



E1453G

Cost Pass-through for Guernsey Electricity Limited 2019
(Guernsey)

Final Decision

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1. EXECUTIVE SUMMARY

Pursuant to its Draft Decision CICRA 19/10 (the **Draft Decision**) regarding a proposed unit tariff increase of 6.8% for Guernsey Electricity Limited (**GEL**), this is the non-statutory final decision of the Guernsey Competition and Regulatory Authority (**GCRA**). After consideration of the responses received to the Draft Decision, the GCRA continues to be minded to allow GEL a 6.8% unit tariff increase, to be in place for 3 years from 1 July 2019. This tariff rise is intended to allow GEL to recover historic uncontrollable costs of £9.8m related to importation and generation of electricity, which are primarily related to the price of oil and exchange rate movements. The period to which the costs to be recovered relate is April 2017 to March 2019.

This Final Decision paper summarises the responses received by the GCRA to the Draft Decision and the GCRA's consideration of those responses and reasons for its continued intention.

2. STRUCTURE OF THIS DOCUMENT

This document constitutes a non-statutory Final Decision. The document sets out the intentions of the GCRA, which has taken full account of responses received to the Draft Decision. The document contains a statement of what the GCRA is minded to allow GEL with respect to recovery of uncontrollable costs and the consequent unit tariff increase.

The document is structured as follows:

Section 3	Outlines the legal framework
Section 4	Sets out summaries of the responses received to the Draft Decision and the GCRA's consideration of these responses
Section 5	Contains the Final Decision
Section 6	Sets out the regulatory process

After this Final Decision has been issued, the GCRA will issue a Statutory Notice of a Proposed Decision.

3. LEGISLATIVE BACKGROUND

Current Licensing Regime

The States of Guernsey has issued a number of States Directions in relation to the licensing of electricity activities in Guernsey. In accordance with those Directions the GCRA (formerly the Director General) issued the first licences for electricity generation, conveyance and supply to the incumbent electricity company – GEL - on 1st February 2002.

Legal Background

Under the Regulation of Utilities (Bailiwick of Guernsey) Law 2001 (the **Utilities Law**), the objectives that the GCRA has a duty to promote (and, where they conflict, to balance) must be achieved in a way that gives equal regard to the interests of the residents of all islands of the Bailiwick. They include protecting the interests of consumers and other users in Guernsey in respect of the prices charged for, and the quality, service levels, permanence and variety of, utility services. In order to ensure the permanence of electricity supplies, the GCRA must have regard to allowing GEL to raise revenues to cover the efficient cost for generation, conveyance and supply of electricity.

Detailed provision for the regulation of electricity in Guernsey is contained in The Electricity (Guernsey) Law 2001 (the **Electricity Law**). Section 5 provides that the GCRA may include in licences such conditions as appear to the GCRA to be appropriate having regard to the nature of the application for the licence, the objectives set out in the Utilities Law, and the enforcement of the Utilities Law and the Electricity Law.

The Electricity Law specifically provides that such conditions can include (but are not limited to):

- Conditions regulating the prices, premiums and discounts that may be charged or (as the case may be) allowed by a licensee which has a dominant position in a relevant market.

These provisions allow the Authority to regulate unit tariffs.

Regulatory Framework

In a previous GCRA document (CICRA 19/16), proposed findings of market dominance in Guernsey were set out following a review of the market. The GCRA considered that GEL was dominant in generation, conveyance and supply of electricity.

The licence of GEL includes conditions in respect of Price Regulated Services (licence condition 20). Condition 20.2 of the Licence provides that:

“The Director General [now the GCRA] may determine the maximum level of charges the Licensee may apply within a relevant market in which the Licensee has been found to be dominant. A determination may;

(a) provide for the overall limit to apply to such charges;

(b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or

(c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.”

This condition allows the GCRA to regulate the prices that GEL charges for electricity it supplies in a way and for a time that it deems appropriate, provided GEL has a dominant position in the relevant market.

As set out in CICRA 19/16, Guernsey’s retail electricity market possesses a monopolist/dominant operator that also has a dominant position through the electricity supply chain.

4. CONSIDERATION OF RESPONSES TO THE DRAFT DECISION

In the Draft Decision the GCRA indicated that it is inclined to allow GEL a cost pass-through amount of £9.8m for uncontrollable fuel, lubricant, exchange rate and other marginal costs related to generation of electricity and for exchange rate costs related to the importation of electricity for the years 2017/18 and 2018/19. The Draft Decision also stated that the GCRA is minded to allow GEL to increase its unit tariffs by 6.8%, such increase to be in place for 3 years from 1 July 2019.

Five responses were received to the Draft Decision:

1. Chris Logan agreed that the proposed increase is reasonable.
2. Stuart Martin set out his opposition to the adjustment of the balance between standing charges and unit tariffs towards a higher proportion of revenue being recovered from standing charges. He also indicated his dissatisfaction with the recent performance of GEL, and the cumulative effect of different taxes and utilities charges on Guernsey residents.
3. Richard Friedrich disagreed with the proposed increase and does not consider a similar cable fault to be uncontrollable. He considers it appropriate to hedge exchange rate changes and wants an investigation of GEL's 'huge losses from FX trading'. He also believes that the cable fault 'should be factored in i.e. before paying dividends' to the shareholder.
4. David Lee also expressed concern at the tariff increase. He does not consider it appropriate to fund capital projects and dividends through price rises, and he is concerned to help mitigate the effects of tariff increases on lower-income households.
5. Sure noted that they became aware of the GCRA's consideration of GEL's request for a pass-through only on issuance of the Draft Decision. It further noted that an increase in electricity prices will have an impact on competitiveness and profitability for Sure and Guernsey as a whole. Sure then set out certain beliefs regarding the requirement for a long-term energy strategy, and in the context of the uncertainty regarding this strategy, expressed concern about the predictability of future price changes and the possibility of future pass-through requests. Lastly it encouraged CICRA to engage with the States of Guernsey to undertake a review of Guernsey's current and future energy needs.

The full text of the above mentioned responses is available on CICRA's website, www.cicra.gg.

GCRA analysis

The proposed tariff increase is a mechanism by which GEL would be allowed to recover past uncontrollable costs: GEL is not able to adjust its prices in response to such pressures in the same way an unregulated entity might. With regard to timing of public notification of this process, GEL's licence conditions require that it gives notice of tariff changes to customers at least one month in advance of any such change. The process being undertaken currently by the GCRA involves two consultation stages, the first of which allowed a response

period of twice the minimum required for a statutory notice of proposed decision under Section 5 of the Electricity Law. The statutory notice of proposed decision dealing with this matter will also allow a period in excess of the statutory minimum. It is also unclear how Sure considers that the opportunity to provide its views to the GCRA in response to the Draft Decision or to find out about the process by means of a public call for information would be qualitatively different from the situation which has prevailed in this case. The GCRA therefore sees no difficulty in making such a process public only after initial information has been gathered from GEL.

The GCRA is not currently in the process of undertaking a full review of tariffs for GEL. While there was a policy proposal from the Commerce and Employment Department in 2015 seeking to exempt GEL from the licensing and regulation provisions within the electricity laws by no later than 1 January 2016, this has not been implemented through legislative changes necessary to give effect to the Department's proposals. Instead, the States of Guernsey are now reviewing their energy policy and the status of its resolution to remove electricity from regulation by the GCRA is currently unclear. Until such time as regulation of the electricity sector has been settled by the States of Guernsey, this places constraints on the regulatory approach to addressing matters such as a comprehensive price control review. Any possible future tariff review is also likely to be impacted by any energy policy issued by the States of Guernsey. The GCRA is already engaging with the States of Guernsey on this subject. In the current instance, it should be noted, the cost pass-through amount will be recovered over three years by means of a unit tariff increase, leaving standing charges unaffected.

The predictability of future price changes and any pass-through adjustments is of course limited by virtue both of uncertainty with regard to the status of regulation and any changes which merit the application of a pass-through mechanism. However in the normal course of yearly price-setting under closer regulatory oversight, prices would be expected to change on a yearly basis, with adjustments for pass-through costs of the type considered here. The likelihood of a period of unchanging prices well beyond a year in duration in such circumstances, (a stability which has recently applied to GEL's prices), is low.

The cumulative effect of a range of taxes and charges with different aims lies outside of the remit of the GCRA to consider. The GCRA believes that such aggregate effects fall more properly to the States of Guernsey for consideration. With regard to the individual impact of this price change on different sectors of society, the GCRA bases its decision-making in part on the assumption that the user of utilities pays for services at a price which reflects the cost of those utilities. Where the reasonable cost of such utilities causes undue hardship, this is a policy matter which also falls to the States of Guernsey for consideration.

The GCRA does consider cable faults to be uncontrollable insofar as undersea transmission cables represent significant long-term infrastructure investment and the difficulties with the GJ1 cable were not foreseeable at the time of installation. Notwithstanding this fact, the GCRA's analysis of the elements of the pass-through request showed a relatively small variance related to the cable fault and a much higher impact from commodity prices and exchange rates.

It is not good practice to second-guess regulated entities' hedging practices based on hindsight, and losses made as a result of hedging are not necessarily an indication of poor decision-making, given that hedging usually aims to exclude both upside and downside risk. Hedging against adverse price movements over

periods significantly in excess of one year is also not easily achievable. As such, the GCRA does not consider a consideration of GEL's hedging practices to be relevant to the current cost pass-through claim.

In its request to be allowed this pass-through amount, GEL stated that it had agreed with the States Trading Supervisory Board that any profits generated in the three-year period of recovery would be retained and not distributed. Further, as stated in the Draft Decision, in any future full review of tariffs the GCRA will require evidence of improving efficiencies in the operations of GEL and should any such review show that this pass-through amount was materially excessive it could be recovered in the course of future price controls.

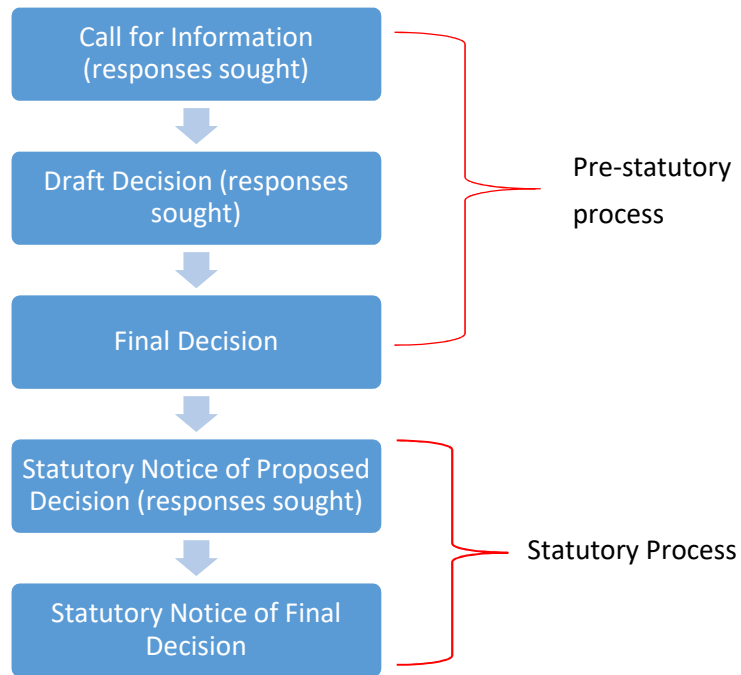
For the above reasons, none of the responses received in response to the Draft Decision merit amendment of the Draft Decision, and the GCRA therefore confirms its Draft Decision as a non-statutory Final Decision in all respects.

5. FINAL DECISION

The GCRA is inclined to find that the maximum unit tariffs charged by GEL should be increased by 6.8%, the increase to remain in effect for 3 years from 1 July 2019. This is in order to allow GEL to recover uncontrollable cost increases of £9.8m related to electricity generation and importation during its financial years 2017/18 and 2018/19. For the avoidance of doubt, this decision applies to tariffs charged by GEL and not any tariffs paid by GEL to other parties.

6. NEXT STEPS

CICRA has recently introduced a revised process for consultations. The Information Notice, CICRA 18/29 “Regulatory Consultation Process” published in July 2018, outlines the new process to be undertaken before carrying out certain regulatory functions in accordance with the relevant statutory process. This process is set out below in diagrammatical form:



Under the new process there is a pre-statutory process. The pre-statutory process consists of a Call for Information, a Draft Decision and a Final Decision. In the context of a cost pass-through, the Call for Information stage consists of information gathering from the licensee because of the confidential nature of the information required. The Draft Decision stage then provides the opportunity for public responses, following which a Final Decision is issued. This paper is thus the third and final stage of the pre-statutory process.

In order to change the maximum unit tariffs which GEL may charge, the appropriate pre-statutory process is followed,¹ and subsequently a decision to change the maximum unit tariffs requires the statutory process to be followed.²

The GCRA will now progress to its Statutory Notice of Proposed Decision. While the GCRA considers any Decision made as part of the pre-statutory process to be the starting point for later parts in the process and as a statement of its current expectations, this Decision is not binding on any party until such time as it has been included in the Statutory Notice of a Final Decision.

¹ See Information Notice CICRA 18/29 “Regulatory Consultation Process”, July 2018

² Sections 5(4) and 5(5) of The Electricity (Guernsey) Law 2001