Office of the Sark Electricity Price Control Commissioner

Proposal to make a Price Control Order

14th November 2019

Summary

1. On 8th November 2019 I reported that I had found, after consultation, that the price currently charged for electricity on Sark is not fair and reasonable. I now propose to set a maximum price for sales of electricity for the next two years of 53 p/kWh, subject to the consideration of any representations that Sark Electricity Limited may raise or any other material matters that become apparent. I judge that, at current fuel prices and electricity consumption, this price is sufficient for Sark Electricity Limited to maintain secure supplies of electricity and provide a reasonable return on its investment.

Background

2. The Draft Determination[1], published on 1st October 2019, came to the preliminary conclusion that the price charged by Sark Electricity Limited for electricity supplies to customers on Sark was not fair and reasonable. I shared my conclusion with the Policy & Finance Committee of Chief Pleas and Sark Electricity Limited. I also sought responses from other interested parties, particularly residents of Sark. Consultees were given until 22nd October to respond and Sark Electricity Limited was given two weeks to respond to matters raised by other parties.
3. These responses were described and discussed in the Determination which was released on 8th November. None of the issues raised or arguments presented have led me to alter the preliminary conclusion that the price charged for electricity was not fair and reasonable.
4. Having found that the current prices are not fair and reasonable, Section 15 of the Control of Electricity Prices (Sark) Law, 2016 (the "2016 Law") empowers me to issue a "Price Control Order" (PCO). According to this Law, I may set a maximum price for electricity, and other electricity related services, for up to two years. In the 1st October 2019 Draft Determination, I described the cost structure of the combined entity of SEHL and Sark Electricity Limited, referred to as "SEL". This document describes how I have arrived at a maximum price I propose to set for two years and how it may be adjusted according to electricity consumption and fuel prices.

[1] Available at www.epc.sark.gg

Estimate of the cost of delivering electricity on Sark

5. The Draft Determination explains how a reasonably efficient operator using the equipment operated by Sark Electricity Limited would be able to earn a reasonable profit if the price were around 53 p/kWh. This estimate was made by considering that electricity on Sark is provided by the combined entity of Sark Electricity Holdings Limited (SEHL), which currently owns the necessary equipment of cables, switches, generators and transformers, and its wholly owned subsidiary, Sark Electricity Limited, which leases the equipment from SEHL, purchases fuel, sells electricity, and operates and maintains equipment. I refer to this combined entity as SEL. I chose this approach because it was simple and reflected reality, as explained in paragraph 22 of the Determination.
6. The Draft Determination explained how I made estimates of the fixed cash costs of operations. The results are summarized in Table 1 below, together with explanatory notes for each cost item. The profitability is calculated by allowing a reasonable return on the investment in SEL. I have taken this value as comprising the value of the assets, as estimated by WSP, together with an allowance for working capital. Working capital is required to cover timing differences between creditor payments and revenue from customers, and allowing for variations in fuel costs and unforeseen problems that could not be remedied by a variation in the Price Control Order.

Table 1

EPC fixed annual cash cost estimate (£) for SEL 2019

	EPC estimate (£)	
Director & Management	60,000	60% of full time equivalent of £85,000 salary plus £9,000 expenses
Staff	210,000	Higher than reported costs for SEL over 2017 & 2018 budget. 2019 1H results imply £190,000 per annum.
Operations	40,000	Assumes annual maintenance of each generator & overhauls every two years. Higher than reported in SEL accounts since 2013.
Services	30,000	Assumes audits for one company and no regulatory costs (see paragraph 15)
Administration	10,000	In line with reported costs over past six years.
Total	350,000	

Annual Financing costs

7. An efficient and economic operator of SEL would seek to recover a depreciation charge and expect to make a reasonable return on the investment. The Draft Determination described how a value of the company was determined and the rate of return it would be reasonable for SEL to earn on its investment. In addition, the report described how an appropriate depreciation charge was calculated from the operating lives of the different types of equipment and their replacement costs. In all, these annual fixed financing charges amount to around £155,000.

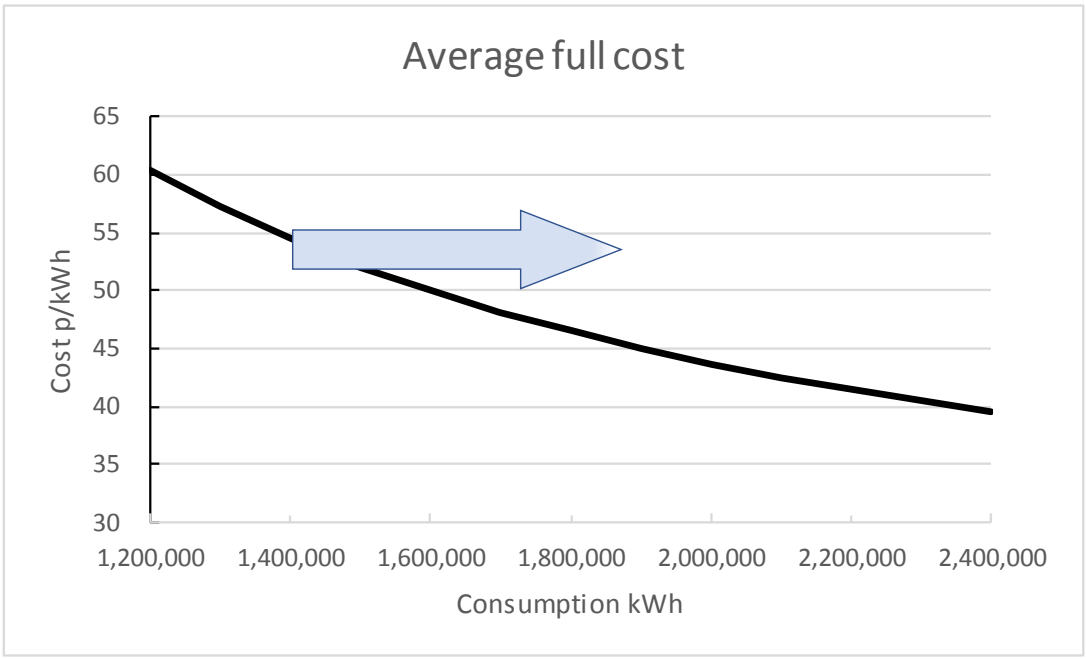
Variable costs

8. The analysis behind the variable cost estimate of 19 p/kWh is set out in paragraph 49 and 50 of the Draft Determination. SEL may purchase fuel at higher or lower prices. However, I am choosing to link the fuel cost in the maximum price to world levels, to ensure that customers will be exposed to fluctuations in fuel prices whilst providing an incentive on SEL to purchase fuel keenly. The current estimate of 19 p/kWh is consistent with SEL's draft management accounts for the first half of 2019.

Total Costs

9. The estimates of the cost, including a reasonable profit, of producing electricity on Sark show how the average costs depend on the overall consumption. Figure 1 below shows this relationship graphically. If annual consumption remains at the anticipated 1,500,000 kWh, the average cost, including finance, of producing power on Sark using SEL's equipment would be around 53 p/kWh.

Figure 1



10. The responses to the Draft Determination suggest that customers would use more electricity in the short term, were the price set around 53 p/kWh. The responses describe how some residents have been curtailing their use of washing machines, tumble dryers, humidifiers, freezers and cooking equipment. Estimates of the likely impact of a price reduction on electricity consumption are fraught with uncertainty. I have been provided with household and business consumption for the Scilly Isles[2], and the South Western region of the United Kingdom. These regions enjoy a similar climate to Sark, but the electricity is supplied at far lower prices. As a consequence, many premises use electricity for space heating. WPD provided my Office with consumption figures for premises with and without electric space heating. If electricity consumption levels for premises on Sark matched those in the WPD area which do not use electricity for space heating, the island would be consuming between 2,300,000 and 3,200,000 kWh each year. This would lead to average unit costs of under 40 p/kWh.
11. A rise of electricity consumption to these levels is not impossible to contemplate. It would represent a return to the demand experienced towards the end of the last decade.

Maximum Price

Cost of generation, distribution & supply

12. I am assuming that demand will remain around current levels for the next year and am proposing a maximum price in the Control Order accordingly at 53 p/kWh. This would allow SEL to enjoy a reasonable profit. I judge that this is sufficient for a reasonably efficient and economic operator to operate the SEL equipment and make a reasonable profit if annual consumption is at 1,500,000 units and the average un-taxed diesel price, as reported for the UK by Eurostat, is around 52 p/litre.
13. In my assessment of the costs a reasonable company would incur providing electricity on Sark, I have not considered the costs of different forms of generation, such as from wind, solar photovoltaics (PV) or use of batteries. This is because it is not yet clear whether it will be possible to secure planning permission for such equipment. However, this may become a material matter in the near future, as explained in the Policy Statement on my Office's web-site[3]. In the meantime, SEL would be able to enjoy enhanced profits up to December 2021, were it to install and speedily commission such plant.

Risk of own generation & price spiraling

14. A number of respondents to the Draft Determination reported that they will be going "off-grid" and generating their own electricity. I raised this possibility in the Determination and Price Control Order of last year. If these projects proceed, SEL will sell less electricity. In the past, SEL has responded to a reduction in sales by increasing the unit price in order to maintain profitability. The Policy Statement on my Office's web-site discusses the impact of such behaviour. I have not taken this potentially material issue into account when setting

[2] Consumer consumption from communication with R. Hey, WPD;.

[3] www.epc.sark.gg

the maximum price for 2020. I may have regard to the level of profit SEL may reasonably expect to earn if, on account of customers going off-grid, the demand on SEL's system falls.

Cost of dealing with regulation

15. The Draft Determination (paragraphs 35 – 39) records that Collas-Crill, SEL's lawyers, have complained that I have not allowed for any costs associated with dealing with my Office in my consideration of the costs of providing electricity on Sark. I explained in the Policy Statement that the recovery of reasonable costs incurred responding to my Draft Determination and this Draft Price Control may be recovered through the tariff. Paragraph 39 of the Draft Determination explains that these legitimate costs could be recovered through the tariff and may be included in the Price Control Order. However, I am insisting that these legal bills are scrutinized by an appropriate independent expert. Despite asking on 13th, 25th September and 4th, 8th, 17th and 28th October 2019, I have yet to receive SEL's acceptance that my office can organise for such a report to be prepared. On its receipt, it may be necessary for me to consult on a variation to the PCO according to section 15(6) of the 2016 Law.

Price Adjustments

16. If the average weekly diesel prices reported by Eurostat over 1st December, 2019 to 30th November, 2020 are higher than £0.52/l, then the maximum price for 1st January 2020 to 31st December, 2021 will be adjusted to allow SEL to recover any shortfall suffered during 2020. The "under-recovery[f]" will be calculated as:

    Under-recovery (£)= ((Actual average price-0.52)/3.20[4])*actual demand (in kWh)

17. The adjustment to the tariff, in p/kWh, will be calculated by dividing the under-recovery by the forecast annual demand for 2021, multiplied by 100 to convert £ into p. Similarly, if the average price is lower than 52p/l, the over-recovery will result in a lower maximum price for 2021, according to the same formula.
18. If demand is lower than 1,500,000 kWh during the year 1st December 2019 to 30th November 2020, a similar adjustment will be made to the tariff for 2021. The tariff adjustment will be made by the same procedure as described in paragraph 16 and 17 above. In this case the adjustment will be calculated as:

    under-recovery[d](£)=0.34*(1,500,000-Actual demand).

19. I am not setting an "over-recovery" adjustment for the next two years. Therefore, SEL benefits from selling more power as it would improve profitability. These adjustments give SEL full protection if demand is lower than 1,500,000 kWh, and allow SEL to retain all the benefit of higher demand until December 2021. Indeed, each additional kWh sold would generate 34p of gross margin.

[4] The 3.20 factor converts prices from £/l into £ per kWhe delivered, taking into account the losses in generation and distribution.

20. Should there be sudden, short term, movements in fuel price and demand, I have powers, under Section 15(6) of the 2016 Law, to vary the Price Control Order, after consultation.

Next Steps

21. I am pleased to accept representations from residents and other interested parties by 3rd December 2019. These representations will be shared with SEL. Respondents should indicate if they do not wish their communications to be published on the EPC web-site (www.epc.sark.gg). SEL will be given two weeks to respond to any representations I receive, so I should be grateful for prompt responses. I would be particularly interested to hear views on whether:-

    a) the maximum price should be set for one or two years;
    b) residents are likely to generate their own power and disconnect from the SEL network;
    c) respondents' views on the timing of adjustments;
    d) how the loss of system consumption resulting from "own generation" should be treated when considering the maximum price;
    e) there are any other matters relating to electricity pricing respondents would like to raise.

22. After I have received these submissions, I will decide whether to make a Price Control Order to come into force on 1st January 2020. I hope this will not be necessary.

Anthony White
Commissioner

14th November, 2019