Office of the Sark Electricity Price Control Commissioner

VARIATION TO THE PRICE CONTROL ORDER

FOR PRICES CHARGED BY SARK ELECTRICITY LIMITED ("SEL")

FOR THE PERIOD

01ST April 2023 – 31 March 2025

Variation to take effect from 01st November 2024.

Shane Lynch

Electricity Price Control Commissioner

01st November 2024

1.0: INTRODUCTION AND SUMMARY

On the 3rd of September 2024, I published a consultation paper on a variation request to the existing Price Control Order ("PCO") from Sark Electricity Limited ("SEL"). I received three written responses to this consultation from SEL and 26 responses from electricity consumers in Sark. These responses are also published on the office website (epc.sark.gg). I wish to thank all respondents for their valuable contributions.

There were five aspects to SEL's variation request. Each of these are set out in summary form below together with my decision. Further details can be found in the body of this report.

Treatment of Inflation:

SEL requested that the annual allowance for fixed operating costs and its return on investment take account of inflation.

I have decided to increase the allowance for fixed operating costs by 5.8%, backdated to the 1st of April 2024.

I have also decided that, from the 1st of November 2024, SEL will receive a nominal rate of return of 7.73% on its Regulatory Asset Value ("RAV"), and that the Regulatory Asset Base (RAB") will no longer be inflated going forward.

New Capital Expenditure:

SEL requested that capital expenditure proposals of up to £573,898 were expressly approved or expressly disapproved and paid for by my consumers over the next two years.

I have already approved £36,472 of this request. I have decided to approve project management costs of £30,250. Urgent asset replacements which SEL wishes to commence in the last five months of this price control will be considered for immediate approval.

Decommissioning Provision:

SEL requested that a provision of £980,370 is accumulated over the next two years, and paid for by consumers, for decommissioning of its equipment and re-instatement of the island after it ceases to operate.

I have decided not to allow for any additional provision at this time.

Accelerated Recovery of The Regulatory Asset Value ("RAV"):

SEL requested that it is allowed to recover from consumers its outstanding RAV over the next two years.

I have decided to adjust the RAV for acquisition assets to £427,922 (on 1st November 2024), to reflect the actual acquisition cost in March 2020, and to allow SEL to recover this from consumers over the next six years. I have also decided that the RAV for new assets, valued at £32,253 (on 1st November 2024), will continue to be recovered over three years.

Legal Costs:

SEL requested that the allowance for legal costs should be increased to include its reasonable legal costs of addressing the legalities of the current situation. SEL also requested that an "agreed percentage figure" of £315,156 historical legal costs should be recovered from consumers over the next two years.

I have decided not to increase the fixed allowance for legal costs, but to consider proposals made by SEL on a case-by-case basis for additional allowances. I have decided not to allow the recovery of historical legal costs.

Impact On Prices:

The table below sets out the current and revised maximum unit price that SEL is allowed to charge under the existing PCO, which ends on the 31st of March 2025. The revised maximum unit price will take effect from the 1st of November 2024.

Current Maximum Unit Price	**Revised Maximum Unit Price**
54 p/kwh	56 p/kwh

It is important to note that the above revised maximum unit price could increase further for approval of additional capital expenditure or legal costs. The maximum unit price may also adjust monthly for changes in fuel prices or consumption.

The modelling forecasts that prices should remain at similar levels for the next few years. However, the model does not take account of any change in circumstance that may have an impact on prices.

2.0 APPLICATION OF INFLATION

SEL's Request and Minded-To Position:

SEL requested that inflation is applied annually to (a) the allowance for fixed operating costs and (b) the allowed rate of return on assets and/or the Regulatory Asset Base ("RAB").

In the consultation paper my minded-to position was to retrospectively increase the allowance for fixed operating costs for 2024-25 by Guernsey inflation in 2023, and to allow the recovery of this in the second half of 2024-25. I was also minded to apply inflation to the allowed rate of return, rather than to the RAB, from the 1st of October 2024.

Consultation Responses:

SEL's Response:

SEL welcomed both minded-to positions in its formal responses to the consultation.

SEL also suggested that I needed to consider evidence on revising the underlying real allowed rate of return, prior to converting this to a nominal basis. This evidence relates to substantial changes in the macroeconomic environment and capital markets, and to Sark and SEL specific risks.

SEL also stated that UK regulators typically fine-tune their annual adjustments to reflect Real Price Effects (RPEs).

Public Responses:

Although a specific question was not asked about inflation in the consultation paper, 7 of the 26 other public respondents expressly agreed that inflation should be applied to fixed operating costs.

One respondent however disagreed with using Guernsey inflation, arguing that it was not representative of underlying inflation in Sark. One respondent highlighted the dedicated work of SEL's employees:

> *"Throughout these years of uncertainty, the small, dedicated team at Sark Electricity has continuously, apart from a few minor outages, supplied electricity to the homes and businesses of Sark, even finding the time and energy to dress the length and breadth of The Avenue with Christmas lights and decorations".*

In a further e-mail, SEL also emphasised that its employees had not yet received a salary increase in 2024.

Final Decision:

The allowance for fixed operating costs (and the dilapidation provision) will be increased from the 1st of April 2024 by 5.8%, which was Guernsey RPI inflation from the 1st of April 2023 until 31st of March 2024. This results in the annual allowance increasing from £330,307 to £349,469.

This increase will be back-dated to the 1st of April 2024 and SEL will be allowed to collect this back-dated amount of £11,177 in the tariff for November 2024. I too appreciate the dedication of SEL's employees and, whilst it is not my role to stipulate how SEL is managed, it would be wonderful to see this dedication recognised as we enter the season of goodwill.

I have also decided that, from the 1st of November 2024, the allowed real rate of return will be converted to a nominal basis using expected Guernsey inflation (as measured by the RPI) of 3.6%, for the period 1st April 2024 until 31st March 2025. The RAB will no longer be adjusted for inflation.

For this PCO variation I have not carried out any analysis of RPEs specific to Sark, although I may do so in any future PCOs or variations. I may also consider outturn inflation compared to ex-ante forecast inflation in my consideration of the future allowed nominal rate of return.

In the next section I consider SEL's request to re-visit the real allowed rate of return.

3.0: ALLOWED RATE OF RETURN

SEL's Request:

In its response to my consultation paper, SEL suggested that I needed to review this value, considering the substantial changes to the macroeconomic environment and capital markets, and the Sark and SEL specific risks.

SEL referenced more recent price controls in the UK electricity sector and argued that, due to the changes to the macroeconomic environment and capital markets, the real rate of return should be increased to between 5.68% and 5.77%.

SEL also argued that the Sark and SEL-specific implicit risk premium of 1.82% was "extremely conservative", for two reasons.

First, networks of small size have significant limitations in accessing capital markets, for example, due to inability to issue benchmark-sized debt instruments. Ofgem, for example, has allowed an additional premium for small district network operators of 26 bps on the cost of new debt, and the smallest of these is roughly 1,000 times the size of SEL.

Second, the regulatory and political risks faced by SEL are likely to be significantly higher than the level of risk faced by UK network operators. SEL referred to the uncertainty created by Chief Pleas' announcement about a replacement grid, and to the regulatory regime immaturity. SEL argues that the risk premium of 1.82% would be clearly insufficient to compensate for the risk of asset stranding – let alone remunerate SEL for the crystalisation of such a risk, were it to suffer a significant RAB revaluation.

Discussion On SEL's Request:

The current PCO, which SEL did not appeal, includes an allowed real rate of return of 5%. In its variation request, SEL did not request that this allowance be re-visited. Nonetheless, I am still prepared to consider SEL's arguments on this issue in its response to the consultation.

I agree with SEL that, due to changes in the macroeconomic environment and capital markets, the real rate of return should be increased.

I do not however agree with SEL that the further risk premium of 1.82% is "extremely conservative". In arriving at this conclusion, I have taken into account the following considerations.

First, SEL provided me with a valuation report for its business prepared in July 2018 and updated in April 2020. In both cases, the analysis used the Capital Asset Pricing Model (CAPM) to estimate a nominal cost of capital of 3.9%. This analysis assumed a company-specific risk of minus one percent, although any risks associated with potential regulation or nationalisation were ignored.

Nonetheless, against SEL's own earlier benchmark and after allowing for regulatory and political risk, the premium in the PCO of plus 1.82% does not appear to me to be "extremely conservative".

Second, I have considered SEL's argument that the risk 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.

The issue of the recovery of SEL's acquisition investment is covered later in this paper. There is a clear recognition that, as a matter of principle and good regulatory practice, the allowance in the PCO must be designed to allow for the recovery of both SEL's acquisition investment in

2020 and any approved new capital expenditure, provided SEL operates efficiently. The design will include an accelerated recovery period that can be changed in response to new developments relating to the construction of a replacement electricity system.

As explained later in this paper, the RAB will be reduced to reflect the actual asset acquisition cost in 2020. This, however, does not equate to the stranding of this investment. It simply removes a future potential windfall that had resulted from the use of an estimated value in the absence of information about the actual acquisition cost.

The real rate of return of 5% in the current PCO was based on the allowed real rate of return for NIE networks of 3.18% in its RP6 price control, suggesting a SEL risk premium of 1.82% real. In the draft determination of the next RP6 price control, the allowed real rate of return has increased to 4.79%. Using the other parameters in this draft determination, this converts to a nominal rate of return of 5.91%. Adding a risk premium of 1.82% results in a nominal rate of return of 7.73%.

Final Decision:

The RAB will no longer be inflated from November 2024. Instead, SEL will receive a nominal rate of return on the RAV of 7.73%.

4.0: ACCELERATED RECOVERY OF ACQUISITION REGULATORY ASSET VALUE ("RAV")

SEL's Request and Minded-To Position:

SEL requested that the PCO is varied such that it recovers its outstanding investment in its acquisition assets over the next two years.

In the consultation paper my minded to position was to accept SEL's request to accelerate the recovering of its outstanding investments in its acquisition assets, but to do this over three years rather than two. I was also minded to us the 2020 acquisition cost for the assets rather than the cost estimated by the WSP model.

Consultation Responses:

SEL's Response:

SEL welcomed my minded-to position to accelerate the recovery of SEL's outstanding investments in existing assets and stated that this approach was in line with good regulatory practice in GB.

SEL also noted that my minded-to position was based on what appears to be a subjective view that it will be about three years before there is any new replacement electricity system. SEL

stated that the task before the Commissioner was to design a robust regulatory framework that allows for the various states of the world that SEL might need to face.

However, SEL strongly disagreed with my minded-to position to retrospectively revalue SEL's RAB, because this was not consistent with good regulatory practice. SEL stated that this may undermine incentives to invest further in SEL, strongly decrease investor confidence in the Sark electricity regime, and increase the required cost of capital for SEL or any other potential investor into the future electricity grid. SEL pointed to an example in Northern Ireland where a retrospective revaluation of the RAB was overturned on appeal.

SEL claimed that the change would significantly lower the expected cashflows for SEL, both through decreased depreciation allowance and significantly lower return on capital allowance in cash terms.

SEL also argued that a RAB based on market value has several important downsides that make it unreliable. Market value disregards all sunk costs and is based on the value in the market at a particular time, and regulators should be wary of using market valuations to set the RAB because investor expectations become self-fulfilling.

SEL also pointed out that section 13(2) of The Control of Electricity Prices (Sark) Law, 2016 lists a number of points that must be taken into account, and it does not imply that any one of the listed factors is determinative. Both the acquisition cost and the replacement cost of plant and equipment are listed, and it is unclear why more emphasis would not be placed on one rather than the other.

SEL also suggested that the Commissioner appears to be of the view that the cost of acquiring the SEL business as a whole equates to the cost of acquiring its plant and equipment. SEL claimed that in this regard the Commissioner was making an error in both fact and law because the price paid in the market can be more or less than the value of the assets owned by the company, not least because of the risk of the market and regulatory environment in which the company operates.

Public Responses:

Most public respondents were of the view that it was optimistic to assume that a new electricity system would be in place in three years' time. Several respondents stated that no changes should be made to the SEL investment recovery period until certain milestones for a replacement electricity system have been achieved. These would include the securing of funding, the appointment of a contractor and a construction program.

Although there may have been some misunderstanding on this point, several respondents supported using the 2020 acquisition cost as the basis for determining SEL's outstanding asset

investment. One respondent pointed out that section 13(2) of the Law refers to the actual acquisition and replacement costs of the assets and not to estimated costs.

Some respondents suggested that SEL's assets had already been paid for through historically high tariffs (and resulting excessive profits), and that there had been no significant asset investment for around 15 years. On this basis, some respondents suggested that consumers had already paid for the assets.

Final Decision:

I will first consider the period over which the outstanding cost of assets should be recovered. Then I will address the basis for determining what these outstanding costs are.

Recovery Period:

I have decided to accelerate the remaining recovery period for the acquisition cost of existing assets to six years, beginning on the 1st of November 2024. The recovery period for the replacement cost of assets (including the recent generator replacement) will remain at three years.

This is a change from my minded-to position of a three-year recovery period for the acquisition cost of existing assets. I have been persuaded by the arguments that there is still insufficient evidence to firmly conclude that SEL will cease to operate in three years' time. I also note that the remaining term of SEL's lease is around six years.

I have also carefully considered SEL's suggestion that the task before me was to design a robust regulatory framework that allows for the various states of the world that SEL might need to face. It is important therefore that any future price control order includes sufficient optionality and flexibility to react to changing circumstances. If, for example, the milestones referred to above were achieved at some point in the future, then the recovery period could be amended accordingly.

I am persuaded that this approach also strikes the right balance between managing prices for consumers, whilst allowing SEL the opportunity to recover its outstanding asset investment costs and a reasonable rate of return.

Outstanding Acquisition Cost of Existing Assets:

I have decided to use the 2020 acquisition cost of the existing assets (i.e. the plant and equipment), rather than a cost estimated by the WSP model, as the basis for setting the Regulatory Asset Value (RAV) from the 1st of November 2024. This is in line with my minded-to position in the consultation paper. This value is £427,922 and I have provided SEL with the details of my calculations.

SEL was strongly opposed to my minded-to position on this matter. In arriving at this decision, I therefore carefully considered the points made by both SEL and consumers in response to my consultation paper, and my duties under The Control of Electricity Prices (Sark), 2016 ("the Law").

I will begin by considering the Law.

The legal functions of my office are to investigate the price charged for electricity and to determine if this price is, or is not, fair and reasonable. In reaching this determination, I must take all material considerations into account, including without limitation several specific matters (listed at section 13(2) of the Law). This requirement also extends to making or varying a price control order.

It seems to me therefore that the principles of fairness and reasonableness should underpin my decision on this issue and that, in taking all material considerations into account, I must examine the particular circumstances associated with this issue.

More specifically, but without limitation, I must take into account any relevant matter in section 13(2) of the Law. I consider the relevant matters here to be:

1. The cost of acquisition of any plant and equipment,

2. The replacement cost of any plant and equipment, and

3. The entitlement of the regulated electricity supplier to receive such a reasonable return, as the Commissioner thinks fit, on the value of the assets (including plant and equipment and working capital).

I therefore must take into account the actual acquisition cost of assets, the actual replacement cost of the assets, and the value of the assets at any time.

The assets used in electricity systems typically have useful lives ranging between 10-60 years. It is usual for regulators to allow for capital cost recovery, in equal yearly amounts, over the useful life of the asset together with a reasonable rate of return on the outstanding investment.

The Law, and equivalent legislation in the UK, does not specifically refer to what is known as the Regulatory Asset Base (RAB). However, regulators and utilities establish a RAB to record and compute the information relating to matters 1-3 above, i.e. the actual acquisition costs of assets, the actual replacement costs of assets, and depreciation payments made to date by consumers. The Regulatory Asset Value (RAV) at any time is then computed as the summation of the actual acquisition costs (or replacement costs), minus depreciation payments to date.

My office established a RAB on this basis from the first price control order in 2017 and has employed this approach for all subsequent price control orders and variations. This approach properly takes account of acquisition costs, replacements costs and the regulatory asset value. I therefore do not agree with SEL that I have placed undue emphasis on acquisition costs.

Any emphasis on acquisition costs has resulted because of the difficulty in establishing what these were. For the first two price control orders (in 2017 and 2019), the previous owner of SEL was unable or unwilling to provide my office with an asset register containing details of actual acquisition costs and dates, actual replacement costs and dates, expected useful lives, and how much of the costs had already been charged to consumers.

It was therefore impossible for my office to comply strictly with the requirements of section 13(2) of the Law because it was unable to establish the actual acquisition costs, actual replacement costs and actual depreciation payments already made by consumers. To establish a RAB and to determine the opening RAV value, my office therefore had to use estimated values, provided by SEL for the 2017 price control order, and provided by consultants WSP for the 2019 price control order.

In March 2020, SEL was acquired by a new owner. This presented an opportunity to establish the actual acquisition costs of the assets in March 2020 and therefore an accurate value for the RAV at that time. However, my office was again unable to obtain this information from SEL As such the RAV used in the January 2021 variation continued to be based on the estimated values provided by consultants WSP. The October 2022 determination and the April 2023 price control order were also based on the WSP estimates but the RAV was reduced because a report by consultants Energy People in 2021 had concluded that some assets were now fully depreciated.

I have since been able to establish what the actual acquisition cost of the SEL business was in March 2020, and what the outstanding liabilities were at that time. I have not been able to establish if there were any current assets at that time, in the form of cash or fuel stocks. However, if one assumes pessimistically that the value of the current assets was zero, subtracting the liabilities from the business acquisition cost equates to the maximum acquisition cost of the assets. This provides an actual, rather than an estimated, opening RAV value in March 2020. The RAV value today can then be computed by subtracting all depreciation payments made by consumers from that date.

I now wish to address the arguments made by SEL on this issue in its response to the consultation paper.

First, SEL argued that a retrospective revaluing of the RAB would undermine incentives to invest, decrease investor confidence and increase the cost of capital.

I want to begin by clarifying that I am not re-calculating the allowed return on capital for the period from March 2020, such that these are based on the March 2020 acquisition cost of the assets rather than the WSP estimate. I am therefore not clawing back any surplus return that SEL received due to the WSP estimate value being higher than a valuation based on the actual acquisition cost. I am however adjusting the RAV downwards from the 1st November 2024 to reflect the acquisition cost in March 2020 and depreciation payments since that time. Future allowed returns will be based on this revised value.

I accept SEL's point that investors prefer a stable regulatory environment, with a stable and predictable RAB, and that this should result in a lower cost of capital. This is clearly a relevant consideration. I am also very much aware of the case referred to in Northern Ireland where an adjustment to the RAV was overturned on appeal.

However, no two cases are ever the same. For this case, I must take into account all relevant considerations and the requirements of the Law. My judgement must be based on the principles of fairness and reasonableness for all stakeholders. It seems to me that the following considerations are also relevant:

1. When considering a variation to a price control order, it seems reasonable and fair to me to consider new material evidence that will have an impact on electricity prices. In this regard, I note, for example, that SEL has asked me to consider new evidence that has resulted in an increase in the allowed cost of capital for SEL[1] from 5.00% to 7.73%.

2. If I were to continue using the WSP estimate for the RAV, SEL would receive a windfall gain. This is because SEL would continue to get additional capital re-payments, together with a return, without having ever invested this capital to acquire assets in the first place. This in turn would result in electricity prices being higher than they needed to be and have an adverse effect on both fuel poverty and economic growth. In my view, such an outcome would be neither fair nor reasonable.

3. Before the enactment of the Law in 2016, SEL had very high tariffs and enjoyed excessive profits. In addition to this, there has been little capital investment in SEL since then. It is therefore likely that, effectively, historic tariffs recovered capital costs on an accelerated basis, rather than on a straight-line basis over the useful life

[1] This new evidence was contained in the draft determination for a Northern Ireland Electricity Price Control published in November 2023.

of the assets. This in turn would imply that the use of straight-line depreciation in the WSP model has resulted in an over-estimation of the RAV.

4. When SEL was acquired in March 2020, legal due diligence could have established that, in making or varying a price control order, my office was required to take into account the actual acquisition costs and the actual replacement costs of assets. The potential new owner could also have established that my office had been trying to obtain this information but that the existing owner was unwilling or unable to provide it.

5. SEL is also aware that my office had requested information about the March 2020 acquisition price for the variation to the price control order later that year, but SEL did not provide it.

6. When SEL was acquired in March 2020, the new owner could have established during due diligence that the basis for determining the RAV had already changed between the 2017 and the 2019 price control orders. In 2017 the RAV was based on an estimation provided by SEL, and in 2019 the RAV was based on an estimation provided by consultants WSP. In the 2022 determination, the RAV asset value was changed again following new information provided by consultants Energy People. Therefore, there already has been a history of changes to the RAV, before and after the March 2020 acquisition, largely because of the use of unreliable estimates.

I now wish to address the points made by SEL about the use of market valuations as the basis for establishing the RAV. I agree with SEL that it would not be good regulatory practice for a regulator to adjust the RAV to the latest market value every time the business is sold. However, there is an important distinction to be made here. In utility regulation in the UK, the opening RAVs were based on the initial market valuations at privitisation. These valuations were typically less than the book valuations. I do not consider the use of the realisable market value for SEL in March 2020 to be inconsistent with this approach, given that this was the first market valuation since the introduction of price regulation.

SEL also suggested that I was making an error in both fact and law by taking the view that the cost of acquiring SEL as a whole equates to the cost of acquiring its plant and equipment. SEL stated that 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 the company operates.

I do not agree with SEL's suggestion for the following reason.

There are different methodologies for valuing a business. These include a cost approach, a market approach, and an income approach. It is clear to me that the Law points to a cost approach for valuing the assets, given that acquisition and replacement costs are identified as material considerations. The RAV used by regulators in the UK is also computed based on a cost approach.

As part of its response to this consultation, SEL also provided me with a valuation report from a consultant from July 2018 and updated in April 2020. This report explains that one way of applying the cost approach is to consider the net asset value of the company. This method values the assets less the liabilities at a given date on either:

1. A break-up basis, which assumes the business is no longer a going concern and that the assets will be sold under a forced sale scenario, or

2. A going concern basis, which assumes that the assets are not sold under a forced sale scenario but are to be valued on an open market basis between a willing buyer and a willing seller.

In March 2020, SEL was sold on a going concern basis between a willing buyer and a willing seller. I valued the SEL assets in March 2020 by adding the cost of the liabilities to the purchase price that was paid for SEL as a whole. In my view, this approach is consistent with the Law and the cost-based approach to valuing assets.

In relation to SEL's point about risk, I would note that SEL is compensated for bearing risk in the allowed rate of return.

SEL claimed that the change would significantly lower the expected cashflows for SEL, both through decreased depreciation allowance and significantly lower return on capital allowance in cash terms. However, taking the variations to the price control order together, the total cashflows from the depreciation allowance and the return on capital are more or less unchanged.

5.0: NEW CAPITAL EXPENDITURE

SEL's Request and Minded-To Position:

SEL presented capital expenditure proposals and requested that these were expressly approved or expressly disapproved. These proposals totaled £573,898, and SEL requested that the investment was paid for by consumers over the next two years. The proposals consisted of the replacement of generators, cables, switchgear and transformers.

Although SEL was confident that all the replacement works could be completed over the next two years, it was unable to provide an indicative work program. SEL also stated that the scope of the replacement work could not be reduced, and that it was not willing to facilitate an independent technical review of its proposals.

Capital expenditure has already been approved for £36,472 for a replacement generator. This work has been completed and the new asset has been added to the RAB. My minded-to position was that I would approve any other investments recommended by an independent technical review of SEL's proposals and that, in the meantime, I will also immediately consider for approval any asset replacements that SEL considers needs to happen urgently.

I was also minded-to to allow SEL a project management fee of £31,250 over a three-year period, subject to periodic reviews, to ensure that SEL was working to deliver the approved projects.

Consultation Responses:

SEL's Response:

SEL claimed that, whilst the Commissioner had recognised the importance of SEL being able to carry out the necessary investments to operate a safe and reliable grid, he had decided to reject SEL's request for a £537,426 capital investment programme. Instead, the Commissioner was minded to accept any investment recommended by an independent technical advisor and to approve a project management fee. SEL stated that this placed pressure on its ability to maintain a safe and reliable grid.

SEL pointed to other electricity regulators in the UK approving capital expenditure to ensure health and safety.

SEL highlighted the example in the consultation paper of a proposal to spend £99,000 on fencing and asked who will be held to blame if a safety incident occurs for want of this expenditure.

SEL stated that the assets replacements in its proposals were already determined as being necessary by independent engineering consultants, although SEL itself contests a number of the assertions and assumptions made in those reports. SEL stated that notably those reports apply the standard expected under UK legislation to Sark where no such legislation applies.

SEL repeated its assertion that it could not prioritise within its proposals because all the works were required.

SEL claimed that the Commissioner's intent was to push out the timing of any expenditure and that it was difficult to see how his proposed approach will allow for any expenditure in the remaining life of this PCO.

Public Response:

Several respondents stated that this capital expenditure should have been made years ago and that, given the historical over-pricing, SEL rather than consumers should pay for asset replacements now.

Several respondents claimed that there was no justification for such a level of expenditure for such a short remaining life. One respondent stated that the proposed costs may be exaggerated. One respondent said that he felt confident that, with general maintenance and a few safety upgrades, the infrastructure could be "nursed" along for a few more years.

Some respondents stated that the system must be safe irrespective of its remaining life, and that necessary expenditure should be recoverable with a reasonable return. One respondent stated that it was a shame that Sark had no licensing law that could impose conditions on providers.

Several respondents pointed out that, after three years, many of the replacement assets will still be relatively new and will have a residual value. Some suggested that some equipment may be usable in the replacement electricity system. Some suggested that ownership of this equipment should rest with the people of Sark.

One respondent stated that there must be an agreed plan by which assets paid for by consumers are transferred to the new operating company and that, in the absence of such an agreement, SEL alone should meet the cost of essential replacements.

One respondent stated that there should be a 3-year rolling programme for capital expenditure, reviewed annually.

Some respondents stated that SEL should provide an indicative programme, and that its proposals must be subject to independent scrutiny to confirm that the costs are reasonable, necessary and appropriate. Otherwise, SEL's proposals represent an unacceptable risk of nugatory expenditure.

One respondent, with experience in tendering, stated that it was unacceptable that SEL could not provide an indicative programme. The fact that SEL is confident that it can complete the work in two years was either based on an existing indicative plan or wishful thinking. Another respondent stated that completion in a two-year period does not stand up to scrutiny and that some of SEL's proposals (i.e. trenching to remove an old transformer) made no sense.

Final Decision:

It is standard practice for regulated utilities to provide regulators with the details of their proposed capital expenditure plans. Typically, these include an indicative work programme together with the associated expenditure profile, the basis for the estimated costs, and the drivers for the expenditure. It is also standard practice that the regulator will then use technical consultants to help access these proposals. This assessment will typically examine the need for the investment, and if the proposal represents the least cost technically acceptable solution. Regulated utilities typically do everything that they can to accommodate the regulator's requirements, such that proposed investments can be executed and added to the RAB as soon as possible.

My requirements from SEL have been straightforward in regard to its capital expenditure proposals. The price control order required SEL to re-submit its proposals prioritised on the basis of safety and reliability. SEL committed to provide this but, in spite of many reminders, I have never received it. SEL has also never been able to provide an indicative work programme with associated expenditures.

Notwithstanding this, I approved expenditure of £36,472 for a replacement generator on an ex-post basis, after SEL provided me with evidence of the expenditure. I have also stated in the consultation paper, published on the 3rd of September 2024, that I will immediately consider for approval any individual asset replacements that SEL considers needs to happen urgently, prior to any assessment by a technical consultant. I have still not received anything from SEL.

SEL has stated that I have decided to reject its capital expenditure proposals and that instead I am only minded to accept any investment recommended by an independent technical advisor. This is a misrepresentation of what I have stated. I have not rejected SEL's proposals and, as other respondents have stated, it is reasonable to expect the provision of some basic information prior to approval and to conduct some level of scrutiny, with the support of a technical advisor if necessary. I am increasingly of the view that SEL, for whatever reason, is either unwilling or incapable of providing this basic information.

The existing price control order already addresses capital expenditure and I do not consider that it needs to be varied. My minded-to position was that I would approve any investments recommended by an independent technical review of SEL's proposals and that, in the meantime, I will also immediately consider for approval any asset replacements that SEL considers needs to happen urgently. I was also minded-to allow SEL a project management fee of £31,250 over a three-year period, subject to periodic reviews, to ensure that SEL was working to deliver the approved projects.

My final decision is the same as my minded-to position. Given that there are only five months left of this price control period, and that logistically not all work can proceed at once (whilst maintaining a reliable supply), I am again inviting SEL to submit to me for urgent approval what asset replacements in would like to commence during this period.

I will also allow for the monthly project management to commence from the 1st of November 2024, with a review of progress during January 2025.

New assets will be added to the RAB after completion of the work and evidence of actual expenditure is provided. These assets will be depreciated over a three-year period.

Given that these new assets may still have considerable residual value after three years, and that consumers will have fully paid for them, this decision is based on the understanding that consumers in Sark are entitled to that benefit. Given that different paths could arise in Sark, I have decided not to determine at this stage how that benefit should be realised.

6.0: DECOMMISSIONING AND RE-INSTATEMENT PROVISION

SELs Request and Minded-To Position:

SEL requested that the PCO is varied such that it is allowed to accumulate an additional provision of £980,370 over the next two years for de-commissioning of its equipment and re-instatement of the island after it ceases to operate.

In the consultation paper I stated that I was not minded to accept SEL's request. I was however minded to allow SEL to accumulate the outstanding provision for dilapidations at the power station over the next three years, rather than until 2030.

Consultation Responses:

SEL's Response:

SEL stated that, because it is still operational, it would not be reasonable to expect that it would have already received requests to remove its equipment.

SEL stated that it does not have any legal rights in the first place to have its equipment on land and hence a landowner has the right to require its removal. Therefore, leaving equipment in situ would, in effect, represent an ongoing contingent liability of SEL having ceased to supply upon deployment of a new grid. SEL referred to the very fact of Mr. Moerman successfully obliging SEL to remove the equipment from his tenement is evidence thereof.

SEL claimed that changes by the Commissioner to the basis of the inflation allowance and depreciation was driven by preparedness for the eventuality that SEL's asset base is decommissioned, and that it would be inconsistent for the Commissioner not to allow SEL to build up a fund to pay for this scenario.

SEL cited examples of regulators in the UK and Europe allowing for pre-funding of decommissioning costs, including the decommissioning of Sizewell C nuclear power station.

SEL stated that deferring the requirement to pre-fund would tend to lead to higher tariffs later and that, if decommissioning does not materialise, SEL could commit to giving back the funds to consumers.

Public Responses:

Many respondents supported the minded-to position in the consultation paper. No respondent was in support of building up a provision of almost £1m. One respondent suggested that building up such a provision from 500 people would be madness.

One respondent considered that it would never be necessary in any case to remove the underground grid.

Some respondents considered that the present owner should have been aware at acquisition of any requirement to decommission the power station.

A few respondents stated that there were no legal requirements to decommission. One respondent noted that, as the company would cease to exist, there would be no one to carry out any decommissioning that might be required.

Final Decision:

My final decision is the same as my minded-to position in the consultation paper. I do not accept that SEL needs to build up a provision of nearly £1m over the next two years.

Furthermore, I have decided that the remaining provision for dilapidations at the power station will be built-up over the next six years, consistent with the present arrangements. This is a change from my minded-to position.

I do not accept SEL's argument that not accumulating a fund is inconsistent with accelerating the return of SEL's investment. SEL's investment crystallised in 2020. A requirement to decommission has not crystallised, beyond perhaps the dilapidations at the power station.

I do not accept SEL's argument either that this represents a contingent liability that should be funded at present. I note that SEL itself has had a provision in its accounts for the last four years for dilapidations, but no further provision beyond that. SEL also has had a regulatory

allowance for dilapidations in the last two price controls but did not previously seek an additional provision beyond that.

At present, there is insufficient evidence to conclude that material decommissioning costs will occur and what the cost will be. The issue can be kept under review and visited again if necessary

7.0: RECOVERY OF LEGAL COSTS

SEL's Request and Minded-To Position:

SEL requested that the fixed cost element of the PCO was increased to take account of its reasonable legal costs in the current situation. SEL incorrectly claimed that the existing PCO did not include any allowance for legal costs.

SEL also requested that an "agreed percentage figure" of £315,156 historic legal costs is paid for by consumers over the next two years.

My minded-to position was that the existing allowance for legal and regulatory costs in the PCO was sufficient to cover reasonable legal and regulatory costs incurred during the process of responding to determinations, PCOs, or variations.

I also accepted that the announcement by Chief Pleas to build a replacement electricity system created a situation for SEL that may well require some additional legal support in the coming years. I was minded-to consider proposals by SEL on a case-by-case basis, given the uncertainty about what the exact nature and purpose of that legal support might be. I added that I would not expect the total allowance for regulatory and legal costs to exceed £30,000 per year.

Consultation Responses:

SEL's Response:

SEL strongly disagreed with the minded-to position.

SEL claimed that the Commissioner contradicted himself by acknowledging the level of uncertainty but then setting maximum allowance.

SEL claimed that the price control order did not clearly indicate what the allowance was for legal and professional services.

SEL also appeared to claim that the Commissioner had a conflict in assessing if legal advice to challenge his work was unnecessary or inefficient.

SEL's position was that historic legal costs should have been recoverable hrough the unit price, and therefore still should be.

SEL considers that legal costs should be the subject of a reasonable assessment and taxation. What SEL cannot accept however is that this should be the responsibility of the very authorities with which it is most likely to enter legal dispute.

Public Responses:

Several respondents supported the minded-to position in the consultation. No respondents supported SEL's request.

Some respondents commented that the evidence suggested that the present owner was somewhat litigious, and that advice from different professionals would have been sufficient and cheaper. One respondent stated that wasting money on lawyers was the choice of the company and therefore that consumers should not pay. Another respondent was fundamentally opposed to paying historical legal costs given the historically high tariffs already incurred by consumers.

One respondent suggested that only unavoidable legal costs should be paid for by consumers.

Final Decision:

My final decision is the same as my minded-to position, as set out above.

I want to address some of the points made by SEL.

Whilst the allowance for legal costs and professional services may not always have been clearly set out in previous PCO decision papers, they would have been set out in the prior consultation paper. Furthermore, SEL responded to those consultation papers and ultimately either accepted or appealed the final PCO decision.

SEL suggests that the Commissioner has a conflict of interest in setting allowances for legal and professional costs. However, this is the same arrangement for regulators in the UK, including Ofgem whom SEL refer to. Utility providers in the UK, like SEL, have a right to appeal against a price control order. The appeal body can amend the regulator's allowance for legal and professional services. It also typically decides on the allocation of legal and professional services costs associated with the appeal.

The PCO is based on an ex-ante allowance for legal and professional costs. As I set out in my minded-to position, consideration will also be given to other circumstances that may arise and reasonably require legal or professional support. I would expect that SEL would bring such a case for my consideration and approval prior to the incurrence of any such costs.

My experience with SEL has been that it has sought the recovery of significant legal costs after the event, and without my prior approval or knowledge. SEL has presented me with invoices, after the event, that had a broad title like "regulatory dispute", but which were completely

lacking in any detail. It would not be good regulatory practice to approve such costs on this basis.

8.0: OVERALL IMPACT ON THE MAXIMUM UNIT PRICE

Maximum Unit Price Formula

The 2003-2005 PCO set a maximum unit price at 53 p/kwh, which was later increased to 54 p/kwh for new capital expenditure. The formula below sets out how the maximum unit price is calculated. This cap is adjusted (monthly or annually) for movements in fuel prices and demand, new capital expenditure, depreciation and inflation.

MUP (p/kwh) = [AFCC –OR] / D + [VFCC] + K

Where:

MUP =Maximum unit price (p/kwh),

AFFC = The allowed fixed cost component (p),

OR = Other Revenues (p),

D = SEL Demand (kwhs),

VFCC = Variable fuel cost component (p/kwh), and

K = Correction factor (p/kwh)

8.3: Key Modelling Assumptions

1. Annual demand is 1,340,000 kwhs, for 2024-25 and 1,400,000 for 2025-26
2. The variation takes effect from 01st November 2024,
3. Fuel prices remain at 24.95 p/kwh,
4. SEL's other revenues remain at £75,760 per year,
5. Fixed operating costs are indexed annually by Guernsey inflation,
6. Guernsey inflation was 5.8% for 2023-24 and
7. SEL receives an allowed nominal rate of return of 7.73%.

Modelling Results

The maximum unit price resulting from the above scenarios are set out in the tables below. F

Maximum Unit Price (p/kwh)

Period	**Nov 24 - March 25**	**April 25 - March 26**	**April 26 - March 2027**
	55.76 p/kwh	54.63 p/kwh	54.94 p/kwh
