



Office of the Sark Electricity Price Control Commissioner

Electricity Prices- Determination

Determination

1. Under section 3 of the Control of Electricity Prices (Sark) Law, 2016 (the "2016 Law"), my Office is charged with determining whether electricity prices set by a regulated electricity supplier on Sark are, or are not, fair and reasonable. Part II of the 2016 Law contains various powers enabling me as Commissioner to investigate electricity charges and under Part III of the 2016 Law, following completion of an investigation, the Commissioner is obliged to make a determination, as described above.
2. My investigations and discussions concerning electricity prices charged by Sark Electricity Limited¹ (SEL), conducted over the period 8th November, 2017 to 10th March, 2018, led me to publish my provisional conclusion on 14th March, 2018. I proposed that the current basic rate of 66 p/kWh, and those rates for larger users, charged by SEL are not fair and reasonable. I have since consulted with SEL as the regulated electricity supplier that will be affected by any determination and the Policy and Performance Committee of the Chief Pleas of Sark. I also consulted others, as I saw fit. At the request of SEL, I twice provided the company with further information and extended the consultation period in order for the company, and its advisers, to understand my reasons for proposing that the prices the company charged were not fair and reasonable. The consultation period finally closed on 30th April, 2018.
3. I have already reported the conclusions of the preliminary consultation of December 2018 and since 14th March, all the responses have been supportive of my findings, except that from SEL. SEL contends that I am wrong in law and/or economics and/or fact. I do not agree and will explain my reasoning below. As such, I confirm my assessment that SEL's basic rate of 66p/kWh and the rates for larger users, are not fair and reasonable. This is because SEL is not taking advantage of advances in technology, nor of lower cost means of running its current operations. I also believe that it is fair and reasonable for the purposes of my determination to take into account and protect the interests of Sark's consumers as a whole. In particular I am concerned for those who do not have access to the financial resources which will be required if others decide to generate their own power thus leading to an almost inevitable rise in prices for those consumers who are unable to do anything else other than obtain electricity from SEL.

1. The Sark Electricity Company Limited is understood to have been split into Sark Electricity Limited (SE) and Sark Electricity Holdings Limited (SEH) in 2014. The original company's assets were placed in SEH and leased to SE which operates the electricity system. I refer to SEL as the combined company.



Next steps

4. Under section 15 of the 2016 Law, having determined that the basic rate and rates for larger users not fair and reasonable, I have powers by way of the making of a price control order, to set a maximum price for electricity sold on the island of Sark. I intend now to consider whether or not to exercise those powers and, if I do exercise them, what maximum price or prices may be appropriate. In order to assist me with my considerations I shall be consulting with SEL and other stakeholders. I intend to publish my estimate of the maximum prices within two weeks to allow a final decision by the end of June, 2018.

Responses to the consultation

5. I described the responses I received from consultees in my Proposed Determination. Since then, I have received written responses from SEL, its customers, from inhabitants of other Channel Islands and interested parties on the mainland. All the customers said that the current prices were too high. Two added that, if prices were lower, they would consider using more electricity, such as to operate their washing machines at higher temperatures and using dehumidifiers in their business premises. They complained about the negative impact the high electricity price was having on the economy. One respondent offered to build a network using renewable power and storage and would deliver power at lower prices than SEL's tariff. Another respondent argued that wind turbines might damage Sark's environment and discourage visitors. One respondent was concerned that the inverters required for solar panels may interfere with telecommunications.
6. SEL contended that the Determination was wrong in law and/or economics and/or fact. I will deal with each assertion in turn.

Wrong in Law?

7. SEL holds that the 2016 Law restricts the Commissioner to consider only whether the existing electricity system on Sark is being run efficiently when assessing whether the prices being charged are "fair and reasonable". SEL contends that the Commissioner does not have the power to consider alternative forms of generation. In fact, Section 13 (2) of the 2016 Law charges the Commissioner to "...take all material considerations into account, including without limitation the following matters – ". The Law then lists a number of factors which must be addressed and which I covered in paragraph 9 of the Proposed Determination². Therefore, the Law is clear that the Commissioner is not restricted to consider only the operation of the existing equipment. Indeed, last December, I set out my approach to determining whether prices are fair and reasonable. It was to assess the price a reasonably efficient operator would charge in order to make an adequate return on investment. I believe that a reasonably efficient operator would consider different forms of electricity

² Office of the Sark Price Control Commissioner, Proposed Determination, March 13th, 2018



production and distribution. As such, I believe that such lower cost forms of generation should be considered in deciding whether prices are fair and reasonable.

Wrong in Economics?

8. SEL raised my concern that, were I to set a price that would allow SEL to make a reasonable return on its assets, then the larger customers would disconnect from the SEL system and generate their own power, forcing higher prices onto the remaining customers. They argue that, if this competitive threat exists, then there is no need to regulate prices. However, whilst such an approach would be acceptable for most products, it is not appropriate for an essential service such as electricity supply. This is why Chief Pleas passed the Control of Electricity Prices (Sark) Law, 2016 Law, which came into effect in 2017 following consideration by the Privy Council of objections raised by SEL. Regulatory policy for electricity supply on the mainland and, indeed, across Europe, is designed to allow competitive forces to set prices where possible, and regulate prices where the scope for competition is limited or has yet to develop³. Competition for electricity supply has not had sufficient time to develop on Sark. As such, it is appropriate to regulate prices for a service that employs a large, shared infrastructure, so that those without access to the necessary financial resources are not harmed.
9. If I make a price control order, I will take into account SEL's costs and make a judgement as to the costs a reasonably efficient operator would incur. SEL claims that, in my earlier analyses, which I have shared with them, I did not make allowances for the actual costs SEL incurs. On the contrary, I have analysed SEL's accounts for the years 2009-2016 as well as the budget estimates for 2018. I have not been able to reveal the SEL figures, on account of a non-disclosure agreement that SEL required me to enter into as a condition of having access to the relevant figures. My estimates of the costs a reasonably efficient operator would incur are based on SEL's actual costs and Alderney Electric's advice but do not include some items that SEL has recovered, and still seeks to recover, from its customers. These include costs relating to international travel, the costs of dealing with regulatory issues, the additional administrative costs arising from SEL splitting itself into an operating company and an asset-holding company and the additional costs associated with SEL being funded entirely by shareholders. Shareholders should absorb these costs.
10. My assessment of the fixed costs of SEL for 2018 is £397,000. SEL has set its tariff on the assumption that its fixed costs will be around £520,000. The difference, some £123,000, arises from higher directors' fees and salaries, legal & professional costs and management expenses.
11. SEL also disagrees with my assessment of the return investors would require, saying it does not adequately reflect the risks it is facing. I anticipate allowing a return in the range 5-10% real per annum, which is considerably greater than that allowed for similar, privately owned, infrastructure companies in the UK. SEL has not explained why it still relies entirely on

³ HMG White Paper, 1988; James Capel "Reshaping the Electricity Industry in England & Wales", February, 1990.



shareholders' funds for finance and has not raised debt. I do not believe customers should continue to pay for this higher cost of finance. Absence of wayleaves, as I explained in the March 2018 consultation paper, is not a valid excuse.

12. My earlier papers described how a reasonable profit margin for SEL may be calculated by multiplying the return by the Regulatory Asset Base (RAB). The December 2017 Consultation paper explained how, in the absence of an Asset Register, which would provide commissioning dates for all the assets, their purchase price and any customer contributions, my assessment was based on SEL's consulting engineer's assessment of the replacement cost of SEL's system, conversations with the directors, and discussions with some customers. My initial assessment of the RAB of £2.4m was published in the December Consultation paper. SEL complains that this figure is considerably lower than SEL's engineering consultant's assessment of £3.6m for the replacement cost, though subsequent corrections by SEL suggested that the full replacement cost would be closer to £3.8m. The estimate of £2.4m took into account that the assets have been used, so suffered from wear and tear, and so were depreciated. Moreover, there is no obvious reason why shareholders should be allowed a return on what the replacement costs might be. For example, the RAB of the UK's water, gas and electricity networks are based on the price investors paid for shares, rather than the replacement cost of the assets, appropriately depreciated. However, I do not know the price SEL paid for its equipment; some may have been second hand and some customers have fully funded the connections to their properties. Since SEL does not maintain an Asset Register, SEL has been unable to advise me of the costs of the assets, nor how many of its assets were funded by the customers – apart from saying that funding by customers was minimal.
13. In setting the base tariff of 66p/kWh for 2018, SEL informs me that they have not included an allowance for depreciation. The overhead lines replacement programme was only completed by 2010 but much of the network is very old, some dating back to the 1950s⁴. In setting the tariff for the years from 2009 until 2016, SEL has sought, and been able, to recover 100% of capital expenditure and return many £100,000s to investors. It seems, when considering the building of the network, that it has already recovered all its costs. The network may have already, in effect, been fully funded by customers and so the RAB could be far lower than I originally estimated.
14. SEL make the point that, were the price to be set at too low a level, it would be tantamount to "stranding" some assets. SEL complains that such "stranding" is not good regulatory practice and will increase investors' perceptions of risk. SEL raises the case of OFGEM and the price control on the gas network in the UK. The UK Government may discontinue the use of gas as a domestic heating fuel by 2050, so there is a risk that new pipes, installed during the regulatory period 2013-2021, might become "stranded", as they have technical lives of 45 years. In view of this risk, OFGEM decided to "front load" the depreciation charge for new investment in the network. This allows network operators to recover the capital costs at a faster rate over the initial years, though the total cost would still only be recovered over the

⁴ SEL, Letter to customers, January, 2018



full 45 years. Indeed, assets may still be “stranded” if gas demand plummets in later years. Moreover, at the same time, OFGEM, decided to extend the period over which companies could pass on the costs of replacement expenditure⁵, rather than include the costs in each year’s tariff.

15. One-off reductions in RAB do increase investors’ perceptions of risk. Such changes have occurred in the UK. In 1995 and 1996, the UK Regulator judged that the benefit to customers, in avoiding unfair prices, outweighed the loss to shareholders.
16. SEL argues that, as a private company, it is only fair that it should be able to cover the value of its investment in full⁶. I would agree, if the investment programme had been previously agreed with my Office. In any case, SEL may have already recovered the cost of building the existing network, so the assets would not be “stranded”.

Wrong in Fact

17. SEL claims that my consultation papers were wrong in fact – but does not indicate where I made errors. I accept that, in my initial paper, I suggested that one of the reasons for the high cost of electricity on Sark might have been due to the cost of burying the network. However, in my second consultation, In the March paper, I noted that Sark’s special circumstances, in that there are no roads to negotiate, mean that cables are relatively cheap to install and have the added benefit of being safe from the effects of high winds.
18. SEL now suggests that it has taken on other work and uses the profits to subsidise prices to customers. There is no evidence in the accounts to indicate how, or whether, this subsidisation took place. Furthermore, the fact that the company has reduced its overheads by scrapping the two-company structure and reducing directors’ fees is a response to be expected by a commercial company in the face of a severe reduction in demand. This cannot be called a subsidy.

Conclusion

17. I confirm my initial finding that the current prices for electricity on Sark are not fair and reasonable. This is because SEL’s prices include allowances for costs that I do not think it is fair to expect customers to pay; namely the additional costs associated with overseas travel, splitting the company in two, reliance on shareholders for finance, dealing with regulatory issues and disregarding the opportunities for new technologies. Indeed, SEL’s interpretation of the Law is incorrect. The Law does not restrict my assessment to consider only the operation of SEL’s existing assets. The fact that there are other, cheaper forms of electricity supply should be taken into account when assessing a fair and reasonable price for electricity on Sark. Competition in electricity supply on Sark has not yet developed. In the

⁵ OFGEM RIIO-GD1 Overview Paper Decision 8.10 March 2011.

⁶ Collas-Crill – response to Commissioner 30th April, 2018; 3.1.6.1



initial stages of competition, less affluent customers will require protection, given the central role electricity plays in people's lives.

Anthony White 18th May, 2018

Commissioner

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