experience, a prudent and competent operator of an electricity system should be able to review its capital expenditure program and identify critical expenditure to ensure safety and reliability for the remaining years of its life. For example, it would seem to me that replacement or repair of the cable across the Coupe is critical, at an estimated cost of £52,000. However, I am not yet convinced that it is necessary to erect fencing at an estimated cost of 99,000 [sic], for a two-year period.'
- 5.10 SEL would respond to that by citing the position created by the technical reports by independent engineering consultants, Energy People and EIS at Chief Pleas' behest. As noted above, SEL contests a number of the assertions and assumptions made in those reports. Notably those reports apply the standard expected under UK legislation to Sark where no such legislation applies. Nonetheless they put the company into a position where it is seeking to maintain infrastructure that has been labelled unsafe. As such deciding which pieces to make safe seems a fool's errand. Taking the Commissioner at his own example, who will now be held to blame if a safety incident occurs for want of £99,000 of fencing?
- 5.11 The Commissioner "once again" invites SEL "to resubmit its capital expenditure proposals" but it remains unclear to SEL how it can deprioritise any work that an independent report has said is necessary from a safety perspective (regardless of whether it agrees with such a report).
- 5.12 Additionally the consultation questions SEL's ability to complete the proposed work in the stated period whilst at the same time proposing to deny the opportunity to commission such work in the knowledge it will be budgeted. Taken in the round, it appears that the Commissioner's intent in this aspect of the consultation is to once again push out the timing of any expenditure – it is difficult to see how the proposed approach will allow any expenditure in the remaining life of this PCO and, as noted previously, this will result in either:

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<sup>25</sup> Ofgem (2022), 'RIIO-ED2 Final Determinations. Core Methodology', 7 November, para. 7.304.

<sup>26</sup> *Ibid.*, para. 7.235.

<sup>27</sup> Utility Regulator Northern Ireland (2017), 'RP6 Final Determination', 30 June, para. 4.5.

<sup>28</sup> *Ibid.*, para. 5.62

- (a) expenditure independently judged to be necessary not taking place (hopefully without tragic consequences); or
- (b) it taking place later with a resultant outsized impact on the unit price.

## **6 Decommissioning and re-instatement provision**

### **6.1 Commissioner's position**

6.2 The Commissioner is minded to decline SEL's request regarding the provision for decommissioning costs of £980,370 to be recovered over the next two years funded via equal monthly instalments. In this regard, the Commissioner notes that 'SEL has not been asked by any other landowner in Sark to remove its equipment'. The Commissioner also notes that he is 'also not aware of any legislation in Sark which would require SEL to remove its equipment.' The Commissioner also suggests that SEL discuss this issue with Chief Pleas, prior to making any requests to his office to explore other potential options. Instead, the Commissioner proposes to accelerate the recovery of the provision for dilapidations at the power station over the next three years (rather than until 2030).

### **6.3 SEL's response**

6.4 Regarding the Commissioner's statement that 'SEL has not been asked by any other landowner in Sark to remove its equipment', we note that since SEL is still the sole electricity provider in Sark it would not be reasonable to expect that it would already have received requests to remove its equipment.<sup>29</sup> Rather, it would be reasonable to expect that SEL would receive requests from Sark's landowners to remove its network components only once the parallel electricity grid has been rolled-out and the operation of the existing grid has been discontinued as a result. The Commissioner is however well aware that SEL is currently in dispute around the "rent" to be paid to another landowner for the use of the land for SEL equipment (as a result of the Commissioner declining to provide wayleave cost guidance) and may as a result be required to remove their equipment. As regards, the lack of legislation requiring SEL to remove its equipment, this is a misunderstanding of the legal position. Absent any legislation requiring landowners to allow such equipment to remain, there is no right for SEL to leave it in situ and hence there is a right for any landowner to require its removal. By analogy there is no legislation requiring fly-tippers to remove rubbish dumped on someone else's land – this is unnecessary precisely because they have no rights to put it there in the absence of the landowner's ongoing consent. The very fact of Mr Moerman's successfully obliging SEL to remove the equipment from his tenement is evidence thereof. Given that a removal request could arise at any time, leaving equipment in situ would, in effect, represent an ongoing contingent liability of SEL having ceased to supply upon deployment of a new grid.

6.5 We flag to the Commissioner that it is consistent with regulatory good practice to ensure regulatory certainty under any state of the world that is likely—at present, SEL is being asked to prepare for a state of the world in which its asset base is decommissioned in a few years. In fact, the Commissioner's changes in the basis of the inflation allowance, as well as to the depreciation policy that is applied to SEL's asset base, is driven by

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<sup>29</sup> Office of the Sark Electricity Price Control Commissioner (2024), 'Consultation on proposed variation to the electricity price control order', 3 September.

preparedness for the eventuality that SEL's asset base is decommissioned. Accordingly, it is inconsistent for the Commissioner to not also allow for SEL to build up the funds to pay for this decommissioning scenario. In other words, given the uncertainty characterising Sark's electricity system, it is essential for SEL to know in advance what would be the regulatory treatment of the potential decommissioning costs that would arise as a consequence of the potential deployment of the new grid.

- 6.6 We note that the regulatory treatment of decommissioning costs has been extensively considered by regulators across different jurisdictions and different sectors. In particular, we observe the following relevant examples.
- 6.7 First, we note that, in the context of the RIIO-GD1 price control (i.e. 2013–2021), Ofgem acknowledged the existence of decommissioning costs in the gas sector and the need to bring forward the recovery of sunk network costs through an accelerated depreciation profile.<sup>30</sup> This example illustrates that in the face of technological change that could lead to partial or full redundancy of the installed asset base, Ofgem has sought to accelerate the recovery of returns against the existing assets.
- 6.8 Second, in a recent mobile radio network services investigation, the Competition and Markets Authority (CMA) has decided that the network operator will be allowed to recover its decommissioning and redundancy costs as a part of final settlement arrangements under the proposed charge control.<sup>31</sup>
- 6.9 Third, in the context of the regulation of the nuclear plant Sizewell C in the UK, decommissioning costs have been proposed for inclusion as one of the building blocks for the determination of the allowed revenues. Specifically, under the UK government's proposal, a portion of revenue is allocated to a decommissioning fund—with additional protection mechanisms against any decommissioning fund shortfall, including allowing for full funding prior to the end of the useful life of the asset and an option for government funding.<sup>32</sup> Specifically, as detailed in special conditions of the Consultation draft of the electricity generation licence, the formula proposed by the regulator to calculate the allowed revenues, both during the pre-PCR phase<sup>33</sup> and during the operations phase, includes an allowance for the Funded Decommission Programme (FDP).<sup>34</sup> As acknowledged by the UK regulator, the FDP building block is effectively a pass-through to cover the annual contribution amount set under the funding arrangements plan (FAP) entered into by the licensee.
- 6.10 Fourth, we note that the German federal network agency, Bundesnetzagentur (BNetzA) has recently provided its view on the topic, in the context of the development of the regulatory framework for electricity and

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<sup>30</sup> Ofgem (2012), 'RIIO-GD1: Final Proposals – Overview', 17 December, para. 6.9.

<sup>31</sup> CMA (2023), 'Mobile radio network services. Final report', 5 April, para. 8.49.

<sup>32</sup> Department for Energy Security and Net Zero (2024), 'Regulated Asset Base Licence Consultation. Government Response to the Consultation on Modifications to Sizewell C Limited's Electricity Generation Licence', April, pp.8–9.

<sup>33</sup> PCR stands for Post Construction Review.

<sup>34</sup> Department for Energy Security and Net Zero (2023), 'ELECTRICITY GENERATION LICENCE: SPECIAL CONDITIONS FOR NUCLEAR GENERATOR', Consultation draft, 6 November, pp.213–217 and pp.276–281.

gas network operators for the fifth regulatory period.<sup>35</sup> In particular, in the context of the provision for decommissioning and dismantling, the BNetzA acknowledges that: '[w]ithin the framework of decarbonisation efforts, network connections will be decommissioned on a large scale'.<sup>36</sup> As a result, '[d]ecommissioning and, in particular, dismantling [parts of the distribution system infrastructure] will lead to very high costs that will have to be passed on to an ever smaller number of customers during the transformation phase'.<sup>37</sup> According to the BNetzA, the necessary contributions for the unavoidable costs of the decommissioning and dismantling of pipelines should be recognised by the regulatory authority, such that the expected costs would be anticipated at an early stage and 'brought forward' so that they would be borne by the currently larger group of network customers.<sup>38</sup>

- 6.11 Fifth, in the context of the regulation of the LNG regasification service in Italy, the Italian Regulatory Authority for Energy, Networks and Environment (ARERA) included an allowance for dismantling costs so that they are covered during the lifetime of the asset, rather than at the time of their decommissioning.<sup>39</sup> In particular, article 12 of the tariff regulation for the sixth regulatory period 2024–27 specifies that such an allowance shall be based on a third-party estimate of the amount of decommissioning costs, net of any provisions already established to cover these costs.<sup>40</sup> The regulator clarifies that such allowance(s) shall also be indexed in the following regulatory periods.
- 6.12 The majority of regulatory precedents allow for recovery of efficient decommissioning costs, however, we are also aware of regimes in which investors bear the responsibility for decommissioning and the associated costs, such as Ofgem's regulation of Offshore Transmission Owners (OFTOs). The regime requires the OFTOs to prepare and pre-fund a decommissioning plan. A crucial feature of this regime is that the rights to an OFTO Tender Revenue Stream (TRS) are awarded by auction.<sup>41</sup> Hence, given the ex ante knowledge of the need to fund decommissioning, the associated costs are priced in the bids made by investors. Moreover, the OFTO regime allows recovery by the asset owners of additional decommissioning costs if these arise due to a change in legislative requirements.<sup>42</sup>
- 6.13 The weight of regulatory precedent thereby suggests that the Commissioner should allow SEL to reasonably and prudently fund its potential decommissioning costs through the price he sets. In this context, we note that, despite the uncertainty over the development of the future parallel grid and the discontinuation of the existing grid, decommissioning can be pre-

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<sup>35</sup> BNetzA (2024), 'Key elements paper', Energy, 18 January, [https://www.bundesnetzagentur.de/EN/RulingChambers/GBK/KeyElementsPaper.pdf?\\_\\_blob=publicationFile&v=4](https://www.bundesnetzagentur.de/EN/RulingChambers/GBK/KeyElementsPaper.pdf?__blob=publicationFile&v=4) (accessed on 7 August 2024).

<sup>36</sup> BNetzA (2024), 'Key elements paper', Energy, 18 January, p. 23.

<sup>37</sup> Ibid.

<sup>38</sup> Ibid.

<sup>39</sup> ARERA (2023), 'Regolazione tariffaria per il servizio di rigassificazione del gas naturale liquefatto per il sesto periodo di regolazione 2024-2027 (RTRG)', Attachment A, Decision n.196/2023/R/gas, 9 May, art. 12, [https://www.arera.it/fileadmin/allegati/docs/23/196-23rtrg\\_ti.pdf](https://www.arera.it/fileadmin/allegati/docs/23/196-23rtrg_ti.pdf) (accessed on 7 August 2024).

<sup>40</sup> Ibid.

<sup>41</sup> Ofgem (2024), 'OFTO End of tender revenue stream—second decision document', 24 January, p. 4.

<sup>42</sup> Ofgem (2024), 'Generic Offshore Transmission Owner (OFTO) Licence', February, p. 58.

funded only while the current grid is still operational.<sup>43</sup> If the need for decommissioning arises once the existing grid is switched off, SEL would face costs and associated losses due to the need to dispose of its network assets. However, if decommissioning is prefunded and the need for decommissioning does not materialise, SEL could commit to give back the funds to consumers. On balance, a clear plan and funding for decommissioning would help to retain optionality over the future of the electricity grid on Sark, whether or not the current grid faces substitution by a potential new grid.

## **7 Accelerated recovery of expenditure on existing assets**

### **7.1 Commissioner's position**

7.2 In the consultation, the Commissioner has accepted SEL's request to accelerate the depreciation for existing assets, in line with the regulatory treatment granted to new assets. However, the Commissioner is minded to accelerate the depreciation for existing and new assets over three years, rather than two years, since in his view 'it will be about three years before there is any new replacement electricity system'.<sup>44</sup>

7.3 At the same time, the Commissioner is minded to revalue the RAB amount based on the information about the acquisition cost of SEL's business in 2020.

### **7.4 SEL's response—accelerated depreciation**

7.5 We welcome the Commissioner's decision to accelerate depreciation of existing assets of SEL's grid to allow for recovery of invested capital before the network is switched off.

7.6 The approach proposed by the Commissioner recognises that some of the assets owned by SEL should be economically stranded due to the presence of other alternatives. Accelerated depreciation allows investors to fully recover both the appropriate return on capital (i.e. profit) and return of capital (i.e. depreciation) associated with these assets. This approach is in line with current good regulatory practice in mainland Great Britain (GB), which is generally consistent with protecting the value of long-lived assets invested in a company, in order to maintain incentives to invest.<sup>45</sup>

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<sup>43</sup> Such that deferring a requirement to pre-fund the costs would tend to lead to a higher tariff burden the later the decision is made—i.e. if the decommissioning fund is not allowed now and is then required to be built up rapidly due to the deferred decision.

<sup>44</sup> Office of the Sark Electricity Price Control Commissioner (2024), 'Consultation on proposed variation to the electricity price control order', 3 September.

<sup>45</sup> For example, as part of the RIIO-GD3 price control, Ofgem has considered the issue that gas distribution networks in the UK are subject to a potential asset stranding risk due to factors such as heat decarbonisation. In order to mitigate the risk to investors, Ofgem has proposed to use a front-end-loaded depreciation profile across the gas sector, thereby bringing forward the recovery of sunk network costs. This example illustrates that in the face of technological change that could lead to partial or full redundancy of the installed asset base, Ofgem has sought to accelerate the recovery of returns against the existing assets—rather than reducing the value of these assets in line with changes in technology or installation of competing technology. In addition to this, Ofgem has differentiated between the regulatory treatment of the gas transmission and gas distribution sectors. While for the gas distribution sector the payback rate shall be no later than 2050, for the gas transmission Ofgem specifies that a further payback date is possible considering the possibility of repurposing the transmission grid, as an example, for the transport of hydrogen. See: Ofgem (2024), 'Decision – RIIO-3 Sector Specific Methodology Decision – Overview Document', 18 July, paras 4.44–4.46.

- 7.7 We also note that the Commissioner’s decision to accelerate the depreciation for existing and new assets over two years instead of three years is based on what appears to be a subjective view that ‘it will be about three years before there is any new replacement electricity system’.<sup>46</sup> We highlight that, in the current uncertain environment, the task before the Commissioner is to design a robust regulatory framework that allows for the various states of the world that SEL might need to face. As an example, if the new electricity grid is deployed in only two years, SEL would be exposed to the risk of not recovering its capital investments if the Commissioner decides to pursue a three-year horizon.
- 7.8 SEL’s response—RAB revaluation
- 7.9 SEL strongly disagrees with the Commissioner’s proposal to retrospectively revalue SEL’s RAB. This is not consistent with good regulatory practice and, in particular, it may lead to the below.
- (a) undermining incentives to invest. A potential RAB revaluation would threaten the confidence in the ability to recover investments. Regulatory consistency is particularly important in the context of SEL, in light of the significant investment needs to ensure the safety and reliability of the electricity grid.
  - (b) undermining the confidence of investor. A RAB revaluation would strongly decrease investor confidence in the Sark electricity regime.
  - (c) an increase in regulatory risk, thereby increasing the required cost of capital. The stability and predictability of the national regulatory regime is a factor that is evaluated by market participants, which thereby affects the cost of financing.<sup>47</sup>
  - (d) spillover effects on costs of financing for other regulated utilities in Sark. If a regulatory change in methodology increases the regulatory risk for SEL, then this is likely to increase the perceived risk—and thereby the costs of financing—for potential investors into the future electricity grid.
- 7.10 These principles of no retrospectivity in revaluation of the RAB have been considered in the context of the Competition Commission review of the 2012 Northern Ireland price control determination for Phoenix Natural Gas Limited (PNGL).<sup>48</sup> In the context of the 2012 control determination, the Utility Regulator (an independent government department responsible for regulating Northern Ireland’s electricity, gas, water and sewerage industries) proposed a reduction of the RAB of around £75m for historical outperformance and deferred CAPEX. The Competition Commission (now part of the Competition and Markets Authority) intervened following an appeal by PNGL.

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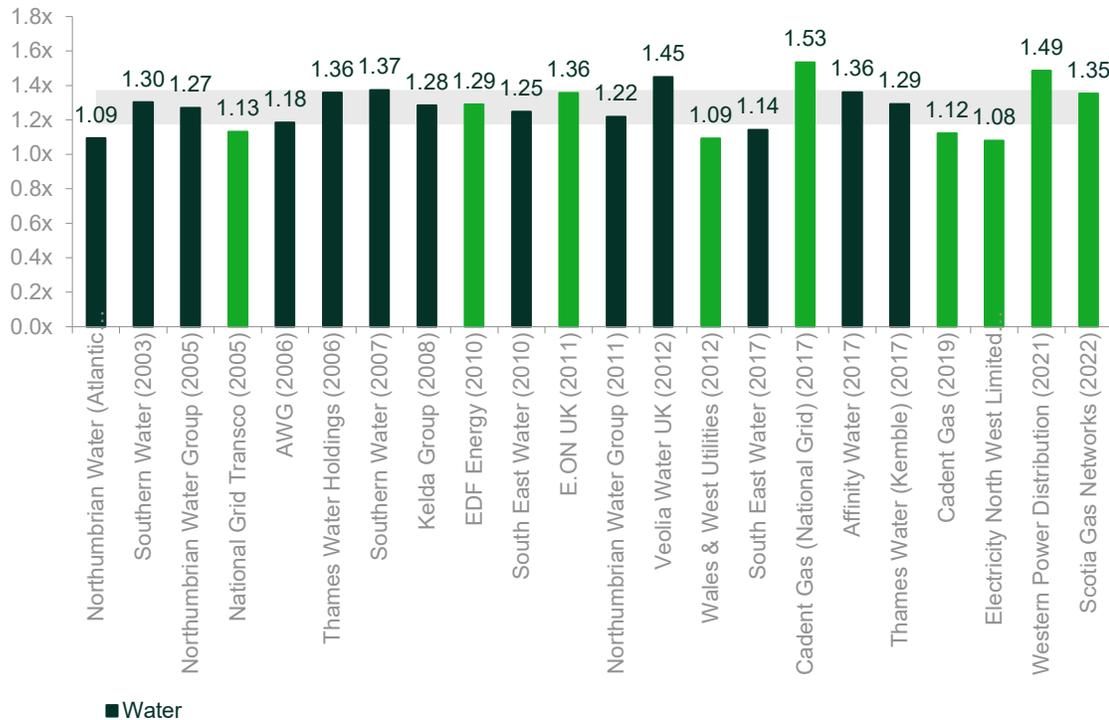
<sup>46</sup> Office of the Sark Electricity Price Control Commissioner (2024), ‘Consultation on proposed variation to the electricity price control order’, 3 September.

<sup>47</sup> For example, Moody’s currently assigns most of the regulatory regimes in the UK a score of AAA for the regulatory stability and predictability sub-factor in its credit ratings. The more stable the regulatory regime and the higher the credit rating of regulated utility debt, the lower its cost of financing tends to be.

<sup>48</sup> PNGL is the owner and operator of the distribution network in the Greater Belfast Area and Larne, and is the larger of the two gas distribution companies in Northern Ireland.

- 7.11 The Competition Commission overturned the Utility Regulator's decision insofar as the RAB adjustment could have a detrimental impact on willingness to invest and the cost of capital. The possible mechanisms for this were identified as follows:
- (a) Ratings agencies may view the regulatory regime as less favourable and, as a result, may demand higher credit metrics for a given credit rating, which may lead to a downgrade of a company's debt. This may have the effect of decreasing the amount of debt that a company can have in its capital structure and/or increasing the cost of the company's debt, both of which could lead to an increase in the overall WACC.
  - (b) Equity investors may view the regulatory regime as less favourable, and as a result may increase the return that they require for investing in a given project. This may have the effect of increasing the required rate of return, in particular for greenfield investments.
  - (c) A perception of regulatory uncertainty may deter investment, on the margin, if companies are unable to form judgements or are very uncertain of what the regulatory environment will be and if, how or when they will receive a return on investments.
- 7.12 Furthermore, regarding the Commissioner's proposed approach to rebase RAB based on market value implied by transactions, we note that such approach has several important downsides that make it an unreliable way to set the RAB. The market value approach to asset valuation disregards all sunk costs, and values each asset on the basis of its value in the market at any point in time. Market values may be inferred using evidence on the value of comparable assets, recent transactions, and/or discounted cash flow valuations.
- 7.13 However, the market value approach may not be appropriate as the primary basis of valuation for regulated companies, since the market value of the business will depend on the regulatory settlement. In other words, the RAB is based on the market value that, in turn, is based on investors' expectation of the regulator's RAB estimate.
- 7.14 Although we understand that, under the current circumstances, relying on a market value approach is likely to result in a lower RAB estimate as compared with the bottom-up valuation made by WSP—and therefore a lower return on capital allowance for SEL—such a relationship might change under different circumstances. The empirical evidence on the value of market-to-asset ratios (MARs) in the UK is generally above one (i.e. the market value in a transaction tends to exceed the RAB value of the network). Specifically, Figure 1.1 below shows a sample of transaction MARs in GB. Since 2003, transaction MARs have been fluctuating in a range of 1.1–1.5x.

Figure 1.1 Transaction MARs of GB water and energy networks



Note: Data as of August 2022.

Source: Oxera analysis, based on data from Dealogic.

- 7.15 To the extent that SEL's RAB is reduced by virtue of the Company being acquired at an undervalue to RAB due to the Sark market and its inherent risk, this effectively reduces the "reward" investors may expect due to their engaging with that risk. This in turn is likely to reduce their willingness to invest in Sark ultimately damaging the island.
- 7.16 In summary, it is reasonable to expect that regulators would be wary of using market valuations to set the RAB amount because investors' expectations become self-fulfilling, thus creating a circularity between transaction values and allowed revenues. In particular, changing the approach for the RAB value after the initial asset value has been set (e.g. in the case of privatisation of assets) is likely to be disruptive for the regulated company and to lead to instability in tariffs that is not in the consumer interest. It is also relevant to note that whether the SEL grid remains in operation and requires funding to deliver necessary network health and safety upgrades, or whether the SEL grid is decommissioned and substituted by a new grid that is developed in parallel, the Commissioner would jeopardise the investability of the sector and the future availability of safe and reliable power in Sark, if he proceeds with a significant step to undervalue the asset base.

## 8 Recovery of professional services costs

### 8.1 Commissioner's position

- 8.2 The Commissioner argues that the PCO already contains an OPEX allowance for legal and regulatory costs, and he deems this amount to be sufficient to cover those costs incurred during the process of responding to determinations, PCOs, or variations. As such, the Commissioner refuses

SEL's request to increase the allowance for legal and regulatory support by a fixed amount in light of the 'significant amount of uncertainty about what the exact nature and purpose of that additional legal support might be'.<sup>49</sup> Instead, the Commissioner is minded to consider proposals made by SEL on a case-by-case basis, provided that these do not exceed the total allowance of £30,000 per year.

8.3 In setting out his position the Commissioner justifies it by stating that 'Unfortunately, I have also experienced what, in my view, I consider to be an unnecessary and inefficient use of legal resources by SEL.'

8.4 SEL's response

8.5 SEL strongly disagrees with the Commissioner's position of allowing the recovery of legal and regulatory costs up to the total yearly allowance of £30,000. We note that the Commissioner contradicts himself when establishing a maximum total allowance for the recovery of legal and regulatory costs while acknowledging that 'there is still a significant amount of uncertainty about what the exact nature and purpose of that additional legal support might be'.

8.6 As regards precedent on this point from GB, we observe that Ofgem does not publish all of the details of its cost allowance modelling in the public domain. However, in its regulatory guidance for cost types, Ofgem classifies professional services, including legal and consultancy services, as a 'contractors' cost category.<sup>50</sup> Additionally, a part of legal services costs can be recognised in the 'CEO' subcategory of 'Core Business Support'.<sup>51</sup> Hence, it appears that subject to an industry-level cost benchmarking process, Ofgem allows for recovery of professional services costs.

8.7 We note that, on a principled basis, the regulatory price control should clearly indicate to regulated companies which costs can be included in the fixed operating cost category, including the costs associated with professional and legal services. Instead, we note that Sark's Commissioner failed to explicitly mention that an allowance for legal costs was implicitly provided within the fixed OPEX allowance. It appears that he also failed to provide any figure indicating the level of the allowance that had been granted for the recovery of these costs.

8.8 Additionally we note that the Commissioner assessing that legal advice on a course of action challenging him is unnecessary and inefficient is akin to the provision of home umpires in cricket. Absent such advice resulting in a determination by the courts that he is wrong, the Commissioner will always be able to assert such challenge is in some way wrong or unnecessary and hence inefficient and not worthy of recovery thus creating a binary and litigious regulatory environment rather than a collaborative one for the good of Sark.

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<sup>49</sup> Office of the Sark Electricity Price Control Commissioner (2024), 'Consultation on proposed variation to the electricity price control order', 3 September.

<sup>50</sup> Ofgem (2023), 'RIIO-ED2 Regulatory Instructions and Guidance Glossary', 19 June, p. 62.

<sup>51</sup> *Ibid.*, pp. 45, 50, 51.

- 8.9 As regards the specific example the Commissioner raises, SEL notes that:
- (a) its concerns around the correction mechanism relate to the Commissioner's application of it and not fundamentally to the validity of a mechanism in general;
  - (b) that this has been made clear to the Commissioner since February of this year at least and was acknowledged by the Commissioner in May<sup>52</sup>; and
  - (c) that in light of the above, challenging at the time of the PCO (ie at a time before the correction mechanism had been improperly utilised) would be impossible; and
  - (d) by the same token, seeking to achieve a fairer and more appropriate PCO through the present variation request without removing the correction mechanism does not indicate approval or acceptance of the improper application of the correction mechanism.
- 8.10 The Commissioner either failing to understand this or choosing to deliberately mischaracterise the position is perfectly illustrative of precisely why the Commissioner having a veto over the recoverability of proper legal spend to challenge him is troubling. In addition we note the Commissioner seems to have ruled out recovery of those historic costs on the basis of this mischaracterisation. For the avoidance of doubt, SEL maintains the position that its historic costs as regards this and other legal expenditure should have been and therefore still should be recoverable through the unit price.
- 8.11 For the avoidance of doubt SEL has always accepted, and continues to accept that its legal costs should be subject to reasonable assessment and taxation. What it cannot accept however is that this should be the responsibility of the very authorities with which it is most likely to enter legal dispute.

## **9 Conclusion**

- 9.1 SEL requested the variation to which the Consultation relates in the hope of addressing a number of troubling issues around the economics of electricity supply in Sark, the bulk of which arise from the project of a second grid being established in a natural monopoly, a fact that ultimately we accept the Commissioner has little control over.
- 9.2 The approaches considered in the Consultation do not however address these issues satisfactorily or in a fashion that would be typical of such a regulator for the reasons set out above. We very much hope the Commissioner will reconsider a number of these positions in light of this submission.

Yours sincerely

Alan Witney-Price  
Managing Director and Owner of Sark Electricity Limited

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<sup>52</sup> Email from Shane Lynch to Alan Witney-Price and Wayne Atkinson 10 May 2024

## Respondents to the Price Consultation, and all other residents

Dear consumer

I want to thank those of you that took the time to respond to this important consultation. Even those whom do not support the SEL position. I do of course recognise that no-one would vote to increase electricity prices and most of you are simply not concerned with the intricacies of best regulatory practice.

I confess that I too wish for a simpler time when logic dictated our approach and not Price Commissioners or Advocates.

When I purchased Sark Electricity my intended approach was incredibly simple.

***The price must first drop and be guaranteed for a period of not less than 5 years if we were ever going to increase usage, which would in turn reduce the price. You the consumer would need comfort for a significant period before you started to rely more heavily on electricity.***

I have repeatedly laid out my plan to Chief Pleas, both Price Commissioners, Government House, the media and indeed anyone who will sit down with me and listen.

- I have sought permission from Chief Pleas for tidal, solar and wind. This has been ignored.
- I have submitted plans for Capital Expenditure to resolve the safety concerns raised and to improve the grid going as far back as 2020. These have also been ignored and therefore the money cannot be spent. After all, who would spend money without knowing they have the approval they require to recover it.

Had I been allowed to adopt my approach the price today would be between 25.5p and 30p per unit with a connection fee pegged against GEL. Under my model, the underwrite value would have peaked at circa **-£463,952**. I offered to personally underwrite the losses until the price match occurred on increasing demand. As with all of my loans to SEL, this would have been charged at 0% interest.

For those of you that are interested, the crossover point is a mere 2.1m units. With SEM in full operation SEL was operating at 2.4m units back in the day (2.9m in the building boom). 2.1m was entirely achievable. This model would have also more than accommodated the CAPEX required to meet the safety concerns.

The price commissioner however chose a model that set the maximum price. While I could have set a lower price than his maximum, any figure below the maximum price could never be recovered in the future. I would have been gifting the money to residents never to be seen again.

Using todays numbers for ease my plan was as below:

Year	Demand	Unit price	Gains / Losses	Accrued Balance
2021	1,218,979	30p	-£171,269.65	-£171,269.65
2022	1,259,260	30p	-£121,081.09	-£292,350.74
2023	1,555,594	30p	-£75,630.99	-£367,981.73
2024	1,683,200	30p	-£56,490.09	-£424,471.82
2025	1,863,200	30p	-£29,490.09	-£453,961.91
2026	1,993,200	30p	-£9,990.09	-£463,952.00
2027	2,123,200	30p	£9,509.91	-£454,442.09
2028	2,253,200	30p	£29,009.91	-£425,432.18
2029	2,410,423	30p	£52,593.36	-£372,838.82
2030	2,651,465	30p	£88,749.70	-£284,089.12
2031	2,916,612	30p	£128,521.68	-£155,567.44
2032	2,916,612	30p	£128,521.68	-£27,045.76
2033	2,916,612	26.5	£27,045.76	£0.00
2034	2,916,612	25.5		

Some of you think that I am not involved in the day to day business because I am not seen physically on the island as I was when my family and I had a home there.

1. I talk to Joanne most days and often up to 10 times a day and I attend to the management of the firm and its funding needs on a day to day basis.
2. It was made clear to my family, in person and in no uncertain terms, that we were not welcome on Sark and that leaving would be beneficial to our collective health. Whether the threat was induced while under the influence is not relevant to me. On behalf of my family I took it seriously.

My love for Sark remains and my commitment to Sark remains.

- It is Chief Pleas that have decided to spend obscene sums of money on a secondary grid that is not required. There is no other jurisdiction that operates two grids alongside each other.
- It is the Commissioner who controls my CAPEX allowance and Chief Pleas that control various permissions. I have always been willing to spend what was required to maintain a safe and secure grid. But I require permission first.

I assure you that I am no less disappointed than you that the situation has developed as it has. That we are now in the process of taking legal action against Sark's Government and others to challenge their questionable conduct in this matter was entirely avoidable.

The direction of travel has been determined by Chief Pleas and The Commissioner. Not SEL.

While Chief Pleas pursues it desire for a second grid, I must ensure that regulatory best practice is applied and my investment is recovered in advance of the second grid becoming live. Sadly, this comes at a significant financial cost that must subsequently be recovered also.

Regards

Alan Witney-Price

## By email

Dear Shane

### 1 Introduction

- 1.1 On 3 September 2024, the Electricity Price Control Commissioner (**Commissioner**) consultation on the proposed variation of the electricity price control order (**Consultation**)<sup>1</sup> in response to Sark Electricity Limited's formal request for such a variation sent on 26 June 2024.
- 1.2 Sark Electricity Limited (**SEL**) responded to the Consultation on Tuesday 24 September 2024. Following correspondence around both that initial response and responses to the Consultation received by the Commissioner from members of the public, the Commissioner, SEL and its advisors spoke by virtual meeting on Friday 11 October 2024. As a result of that meeting it was proposed that SEL provide additional thoughts around specific issues. This letter constitutes SEL's further response in relation to the Consultation.

### 2 Allowable return and risk premium

- 2.1 In the April 2023 PCO, the Commissioner has allowed SEL a real return of 5%, benchmarking the figure against the 3.18% allowed for NIE Network in Northern Ireland. The implied 1.82% premium was said to be in recognition of the additional risks faced by SEL. The Commissioner has not provided a specific breakdown or estimation methodology used to arrive at the implied risk premium level. In the consultation, the Commissioner has recognised the unique risks faced by SEL as the electricity provider on Sark. Specifically, he has emphasized that '[t]he announcement last year by Chief Pleas that it intends to tender for a completely new electricity system' casted doubts on the long-term future for SEL. We consider that the language used by the Commissioner indicates that, in particular—but not exclusively—he sees that there is uncertainty around the extent to which SEL will remain the sole monopoly provider on Sark.
- 2.2 The potential of losing its status as the sole electricity provider on Sark represents a significant risk factor, however, we believe that this is just one of relevant risk factors to which SEL is exposed that should be taken into account.
- 2.3 First, SEL faces significantly higher risk than its UK counterparts due to its small size. Networks of small size have significant limitations in

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<sup>1</sup> Office of the Sark Electricity Price Control Commissioner (2024), 'Consultation on proposed variation to the electricity price control order', 3 September, <https://www.epc.sark.gg/consultation-on-variation-request-for-the-2023-25-price-control-order.html> (accessed on 13 September 2024).

accessing capital markets, for example, due to inability to issue benchmark-sized debt instruments. For example, Ofgem has allowed an additional premium for small District Network Operators that issue debt infrequently (due to inability to issue benchmark-sized bonds regularly), the additional premium was estimated at 26bps on the cost of new debt.<sup>2</sup> The smallest of the UK DNOs is roughly 1000 times the size of SEL. Due to the relative size of SEL, it is unlikely to be able to issue any bonds at all. Moreover, the ability to issue debt in the context of the Sark economy may be challenging. For example, we note that Sark government does not appear to have an external credit rating or issue sovereign debt at all. These factors illustrate that the financing costs of SEL are likely to be significantly higher than its UK counterparts.

- 2.4 Second, the regulatory and political risks faced by SEL are likely to be significantly higher than the level of risk faced by the UK networks. Such risks are not limited to the uncertainty that the Commissioner has recognized in relation to the Chief Pleas' policy as regards the future of the electricity system in Sark. In this context, we note that as part of the 2012 PNGL Determination (in Northern Ireland), the Competition Commission outlined several avenues through which political and regulatory risks affect the WACC:<sup>3</sup>
- (a) Rating agencies having less favourable view of the regulatory regimes, thus, requiring higher thresholds to maintain a given credit rating, which may lead to an overall increase in WACC;
  - (b) Equity investors viewing the regime less favourably and therefore, requiring a higher return for a given project;
  - (c) Perception of regulatory and political risk deterring investment due to uncertainty in receiving the allowed returns.
- 2.5 The factors were recognised by the Competition Commission as significant drivers of WACC and are likely to be more pertinent in the case of the Sark regime, compared to the relative risks of the GB and Northern Irish network regimes.
- 2.6 On balance, the implied 1.82% risk premium for SEL relative to the Northern Ireland networks seems to be extremely conservative and an underestimate of the returns any potential investor in SEL (or any network asset in Sark in general) would require. In other words, such a premium may partially compensate SEL for a host of factors such as political risk, regulatory regime immaturity, illiquidity and small company premia—all of which are recognized risk factors, and for which there is regulatory precedent from UK regulators. However, this premium would be clearly insufficient to compensate for a risk of asset stranding—let alone to remunerate SEL for the crystallisation of such a risk, were it to suffer a significant RAB revaluation.
- 2.7 In this context, we note that, in the context of the Consultation of the proposed variation of the PCO, the Commissioner is minded to revalue SEL's RAB on the basis of the acquisition price of SEL's business in 2020. We understand that such a RAB write-down could be worth as

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<sup>2</sup> Ofgem (2022), 'RIIO-ED2 Final Determinations. Finance Annex.', 30 November, para. 2.48.

<sup>3</sup> Competition Commission (2012), 'Phoenix Natural Gas Limited Price Determination', 28 November, para. 8.83.

much as half of the current RAB value for SEL. This change would significantly lower the expected cashflows from operating the SEL network, both through decreased depreciation allowance and significantly lower return on capital allowance in cash terms. Such a significant change, as a revaluation of an established RAB value on a retrospective basis (i.e. revising a value which already exists, anchored on prior regulatory decisions), would be an example of extreme regulatory uncertainty. This would lead to very significant reductions in the expected return on the investment in SEL. It is clear that a change of this scale would in no way be compensated by the additional implied 1.82% return uplift for 'SEL-specific risks'.

- 2.8 Lastly, as we have already submitted in SEL's response to the Consultation, the value indicated by the Commissioner for NIE Networks refers to the sixth regulatory price control ('RP6'), which applies for the period from 1 October 2017. Considering the substantial changes in the macroeconomic environment and capital markets that have occurred since then, it would be appropriate to use updated market data. As a result, the allowed WACC for the next period needs to increase, irrespective of the risk premium that is added.

### 3 Interpretation of the Law

- 3.1 We note that the Commissioner has repeatedly referenced s.13(2)(a)(i) of the Control of Electricity Prices (Sark) Law, 2016 (the **Law**):

*"(2) In determining whether a price is, or is not, fair and reasonable the Commissioner shall take all material considerations into account, including without limitation the following matters -*

*(a) the cost of generating and distributing the supply of electricity, including the cost of –*

*(i) acquisition and maintenance of any plant and equipment,"*

and suggested it requires him to rebase the RAB as a result of his now knowing the purchase price of SEL. In this regard we would note (in addition to the commentary on this point provided previously) as follows.

- 3.2 Firstly s.13(2) of the Law simply lists a number of points that must be taken into account. It does not imply that any one of the listed factors is determinative. Also among those items is the replacement cost of the same equipment (s.13(2)(b)). Since the two are, as noted on the call, inherently disparate it is unclear why more emphasis would now be placed on one rather than the other.
- 3.3 Secondly, the Commissioner appears to be of the view that the cost of acquiring SEL as a whole equates to the cost of acquiring its plant and equipment. In this regard the Commissioner is making an error in both fact and law. As the courts have repeatedly made clear,<sup>4</sup> ownership of shares in a company is precisely that, it conveys ownership of a bundle of rights related to the underlying company, no more, no less. The price that is paid in the market can be more or less than the (book or regulated or replacement) value of the assets owned by the company, not least because of the risk of the market and regulatory environment in which

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<sup>4</sup> see for example *Macaurea v Northern Assurance Co Ltd* [1925] AC 619

the company operates (and certainly conveys no direct ownership right in respect of the company's assets). As a result, the pricing of one is in no way determinative of the pricing of the other. And indeed, regulatory practice supports that changes in market value should not be determinative of changes in the existing rolled-forward RAB value. Additionally, we would note that the Commissioner regulates (and indeed can only regulate) regulated suppliers of electricity, in this case SEL. The price SEL has paid for its assets is unchanged, its balance sheet in this regard remains unchanged as a result purely of a change in ownership.

#### **4 Legal and Regulatory Cost**

- 4.1 We note the Commissioner's views expressed in email of today's date around legal and regulatory costs. The Commissioner appears to conflate the issue of ex ante legal cost allowances and ex post legal cost awards. The point that the Commissioner cites as regards the CMA (or other relevant authority) deciding on cost recovery (and the reference to determinations of the Court of the Seneschal) is not pertinent to the question of the adequacy of the ex-ante level of allowance. The CMA (or other) would only tend to decide on costs award in the event of an appeal, which is not the case here.
- 4.2 SEL is asking the Commissioner to ensure an adequate level of ex ante allowances. In that regard, the Commissioner has stated that the "*PCO includes a fixed allowance of £17,798 per year for legal and regulatory costs and that in my view this allowance remains sufficient to cover reasonable legal and regulatory costs incurred during the process of responding to determinations, PCOs or variations.*"
- 4.3 With respect this view ignores the reality of the position SEL finds itself in. As regards precedent on this point from Great Britain, we observe that Ofgem does not publish all of the details of its cost allowance modelling in the public domain. However, in its regulatory guidance for cost types<sup>5</sup>, Ofgem classifies professional services, including legal and consultancy services, as a 'contractors' cost category. Additionally, a part of legal services costs can be recognised in the 'CEO' subcategory of 'Core Business Support'.
- 4.4 Hence, it appears that subject to an industry-level cost benchmarking process, Ofgem allows for adequate recovery of professional services costs.
- 4.5 By way of comparison, we understand that Guernsey Electricity Limited spends circa £140,000 on legal fees per annum, almost ten times that allowed by the Commissioner. Whilst we accept that Guernsey Electricity has a substantially bigger customer base, broadly it is still required to respond to similar regulatory and legal issues and is exposed to all the same costs in terms of property conveyancing, legislative updates and similar non-client focused expenditure.
- 4.6 In fact, one could demonstrably argue that Sark is a more litigious environment with additional legal expenditure likely to be required. This

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<sup>5</sup> Ofgem (2024), 'RIIO-3 Sector Specific Methodology Decision – ET Annex', 18 July;

is exemplified in claims the company has faced from Mr Moerman and the tense position between the Company and other landowners.

- 4.7 Guernsey Electricity is also not faced with the unique circumstances Sark has been faced with. We note that the Commissioner acknowledges 'there is still a significant amount of uncertainty about what the exact nature and purpose of that additional legal support might be'. In this context, it would be unreasonable for the Commissioner to retain a position of allowing the recovery of legal and regulatory costs up to a maximum total yearly allowance that has not been robustly benchmarked.
- 4.8 It is particularly important to understand variations in legal and regulatory costs in light of changes in the regime or market environment. It is reasonable to expect that higher levels of professional services expenditure will be incurred when the regime is in flux, as is the case in Sark. Furthermore, there is recent precedent from Ofgem in the context of the SSMD<sup>6</sup> of dealing with higher uncertainty in expenditure and allowing this to be front-loaded, in the context of the energy transition. Specifically, Ofgem is proposing to allow for 'Pre-Construction Funding' to fund companies for costs associated with project development, such as surveys and assessment of environmental and design feasibility, stakeholder engagement and consultation, project design and engineering development, and wayleaves and planning applications.
- 4.9 We note that the Commissioner again seeks to justify this position by saying SEL did not appeal against the 2023 PCO. We would again note that SEL's failure to appeal at the time should not be taken as an acceptance that certain aspects of the PCO was correct. Indeed, the Commissioner has himself accepted that the PCO contained a manifest error that the Company only became aware of a year after the PCO was made when no inflationary increase occurred. Notwithstanding the nature of this manifest error, it took SEL a number of calls and Advocates letters to reach the point at which the Commissioner acknowledged this error. It now appears the Commissioner claims that SEL must pay for this error because no appeal was made.
- 4.10 As was made clear on the call of 11 October, this establishes a binary position where SEL must appeal every decision to the Court of the Seneschal because a failure to do so renders any cost of any alternative action unrecoverable.
- 4.11 As was also made clear this creates a situation where the Commissioner sits as judge of his own cause as the Commissioner may (as he did in the Consultation) suggest that any challenge to his decision other than a court challenge was wrong and therefore not reasonable expenditure.
- 4.12 As presently established the allowance for legal and regulatory costs is flawed in a number of ways:

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<sup>6</sup> Ofgem (2023), 'RIIO-ED2 Regulatory Instructions and Guidance Glossary', 19 June

- (a) firstly, it is not an accurate reflection of legal and regulatory costs in a specialist jurisdiction such as Sark and so is disproportionately low as a matter of fact;
- (b) secondly, the figure in question appears to have reached without any real attempt to quantify acceptable costs or any real scope of necessary work, to the point that the current PCO is, in the present inflationary market, less than the preceding one;
- (c) thirdly, it is legally flawed in that it allows the Commissioner to act as judge of whether costs to be incurred in challenging him are reasonable, thereby breaching the principles of natural justice. The only counter to this is appeal to the Court of the Seneschal with attendant risk and expenditure; and
- (d) fourthly, it is unreasonably rigid in that there is, it would appear from correspondence, no re-opener which would allow unquestionably legitimate legal fees to be recovered (where for example post-PCO some new event incurring legal expenditure occurs). SEL does not have significant cash reserves in the manner of the UK utilities. Defending a claim in Sark could quite easily drive the company to insolvency before a judgment was obtained where its total recoverable legal expenditure is capped at £17,798 per year.

## **5 Conclusion**

- 5.1 As previously noted a number of troubling issues centre around the economics of electricity supply in Sark, as a result of public belief a second grid will be established in a natural monopoly, a fact that ultimately we accept the Commissioner has little control over (albeit we note that the Commissioner has previously suggested that expenditure not necessary for the supply of electricity may not be recoverable expenditure in the unit price and we query how this will interact with a globally unprecedented and unnecessary duplicate grid).
- 5.2 The positions expressed in the Consultation are, we believe, unhelpful in addressing these challenges, and detrimental to the long-term position of the Sark community (in addition to the more immediate issues faced by SEL). We very much hope the Commissioner will reconsider a number of these positions in light of this further submission.

Yours sincerely

Alan Witney-Price

Managing Director