



Office of the Sark Electricity Price Control Commissioner

Review of Price Control Order of 20th December 2019 & Proposed Variation

October 15th 2020

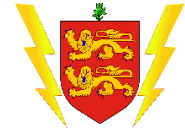
Summary

1. Electricity consumption in Sark has been considerably lower than anticipated for the purposes of the Price Control Order that I made in December 2019 in my capacity as Commissioner. This is as a result of the lower level of economic activity caused by the Coronavirus pandemic but compounded by the substantial errors discovered by Mr Alan Jackson (in his capacity as Sark Electricity Limited's ("SEL") new owner) in the historic consumption data provided by SEL to my Office last year. In addition, I am aware that SEL might invest in a capital replacement programme necessary as a result of the continuing degradation of SEL's equipment and to maintain supplies to a specific group of residential properties located in the north eastern area of Sark. Therefore, I have undertaken a review of the PCO, based on actual levels of consumption and diesel fuel prices.
2. Further to my review, I propose to reset the maximum price SEL may charge for electricity at around 58 p/kWh for the next year. My calculations suggest that this would allow SEL to recover £65,000 (6p/kWh) over the year to make up for the shortfall resulting from the lower electricity consumption and earn an appropriate return on its investment. Once the £65,000 has been recovered, presumably after one year, the price will likely fall to about 52p/kWh.
3. In future, I propose that the maximum price will be adjusted every four months. This should avoid the need for large adjustments to the tariff that would follow from deviations in consumption and diesel fuel prices from my assumptions.

Background

4. On finding that the 66 p/kWh price of electricity charged by SEL¹ was not fair and reasonable, my Office made a Price Control Order (PCO) on 20th December 2019 under section 15 of The Control of Electricity Prices (Sark) Law, 2016 (The "**2016 Law**"). In accordance with section 15(3)(a) of the 2016 Law, this specified a maximum per unit price of 54 p/kWh at which electricity could be sold in Sark until December 2021.
5. On April 30th 2020, Mr Jackson informed me that the consumption figures provided to my Office by SEL's previous owner were seriously in error. The consumption for 2018 had been significantly overstated and the electricity consumed by the auxiliary power station plant had been erroneously included in the sales. Consequently, he advised that it was extremely likely that actual consumption of electricity by customers in Sark during 2020 would be well below 1,500,000 kWh and so the price in the PCO should have been set at a higher level.

¹ See Determination 8th November 2019 at www.epc.sark.gg

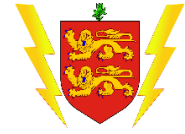


6. I recognised the uncertainty in the estimates of electricity consumption and diesel fuel prices when I calculated the price set in the PCO. The PCO included a price adjustment mechanism whereby, if consumption turned out to be lower than the 1,500,000 kWh estimate, the maximum per unit price would be increased in January 2021 to allow SEL to recover the revenue shortfall over the following year. Similarly, if the average price of diesel fuel, as indicated by the average UK untaxed price, was different from the 52 p/litre assumed in the PCO, the maximum per unit price for 2021 would be adjusted to account for any under or over charging.
7. On two occasions, I have asked SEL whether it would prefer the price to be adjusted more frequently, but I did not receive a reply. Nevertheless, if the actual consumption is so low that the ongoing viability of SEL as a business may be threatened, then SEL might not survive to recover the revenue shortfall. That would be unfair to SEL's owners. I wrote to SEL in May 2020 advising that, according to the information provided to me by SEL, the company should have been operating profitably, despite the impact of the Coronavirus on consumption levels. I therefore did not see the need for a Variation, given the existence of the under-recovery mechanism. SEL claimed that there were errors in my calculations but has been unwilling to provide details, despite numerous requests to do so.
8. SEL had also informed me of an intention to make changes to the tariff structure, as presented to residents of Sark at a meeting at the Island Hall on 2nd July 2020. The proposed changes would, as I understood them, involve material increases in standing charges. In order to implement the proposed changes, a Variation to the PCO would need to be made. I have been awaiting details of these proposals.
9. On 24th June 2020, Mr Jackson informed me that a customer had requested that SEL remove electrical equipment and cables from his property. This was in circumstances where SEL did not appear to have any express right (e.g. under an extant wayleave agreement) to place upon the property and use the equipment and cables concerned. In addition, the removal of the equipment and cables would also jeopardise the ability of SEL to continue to supply 19 residences that were connected to the grid via the equipment and cables concerned. Mr Jackson subsequently wrote to me on 2nd July, 2020 and requested me to undertake a review of the PCO of 20th December 2020. Amongst other things, he indicated that any legal expenses incurred as a result of any refusal by SEL to acquiesce to the customer's request should be recovered from customers through the tariff. Mr Jackson has also since claimed² that the cost of unbudgeted remedial works to keep the 19 residences connected would be substantial.
10. In view of all the above matters, I am therefore considering whether to vary the maximum per unit price SEL, as a regulated supplier, may charge for electricity in Sark, as permitted under section 15(6)(a) of the 2016 Law.

Legal Framework for a Variation

11. I have powers under section 15(6) of the 2016 Law to vary the maximum price of electricity supplied in Sark at any time. When considering whether to make a Variation,

² SEL, Open letter to Commissioner 5th September 2020



section 16(1) of the Law obliges the Commissioner to take all material considerations into account including, without limitation, the following matters, as set out in section 13(2) of the 2016 Law:

- a. the cost of generating and distributing the supply of electricity, including the cost of
 - i. Acquisition and maintenance of any plant and equipment,
 - ii. Fuel and other consumables, and
 - iii. Labour

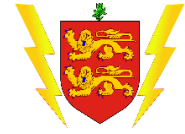
required to generate the supply.

- b. The replacement cost of any plant and equipment required to generate and distribute the supply,
- c. The quality and reliability of the supply of electricity and the economy and efficiency with which the supply of electricity is generated and distributed,
- d. The margin of profit obtained by the regulated supplier,
- e. The margin of profit obtained by such other electricity suppliers generating and distributing a supply of electricity in similar circumstances in such other islands as the Commissioner thinks fit,
- f. The entitlement of the regulated supplier to receive such reasonable return, as the Commissioner thinks fit, on the assets (including plant and equipment and working capital) operated or used by the supplier for the purpose of generating and distributing the supply, and
- g. Any representations made in response to a request given under section 14, or otherwise.

12. I described my consideration of the above matters in the Draft Determination of 1st October 2019³. I explained (paragraph 19) that I interpret the 2016 Law to imply that I must consider the costs that a reasonably efficient and cost-conscious supplier would incur in providing the supply of electricity in Sark. Accordingly, under matters a., b., d., & f. as set out in paragraph 11 above, I have made estimates of the costs of annual labour, services, operations, administration and the profit that would be fair for investors, based on the value of the assets employed to deliver the supply. In order to calculate a reasonable return and profit, WSP consulting engineers provided my Office with a valuation of the electrical assets and, in line with consideration e., as set out in paragraph 11 above, I considered the returns enjoyed by other network utilities in the UK and in other islands. SEL has stated that it will not challenge my approach⁴ as set out in the Draft

³ I consider Sark Electricity Holdings Limited and its wholly owned subsidiary Sark Electricity Limited as a combined entity. This is consistent with the way in which the companies are managed and operated. They are “associated” companies according to section 5(9)(b) of The Law.

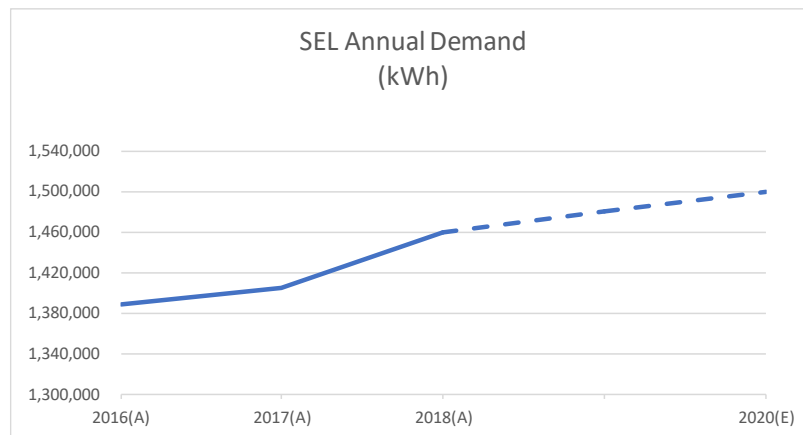
⁴ Consent Order, Court of the Seneschal, Sark; 3rd April 2020



Determination of 1st October and the Determination of 8th November 2020. Indeed, I note that SEL's fixed costs (labour, services, operations, and administration) for the period January to July 2020 are consistent with my estimates⁵.

13. I also made an estimate of the likely electricity consumption in 2020, based on SEL's reported electricity consumption figures for 2016-2018. These showed a small increase through to 2018 and I projected a further increase to 2020, albeit at a slower rate, as shown in Figure 1 of the PCO, reproduced below. The variable costs were derived from technical details of diesel engines and world fuel costs, adjusted for delivery to Sark. This is set out in the 1st October 2019 Draft Determination at paragraphs 49 to 50.

Figure 1
Consumption Forecast



Source: PCO, page 8, December 2019

14. In deciding whether or not to vary the current price, the matters that require further consideration are, in my view:

- a) errors in the consumption figures previously provided by SEL,
- b) diesel fuel prices and cost assumptions in the Determination,
- c) impact of customers choosing to disconnect from the SEL network,
- d) costs arising from one customer's request to disconnect from the SEL network,
- e) "under-recovery" due to SEL under the current PCO,
- f) quality of supply,
- g) the reasonable profit for SEL, and

⁵ SEL's email to Conseillers, 16th September 2020



h) SEL's right to place and operate equipment on others' property.

a) Errors in SEL's historic consumption figures

15. Mr Jackson, who took control of SEL in March 2020, informed my Office on 30th April 2020 that the historic consumption figures provided by SEL contained two serious flaws. In the first place, the 2018 figure had been overstated by 102,109 kWh by Mr David Gordon-Brown (who effectively managed SEL immediately before this role was taken on by Mr Jackson) in an attempt to correct for overcharging customers in November 2018. I do not understand the logic of such an adjustment process. Nevertheless, since publishing the PCO, I have been provided by Island of Sark Shipping (IOSS) with the fuel delivery figures for SEL. These show that deliveries of fuel to SEL fell by 9% from 2017 to 2018, so that, even allowing for possible changes in stocks, the consumption of electricity in 2018 was likely to have been lower than in 2017.
16. Mr Jackson also advised that it appeared that the electricity consumption of the cooling system for the generating engines had been mistakenly included in the figures since mid-way through 2017. This implies that the actual consumption was likely to be around 5% lower than reported by SEL since, I assume, around June 2017 when these meters were installed. Mr Jackson believes, on account of these errors and the impact of the Coronavirus on economic activity and consequently on electricity consumption, that the actual consumption for 2020 is likely to be well below the 1,500,000 kWh estimate in the PCO.
17. The historic electricity consumption figures provided to me, at different times, by SEL are shown in Table 1. I have received four estimates of the consumption for 2019 in the past six months. They range from 1,261,038 (12th May) to 1,297,236 (16th September) kWh. SEL does, however, believe that the records of revenues recovered from customers are reliable and a reconciliation of tariff revenues and unit tariff prices leads me to consider that consumption in 2019 was likely to have been around 1,297,000 kWh, although I have not been able to verify these figures.

Table 1

SEL Estimates of Actual Annual Consumption (kWh) & basis of EPC forecast for 2020

	SEL			EPC
	2018	12&14 May	16-Sep	PCO
2015	1,519,106	1,519,106	1,511,229	
2016	1,388,158	1,388,158	1,594,409	1,388,158
2017	1,404,749	1,332,837	1,485,440	1,404,749
2018	1,459,597	1,297,205	1,236,349	1,459,597
2019	1,315,369	1,261,038	1,294,128	1,297,236
2020				1,500,000

Note: SEL provided consumption figures on 12th May 2020, and the readings of the auxiliaries' meters on 14th May. Two different figures for 2019 consumption were presented in documents delivered on 16th September 2020.



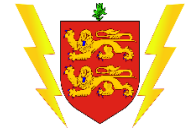
18. I agree with SEL that consumption in 2020 is likely to be lower than the 1,500,000 kWh I forecast, owing to SEL having inflated earlier figures, coupled with the impact of the Coronavirus on the economy. Over the period January to July 2020, electricity consumption was 18% lower than in the same period for 2019. According to Isle of Sark Shipping Company's (IOSS) records, deliveries of fuel to SEL fell by 8.7% over the nine months to end September 2020, compared to the same period in 2019. Assuming that there has not been a large movement in stocks, there has been no overall change in the efficiency of the electricity system, and economic activity continues to be depressed by Coronavirus-related restrictions, I estimate that electricity consumption is likely to be around 12% lower for the year, i.e. around 1,140,000 kWh. I believe it would be prudent to assume that economic activity, and hence electricity consumption, will remain at this level for the following year.

b) Diesel Fuel Costs

19. Fuel prices are a major driver of the cost of producing electricity by the SEL system. I am keen to ensure that SEL has an incentive to operate efficiently so that it may be rewarded if it operates efficiently, and vice versa. The Draft Determination of 1st October 2019, at paragraph 49, described how I estimate the fuel costs of electricity generation. I assumed a 10% degradation in efficiency of a similar but new, diesel engine and based the fuel cost on the published average UK untaxed road diesel price. I also allowed 5% losses in the power station's auxiliary equipment and 7% losses on the distribution network. Based on SEL's reported consumption figures for 2011 to 2017, the UK untaxed price followed SEL's derived fuel costs reasonably well. In effect, there appeared to be a 7 p/litre differential between SEL's yearly average delivered fuel cost and the average UK price. With these assumptions, I calculated that the fuel would cost around 19⁶p/kWh. In the event, SEL's actual fuel cost in 2019 amounted to 18.2 p/kWh⁷.
20. However, it seems that the generators may have been delivering less power to customers from the fuel consumed, given the inclusion of the auxiliaries in the reported figures. Since February 2020, I have been supplied with the volumes of fuel delivered to SEL as well as the cost of untaxed diesel fuel delivered to both SEL and IOSS. The average cost of fuel delivered to SEL in 2019 was 53.3 p/litre, rather than the 59 p/litre assumed in the Determination and PCO. It appears that the inclusion of the auxiliary loads in the consumption figures had masked the lower delivered cost of fuel.
21. In order to estimate future fuel costs, I propose to use the assumptions concerning the diesel engines' efficiency and system losses described in the Determination and IOSS's purchase price to arrive at the delivered fuel cost for SEL. This should be advantageous to SEL on account of its ability to purchase fuel at a more competitive rate than IOSS, owing to its larger consumption of fuel. IOSS's fuel prices are currently £303.5/1000 litres or 30.35p/litre. I will add IOSS's delivery charge of 6.74 p/litre to arrive at a price of approximately 37 p/litre.

⁶ Reported as ~19 p/kWh in the 1st October 2019 Draft Determination.

⁷ SEL 2019 Draft Accounts, assuming 1,297,000 kWh consumption.



c) Customers choosing to disconnect from the SEL system

22. The Determination⁸ explained why I believe that SEL's current approach to own generation represents a threat to the continuation of an integrated electricity system in Sark. Although the company has stated that it welcomes the introduction of renewable power, its Policy no 26, which describes its approach to customers generating their own power, effectively forces customers wishing to generate their own power to disconnect from the grid. If they do not disconnect and agree to the "buy-back" arrangement, SEL will buy all the output from these customers at 15 p/kWh but charge them for all electricity consumed at the SEL tariff, 54 p/kWh, even if they have generated it themselves. It is therefore not surprising that some wealthier customers have chosen to disconnect.

23. On 5th September 2020, Mr Jackson informed me, for the first time, that there were technical reasons why the SEL system could not connect anymore own generation. He had spoken to the engineer whose company, North Lincs Engineering Limited, had installed the control system and currently provides maintenance services to SEL. Mr Jackson reported that⁹:

"...his expert opinion is that we are at the limit of input from customers own generation until such time as the new bi-directional transformers and battery buffers are in place."

24. I was surprised by this statement. In the first place, David Gordon-Brown had written to me on 19th June 2019 saying:

"Our grid happens to be very well suited to distributed generation and would need minimal enhancements"¹⁰

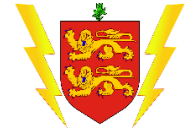
25. Moreover, my earlier experience in the industry and my knowledge of physics led me to question this assertion about the need for new bi-directional transformers. Transformers are intrinsically bi-directional, unless they have sophisticated tap changers, and I do not believe any are installed on SEL's transformers. As a result, I spoke to the engineer at North Lincs Engineering Company. He did not agree with Mr Jackson's claim that the SEL system was at its limit. He thought that the current system might well be able to accommodate more renewable electricity, though there would be a limit eventually. He agreed that in circumstances where batteries were incorporated in the customers' own generation systems, SEL's system integrity could be improved if the customers remained connected. In extremis, it would be possible for larger own generators to install a switch to disconnect automatically, were the grid imperilled.

26. Furthermore, Mr Jackson did not mention a constraint on own generation during his presentation at the Island Hall on 2nd July 2020, when he asked residents if he could "rent their roof" and install

⁸ www.epc.sark.gg, Determination 8th November 2019, paragraphs 42-44

⁹ SEL's "Open" letter to Commissioner, 5th September 2020

¹⁰ Letter from David Gordon-Brown to Commissioner, 19th June 2019



solar panels on them. In addition, SEL still advertises that it is willing to connect customers' own generation – as long as they agree to the buy-back arrangements¹¹.

27. I therefore do not accept that the system is currently at the limit of input from own generation. SEL is effectively forcing customers with own generation from the network, rather than exploring with them a mutually beneficial alternative arrangement whereby they may remain connected. All of the four “own generators” with equipment installed this year have expressed to my Office a wish to remain connected to SEL’s system on the basis of a fair arrangement. Mr Jackson has been informed of this. Consequently, as I explained in the Determination of 8th November 2019, I do not believe it would be fair for SEL to expect less-wealthy customers to pay more for electricity should SEL’s sales fall as customers install their own generation. I therefore propose to use the island-wide level of electricity consumption in the calculation of a reasonable maximum price, as stated in the Price Control Order at paragraph 14(iv).
28. The problems caused by own generation for SEL were predictable and, in my view, avoidable. At the meeting at the Island Hall on 2nd July, Mr Jackson described a new tariff system, whereby customers would pay a higher fixed charge for being connected but a lower charge for units of electricity consumed. In May 2020, I suggested to SEL that such a system could be attractive to “own generators”. For their “connection charge”, these customers could remain connected and sell surplus power to SEL and purchase from SEL when their own systems are short, such as may occur if the sun is not shining on their solar cells. Each of the four own generators mentioned have said they would welcome an arrangement along the lines described above. The precise details of an “own generator” connection agreement would be for SEL to negotiate with its customers.
29. Mr Jackson has now said that it is no longer SEL’s intention to modify the tariff structure¹². I regard this as a missed opportunity for both SEL and the people of Sark to achieve a more equitable basis upon which the cost of generation and use of electricity is borne by the island community. For example, as Mr Jackson argued at the Island Hall meeting on 2nd July, such a scheme would lead to the owners of infrequently occupied dwellings (of which there is a significant number in Sark) paying a fairer share of the fixed costs of electricity.

(d) Costs arising from a customer deciding to “own generate”

30. As a result of SEL’s attitude to renewable generation owned by customers, one of the customers who has installed his own generating equipment asked SEL on the 9th June 2020 to move its allegedly unsafe equipment from his land. On 24th June, SEL sought my assurance that any legal costs in opposing this request could be recovered in the tariff. My general disposition is described in the Determination, when I considered the legal costs associated with an Appeal. The Determination stated:

¹¹ See www.sarkelectricity.com/pricing within Alternative Supplies Policy which describes Policy No 26.

¹² Letter from Carey Olsen to Commissioner, 16th September 2020



*"I do not believe it is reasonable for a commercial entity to feel able to initiate Court proceedings in the knowledge that, whatever happens, it will be able to recover its costs from its customers."*¹³

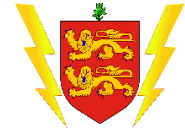
31. I understand that SEL has now accepted that it has no case in Law to deny the landholder's request and has consented to a Court Order requiring it to remove its equipment etc.. The matter of the need for recovery of additional legal costs does not appear, therefore, to arise. However, the 19 residences I refer to earlier in this draft Variation have now been disconnected from the SEL system.
32. The cost of reinstating the electricity network to maintain supplies to other customers is another matter. SEL has indicated, in a letter to my Office of 5th September 2020, that the necessary alterations to the electricity network will cost around £100,000. If the project proceeds, this sum, and a return, might be recovered over 50 years as capital expenditure. I will require evidence from SEL that the proposed works represent the most cost-effective way to maintain supplies. I note SEL has also chosen not to explore a mutually attractive commercial arrangement which would have allowed the customer, and other own generators, to remain connected to the SEL network and that SEL has not explored with the owner an apparently convenient route for the cables with the owner in question, which was offered as an option by the customer. I have written to SEL to ask why it appears to have chosen a longer and more disruptive route for the re-cabling, but it has not responded, despite reminders.

(e) Under-recovery

33. The price adjustment mechanism, set out in the PCO at paragraphs 26 & 28, is based on annual consumption figures. SEL has informed me that the period of January to September is typically responsible for 76.4% of a year's consumption. Assuming the same pattern in 2020, the PCO forecast for January to September would have been 1,146,000 kWh. The consumption figures for January to July 2020 are reported by SEL to be 599,896 kWh, 18% lower than in 2019. However, over January to July, fuel deliveries fell by 12% from 2019 levels. By the end of September, deliveries to SEL had recovered to be only 8.7% lower than in 2019. In the absence of relevant reliable information from SEL, but to be prudent, I assume that electricity consumption fell by 12%. This implies that SEL consumption was about 875,000 kWh over January to September 2020. The under-recovery caused by the lower consumption was £92,000, as calculated according to the equation in paragraph 28 in the PCO.
34. The average un-taxed UK diesel price for Jan-September 2020 was 42.07¹⁴ p/litre. The price assumed in the PCO was 52.0 p/litre. Therefore, the cost of delivering the 875,000 kWh was £27,000 lower than anticipated, calculated according to paragraph 26 in the PCO. Thus, the total under-recovery suffered by SEL up to the end of September is around £65,000 and this should be recovered from customers. Presently, there is some uncertainty in these figures, owing to the uncertainty associated with the consumption figures, as described in footnote 6 on page 5. At the estimated annual consumption figure of 1,140,000kWh, this will result in adding around 6 p/kWh

¹³ www.epc.sark.gg, Determination 8 November, 2019, paragraph 36

¹⁴ www.gov.uk/government/statistical-data-sets/oil-and-petroleum-products-weekly-statistics



to the tariff for a year, depending on the figure used to determine the actual forecast consumption figure for the purpose of setting the tariff.

35. In future, I propose to adjust the tariff every four months. This would limit the size of any under-recovery adjustments and assist SEL with its cashflow forecasting. This will require determining the pattern of the consumption forecast for the year. I propose that SEL's seasonally adjusted pattern is adopted, as described below. For example, if the annual forecast is 1,140,000 kWh, the "target" for November 2020 - February 2021 would be 30.6% or 350,000 kWh. I welcome alternative proposals. I accept that this need to reset the tariff every four months would represent some uncertainty to customers but the inconvenience will, I hope, be relatively minor.

Table 2

Proportion (%) of Consumption in Each Month

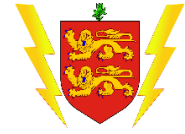
Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
7.43	7.15	7.33	8.3	9.14	9.35	10.06	9.42	8.25	8.1	7.43	8.05

(f) Quality of Supply

36. Mr Jackson has warned that SEL is considering reducing the operating hours of the station by possibly five hours¹⁵ a day and whether to provide any supply of electricity to the 19 residences (on the La Tour tenement) referred to above. A reduction in the quality and reliability of supply is a matter I must take into consideration under section 13(2)(c) of the Law.
37. The reason given for this warning is that Mr Jackson will no longer underwrite SEL's operational capital expenses. Mr Jackson complains that the current PCO is causing SEL to operate at a loss and does not include any allowance for capital expenditure.
38. SEL has reported that¹⁶, over the period 1st January to 31st July 2020, SEL made a loss of £6,365. I note that the average revenue SEL received from selling electricity was 52.3 p/kWh, owing to the discounts given to particular customers, such as prompt payers and large consumers. Without these optional discounts, SEL would have enjoyed a profit of approximately £4,000. Moreover, the Profit & Loss Statement provided by SEL showed that this loss was made after including a "Depreciation Charge" of £39,063. This demonstrates that SEL's cash position improved by £32,698 over the seven months and could have been higher within the constraints of the existing PCO. Many companies would have been delighted to be in such a position following the worst economic downturn in living memory. Besides, SEL will recoup the "under-recovery" as described in section (e) above. When Mr Jackson conducted due diligence in advance of acquiring SEL in

¹⁵ SEL, email to Conseillers, 16th September 2020

¹⁶ SEL, email to Conseillers, 16th September 2020



March 2020 he should have been aware of the mechanism in the PCO which would allow SEL to recover any shortfall, as well as their historic failure seek more frequent adjustments, when invited to do so.

39. The process for recovering capital expenditure (capex) is described in the consultation of December 2017¹⁷. I do not believe that it is reasonable to expect customers to fund capex in advance, as this would require a dramatic price increase whenever an engine, for example, is replaced or when an extension, renewal or enhancement is made to the network. This would accelerate SEL's loss of market share to own generators. Rather, I am of the view that capex should be recovered over the expected life of the associated assets, by customers paying a "depreciation charge". This is the customary practice for funding infrastructure of this nature. Mr Jackson should have been aware of the state of the equipment as part of the due diligence process and been aware of a possible, if not probable, requirement for capital expenditure. An effective operator would have ensured that, on purchasing the company, it had access to sufficient funds to be able to operate the company successfully. Other potential purchasers of SEL spoke to me about this matter when carrying out their own due diligence. I therefore do not believe that there is any merit in Mr Jackson's arguments justifying his decision to cease funding SEL's operations and capital programme. I am not aware of SEL's current cash position, since SEL has not provided me with copies of the 2019 accounts, draft or otherwise, for SEHL.

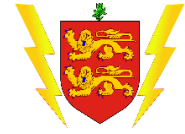
(g) Reasonable rate of return and profit

40. The methodology I have adopted for calculating a reasonable price is described in paragraph 24 of the Draft Determination of 1st October 2019. The methodology calculates the price that a reasonably efficient company would require to deliver electricity to customers using the SEL system and earn a reasonable return. I made estimates of the various cost items, as set out in Table 1 of the PCO. I note that SEL accepted these costs as being reasonable on 11th March 2020.

41. I have recalculated the RAV of SEL for 2020, allowing for Guernsey inflation of 2.4%, for further depreciation and noting that there was no capital expenditure in either 2019 or 2020. The RAV is now £1,160,000.

42. The economic impact of the Coronavirus and the general downturn in the world economy has influenced the returns investors are willing to accept for relatively low risk investments, such as utility companies. The return on capital set by OFGEM for the UK utilities has recently been lowered to 3.13% nominal per annum. For these companies, prices are set for 7 years, so they are exposed to movements in their underlying costs. I am proposing that the maximum price should be adjusted every four months to accommodate differences between outturn and forecast consumption and diesel prices, as described in paragraph 6 above. As such, SEL would no longer be exposed to the cash flow risk of having price recoveries delayed by a year. I know of no other utility company that is as "insulated" from market movements. I propose that, on this basis, the specific risk of a reasonably well operated utility is very low and, following the methodology set out in the Draft Determination at paragraph 42, a return of 4.5% would appear reasonable, given that the risk free rate is now 0.23%, rather than 1.5% and the equity market premium has risen

¹⁷ Available at www.epc.sark.gg



from 5.75% to 6.75%. Indeed, given the maximum duration of any Variation is two years, there may be a case for automatically adjusting the allowed return every two years, in line with movements in the risk-free rate and the equity market premium.

43. It is usual practice, certainly in the UK, for the return earned by a regulated utility to be related to the quality of supply. In this regard, I believe the decision to withhold funds from the company announced in SEL's letter to Conseillers of 16th September, will inflict hardship on Sark residents, in the form of the intermittency of supply, scheduled or otherwise, and the associated anxiety and inconvenience it will cause. Similar behaviour in the UK would result in a reduction in the return a regulated utility would expect to enjoy. Indeed, OFGEM are proposing a 2% reduction in shareholders' returns for poor performance. I therefore propose that a rate of return in the range 2.0% to 4.5% pa. nominal for SEL under its current proposals is appropriate.
44. I would be delighted were SEL to reverse its decision to withhold capital from the electricity system in Sark. The reason for the performance penalty described above would no longer exist and the company would be able to enjoy a return in line with other regulated utilities.

Table 3
Returns on utility shareholders' equity

Milsted Langdon	OFGEM RIIO 2	EPC	EPC
Jul-18	Jul-20	Dec-19	Oct-20
3.90%	1.5-7.5%	7.30%	2.0 - 4.5%

Sources: Milsted Langdon Valuation letter to SEL, July 2018, OFGEM, RIIO-2, July 2020. RIIO figures adjusted for indexation to CPI-H, i.e. consumer prices index but including housing costs. The EPC figures are returns on RAB.

h) The need for wayleaves

45. SEL has complained to Chief Pleas and the Press, that it is commercially unviable without the right to statutory wayleaves. Mr Jackson argues that, without the ability to maintain his equipment on others' property, SEL is rendered commercially unviable. This has not been the case in the past, nor would it be for a company that enjoyed the trust of its customers. The views of Sark's residents, reported in the Determination of 8th November, revealed that the granting of a voluntary wayleave is a matter of trust. Of the six responses I received concerning wayleaves, four declared that the granting of a wayleave would depend on the character of the owner of SEL.
46. The original owner of the electricity system on Sark, Mr Robson, successfully negotiated wayleaves with the landholders in Sark on a voluntary basis. In return for annual payments of around 6d (75p in today's money) per pole per annum, Mr Robson was given access to maintain his equipment. The Gordon-Browns, either Timothy or David, allowed these agreements to lapse. Nevertheless,



SEL prospered during the 2010s and was commercially viable despite the absence of wayleaves, statutory or otherwise.

47. There is nothing to stop Mr Jackson seeking to negotiate wayleaves with any customer where one is required. Indeed, even were a statutory wayleave scheme introduced through legislation at some future point, it is often the case, and it certainly is in Guernsey, that recourse to such a statutory wayleave must be preceded by attempts by any person wishing to exercise rights over another's land to enter into a suitable arrangement with the relevant landholder.

48. The PCO did not make a specific allowance for the costs of wayleaves, either their establishment or the on-going costs. During the course of correspondence with me, Mr Jackson has indicated that he estimates the amount of legal costs for negotiating and concluding wayleave agreements for all SEL equipment and cabling may amount to £175,000. He has also suggested that those costs should be recoverable from consumers via the per unit tariff. I am not convinced that the figure suggested by Mr Jackson is reasonable. The old wayleaves agreements negotiated by Mr Robson could serve as a template for new agreements, thus saving legal costs of the amount referred to by Mr Jackson. Alternatively, the website of Scottish and Southern Electricity has templates which are available. It is, in most instances, simple and uncomplicated legal work and any legal costs should be accommodated within the existing budget of SEL. In addition, in relation to this issue, I believe that the Law Officers of the Crown have already prepared a draft document that has been provided to the Chief Pleas and which might serve as a template.

49. The on-going annual costs to SEL are also unlikely to be as high as the £50,000 per annum Mr Jackson suggested to the Policy & Finance Committee of Chief Pleas¹⁸. In arriving at an assessment of the fixed reasonable costs of electricity supply, I will assume a standard wayleave cost schedule is paid by SEL to private landholders, as set out in Table 3 below. The costs are intended to recompense the landholder for the lack of amenity and the inconvenience of SEL being allowed suitable access to its equipment for inspection and maintenance purposes. They are based on the 2018 payments by Scottish & Southern Energy Limited. I estimate that annual payments relating to buried cables are likely to be in the order of £1,500 and those for switches and transformers on private land could amount to £3,000.

¹⁸ SEL, Letter to Conseillers, 3rd September 2020



Table 3
Proposed Wayleave Charges

Item	Measure	Rate/annum
Underground Cable	50m or part thereof	£ 2.50
Equipment (interfering with arable operations)	<10m ²	£ 75.00
	<15m ²	£ 90.00
Equipment (non-interfering)	<10m ²	£ 25.00
	<15m ²	£ 30.00

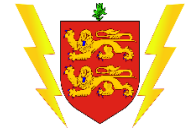
Setting a maximum price

50. My assessment of SEL's costs going forward are set out in table 4 below. The fixed cash costs have been increased from those in the PCO by Guernsey inflation of 2.4%. The Depreciation charge has been calculated from the asset value assessment carried out by WSP and updated to 2020. The management of SEL is not restricted to this budget allocation as it was only produced in order to arrive at a reasonable level of costs a reasonably efficient company would incur. The services component included £20,000 for legal expenses. I believe that this should be sufficient.

Table 4
SEL's Annual Fixed Costs 2020

Salaries	276,480
Operations	40,960
Services	46,000
Admin	10,240
Depreciation	60,830
<i>Total</i>	<i>434,510</i>

51. With a return of 3 % per annum on RAV, this would imply setting a charge of around 52p/kWh, assuming that the standing charges of £2 per month continue. A 1 p/kWh change to this allowed price would alter the return achieved by 1% per annum. However, to allow for the "under-recovery", 6 p/kWh must be added to the price for one year, as mentioned in paragraph 28 above. In future, prices could be adjusted every four months to allow for changes in diesel fuel prices and variations in consumption from forecast. I will require some validation of these consumption figures. The assumptions concerning underlying costs will only be revisited if there is a Variation, such as may be prompted were SEL to propose a capital investment programme, or a fully worked up proposal to change the tariff structure. Otherwise, the adjustment mechanism will continue



until October 2022. Such a Variation would include consideration of the allowed profit margin, or rate of return.

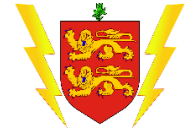
52. I propose to include the consumption of “own generators” in the calculation of “island wide” electricity, for the purposes of adjusting the maximum price. If SEL’s sales fall as a result of Stocks Hotel going “off-grid” this month, SEL will not be able to make up for the loss by raising its prices. Stocks Hotel’s consumption last year was around 150,000 kWh. I calculate that SEL would not make a profit but still generate cash at the proposed tariff.

Conclusions

53. I have reviewed the assumptions used to arrive at the maximum price a regulated supplier in Sark may charge for electricity. I propose to vary this price to around 58 p/kWh for the next year, as I believe that this would allow SEL to earn a reasonable return, given annual consumption levels in Sark of 1,140,000 kWh and a diesel fuel price of 30.3 p/litre at Guernsey. The price of 58 p/kWh includes an allowance of around 6 p/kWh to allow SEL to recover its shortfall in revenues caused by the consumption and fuel cost assumptions differing from those I assumed in the PCO. The price the following year will be around 52 p/kWh. This review has demonstrated that the shortfall in electricity consumption is not threatening the viability of SEL, but that the company is facing additional demands on its resources, prompted by customers deciding to generate their own electricity and the need to replace old equipment.

Next Steps

54. I am pleased to accept representations from SEL, residents and other interested parties by noon on 30th October 2020 on the contents of this proposed Variation. These may be sent by post or by email to commissioner@epc.sark.gg. 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 respondents’ views on:
- a) the level of return I am considering for the next two years of 2-4.5% per annum nominal, given that the asset base to which it applies is indexed to inflation and no tax is levied in Sark.
 - b) The adjustment to the allowed return in line with movements in capital markets, i.e. the risk-free rate and equity market premium.
 - c) the consumption forecast of 1,140,000 kWh as the basis for the tariff.
 - d) the reasonableness of 58 p/kWh as the price for the next year, given the recovery of the £65,000 during the next year and assuming that consumption and diesel fuel price assumptions remain at current levels.
 - e) the use of “island wide” consumption in the price adjustments, rather than SEL’s sales.



- f) the proposed timing of four-monthly adjustments and how the annual forecast should be allocated between the months.
- g) a tariff structure with higher standing charges but lower unit prices.
- h) any other matters relating to electricity pricing respondents would like to raise.

Once I have received and considered these representations, I may issue a Variation.

Anthony White
Commissioner
15th October 2020

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