STATES OF JERSEY

ELECTRICITY TARIFFS: REGULATIONS UNDER ARTICLE 22 OF THE ELECTRICITY (JERSEY) LAW 1937 (P.41/2009) – REPORT OF THE MINISTER FOR ECONOMIC DEVELOPMENT

Presented to the States on 8th September 2009
by the Minister for Economic Development

STATES GREFFE

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REPORT OF THE MINISTER FOR ECONOMIC DEVELOPMENT IN RESPONSE TO P.41/2009: ELECTRICITY TARIFFS: REGULATIONS UNDER ARTICLE 22 OF THE ELECTRICITY (JERSEY) LAW 1937

Background

This review stems from the Report and Proposition of Senator A. Breckon (P.41/2009) lodged on 24th March 2009. That Proposition tasked the Minister to –

> "*exercise his powers under Article 35 of the Electricity (Jersey) Law 1937 to safeguard the public interest by bringing forward for approval without delay Regulations under Article 22 of the Law to determine the tariffs to be made by the Jersey Electricity Company in respect of electricity which it supplies at rates which are at a reduction of 20% reduction from the present tariffs, with the reduction to take effect no later than 1st July 2009.*".

That date was later amended so that –

> "*for the words "1st July 2009" substitute the words "1st October 2009 and with no further increase in tariffs during 2010".*".

In considering the Proposition, the Minister was mindful of his obligations under the Law and so presented the following comment to the States –

"***COMMENTS***

While I acknowledge the request presented by Proposition 41/2009, namely to exercise powers delegated under Article 35 of the Electricity (Jersey) Law 1937, it is important to comprehend that prior to bringing forward any Regulations under Article 22 in respect of determining tariffs, I am mandated to undertake a thorough examination of all relevant matters prescribed under Article 22(2).

This Article details 7 key areas for analysis and consideration to enable the States to reach an informed choice and be certain of acting in the public interest. The States must therefore take account of –

- *the present needs of the Company and the future expansion of services provided by the Company;*
- *the ability of the Company so long as its undertaking is managed efficiently to pay –*
  - *interest on and reimbursement of any debentures, loans or other borrowing of the company,*
  - *a dividend on the preference shares issued by it at the rate fixed under the terms of issue of such shares, and*
  - *a reasonable dividend on the ordinary shares issued by it;*
- *any capital expenditure which the Company may reasonably be expected to incur during the next 5 years and the desirability of the Company's charging such expenditure, or any part thereof, to revenue;*

- *the ability of the Company to pay all proper expenses of and connected with the working, management and maintenance of the Company;*

- *the provision of any contributions, whether set apart out of revenue or otherwise, which the Company may lawfully carry to a reserve, contingency or amortization fund;*

- *the ability of the Company to make good depreciation, whether or not provision therefore is made by a reserve or contingency fund; and*

- *the ability of the Company to meet all other costs, charges and expenses, if any, properly chargeable to revenue.*

Evidently this is no light undertaking. To meet the requirements of Article 22(2) it is implicit that I must commission an independent review of the Jersey Electricity Company using the paragraphs above to form the terms of reference. The Economic Development Department will undertake the process of securing an independent agency to complete the review as soon as reasonably practicable in accordance with the Financial Directions.

It is important for Members to appreciate that if the States fail to have sufficient and reliable information in respect of the matters prescribed under Article 22(2), which material is necessary for making an informed decision on a proposition under Article 22(1), it is highly probable the decision would be struck down by the courts on a challenge by way of judicial review.".

The Minister subsequently met with Senator Breckon and they agreed that for reasons of efficiency, speed and in an effort to keep expenditure to a minimum, a compromise position would be acceptable. It was agreed that the Minister would commission a review of electricity pricing by the Department and that officials would liaise with both the Economics Unit and the Statistics Unit of the Chief Minister's Department to utilise relevant expertise. Terms of reference were then drawn up as outlined in **Appendix 1** and agreed at a meeting between the Minister and Senator Breckon held on 30th July 2009. This resultant Report is intended to better inform the States prior to the debate on P.41/2009.

Terms of Reference

The purpose of the review is to make available information from the J.E.C. on the justification of the recent price rises and to assess their economic effects, with the aim of adding to the debate about whether recent rises in electricity prices are in the best interests of the Island. As a starting point, the review should set out the relevant considerations and explain the relationship between them, including, but not limited to – the viability of electricity providers, distributional and fairness concerns and any consequences for the wider economy – for example on competitiveness and States' finances. In doing so, the report considers the situation in Guernsey and also, albeit to a far lesser degree, the Isle of Man. Comparative data from the U.K. and other E.U. states is also utilized where relevant.

In choosing to undertake a review of this scope, care must always be taken to ensure that it is manageable and delivers an outcome that is both meaningful and beneficial. To that end, certain issues cannot be included. The report does not concentrate, for example on the pros and cons of price regulation, nor whether the J.E.C. should be in full public or private ownership. The first is outside of our experience, whilst the second is a political matter. This review is guided in large measure by what can be termed 'tests of reasonableness', given the structure and capital investment plans of the company as it now stands. In determining this, the Report is guided by Article 22 of the Law which states that, in determining appropriate electricity tariffs, the States must take account of the following –

- the present needs of the Company and the future expansion of services provided by the Company;
- the ability of the Company so long as its undertaking is managed efficiently to pay –
    - interest on and reimbursement of any debentures, loans or other borrowing of the company,
    - a dividend on the preference shares issued by it at the rate fixed under the terms of issue of such shares, and
    - a reasonable dividend on the ordinary shares issued by it;
- any capital expenditure which the Company may reasonably be expected to incur during the next 5 years and the desirability of the Company's charging such expenditure, or any part thereof, to revenue;
- the ability of the Company to pay all proper expenses of and connected with the working, management and maintenance of the Company;
- the provision of any contributions, whether set apart out of revenue or otherwise, which the Company may lawfully carry to a reserve, contingency or amortization fund;
- the ability of the Company to make good depreciation, whether or not provision therefore is made by a reserve or contingency fund; and
- the ability of the Company to meet all other costs, charges and expenses, if any, properly chargeable to revenue.

Although this review is not a formal Article 22 process, insofar as the States has not requested the Minister to act under the Law, nevertheless to be informative the review must address all of these issues. Furthermore, in order to address concerns about the effects on the wider economy, the Review will also consider the 24% electricity price rise in terms of –

- the effect of upon the RPI, both immediately and in the medium term, and any effects that this may in turn have on competitiveness;
- the impact on different socio-economic groups, but particularly the elderly;
- the effect upon the fiscal position of the States of Jersey, both in terms of income and expenditure;
- any other impacts on the wider economy.

PART I

The Jersey Electricity Company (J.E.C.)

The J.E.C. was formed in 1924 and the States of Jersey took a majority shareholding in 1936, prior to the coming into force of the Electricity (Jersey) Law 1937. Under that Law, the Minister for Economic Development has responsibility for the operation of the Law, with the Minister for Treasury and Resources taking the position of shareholder. Article 35 of the Law states that –

> "*the States may delegate to the Minister for Economic Development, the power and duty of representing the States in all or any matter arising out of this Law and generally of safeguarding the public interest.*".

While the States is the majority shareholder in the J.E.C., the company is not a wholly-owned public asset and operates according to normal commercial principles. This makes determining the Minister's role to safeguard the public interest more problematic because he must balance, not only the needs of consumers and Islanders generally, but also the strategic needs of the Island with that of the responsibility of the company to provide a reasonable return on investment and build up sufficient strategic reserves to maintain a healthy level of capital reinvestment and development. This is no mean task.

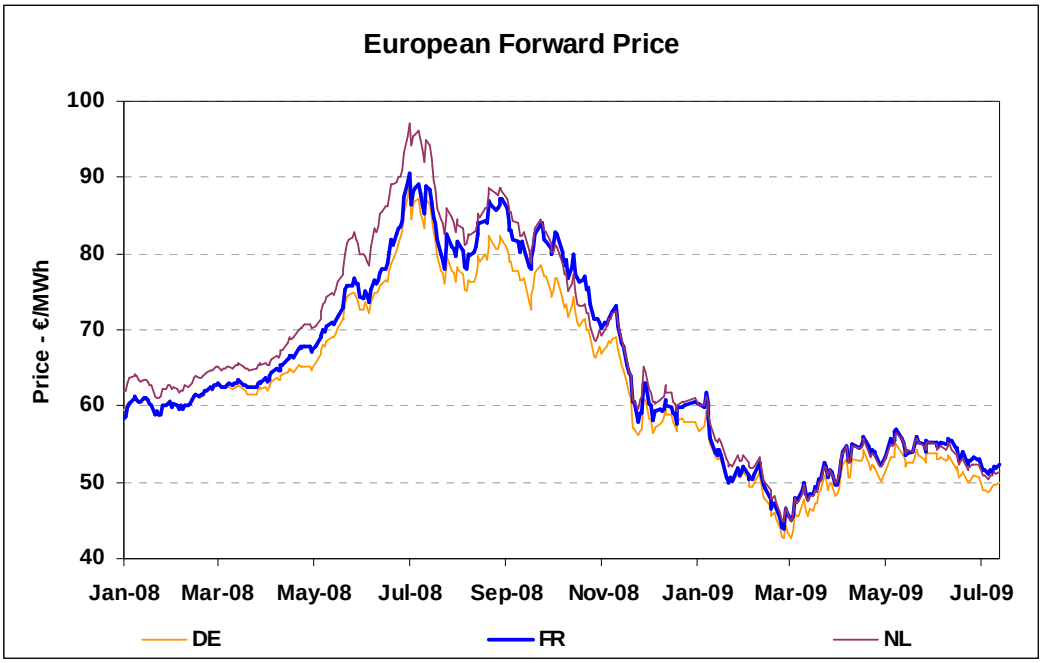
In considering this review, the Minister took as his starting point the legal and regulatory framework underpinning the work of the J.E.C. As noted previously, the company does not have a specific utility regulator to which it is accountable, but instead must be able to assure itself and others that it is not operating contrary to the Competition (Jersey) Law by virtue of its dominant position in the supply of electricity in Jersey. The power supply market in Jersey does have several participants, including Jersey Gas and a number of companies providing home heating oil, coal and other fuel types; and this level of competition constrains the company to some extent making for a largely self-regulating market.

The J.E.C. does compete with Jersey Gas in the domestic heating market, where customers may be sensitive to the relative price of gas and electricity. The cost of gas is largely determined by the world market and is wholly imported. Electricity is also largely imported from France, where the cost is linked to the price of fuels and carbon, but a small percentage is self-generated and the cost is then determined directly according to the imported oil price. In considering the consumer price of electricity, therefore, close attention needs to be given to the global and European energy markets.

Price increases: European perspective

Prior to the advent of the European internal market, the J.E.C. was able to import electricity directly from France at extremely favourable rates because the predominant generation came from relatively cheaper nuclear fuels, but also because the French market included large-scale subsidies that it was able to indirectly benefit from. Since 1992, however, electricity market integration has occurred, a system that is supposed to be beneficial to all markets through increased competition and enhanced security of supply. Utilyx Ltd., a specialist electricity consultancy, notes in its paper: 'The Integration of Europe's Energy Markets', how the integration of national markets has perversely led to an increase in the cost of electricity, an issue of great relevance to the J.E.C. as noted below.

Although France still sells its electricity internally, it can also sell across national frontiers through the European grid. In a case where electricity with a lower marginal cost of production, such as France, is sold competitively to neighbouring markets, such as Germany, the price in the integrated market can then be established. This generally occurs between the lowest price and the highest prices of these respective markets which leads to a convergence of electricity prices. This price convergence results in the transfer of surpluses between European operators; this not only benefits consumers in the high cost production countries, but it will also increase the profitability of the lower cost producers in the other countries. But market integration also results in increasing electricity prices, especially for consumers in countries enjoying large power generation capacities at low cost, such as in France. This leads in turn to a tracking of prices across the various markets and particularly between France, Germany, Belgium and the Netherlands. This is demonstrated through a European Forward Price Comparison as shown below.



(Source: EEX, NordPool, Powernext ; analysis by Utilyx)

Prior to liberalization, the price per kWh was generally fixed by the government, or at least with its agreement, and this regulated tariff was calculated by the (generally publicly-owned) incumbent in charge of electricity generation and distribution. The customer had to pay a fixed premium each year and bills were proportional to the quantity of kWh consumed, and the price of this kWh was relatively stable over time. Following liberalisation, however, around half of the price paid by customers opting for market prices is now variable.

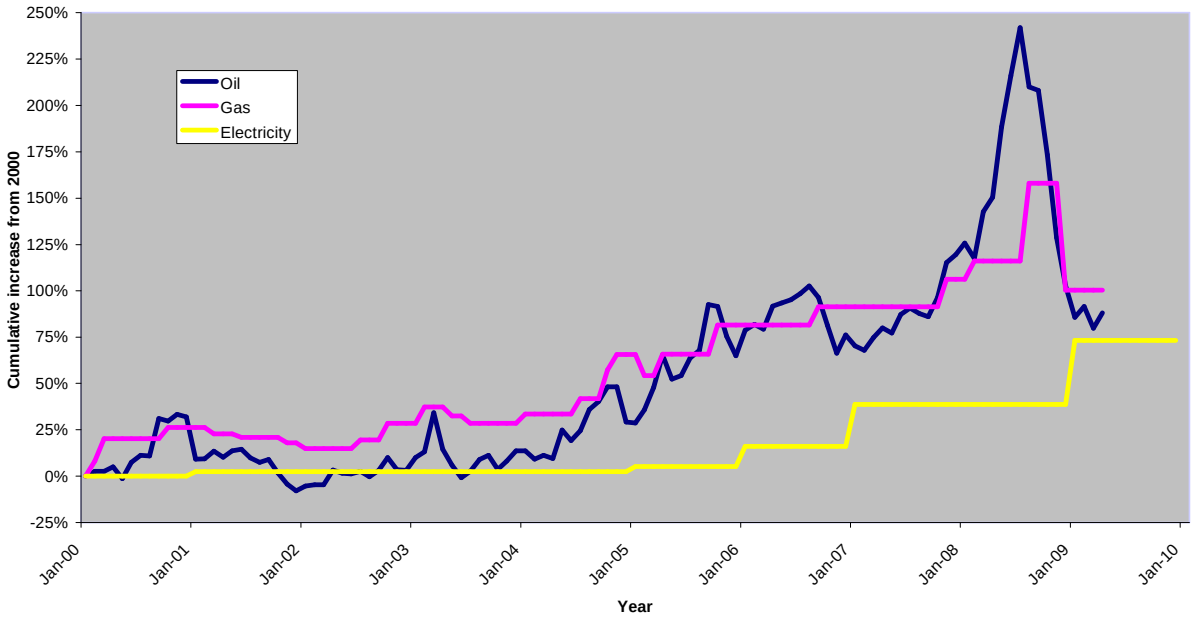
The variable part of the kWh price varies each hour and each day in relation to the conditions observed on the wholesale spot market. This variable price is higher during peak periods and lower during off-peak periods, in relation to the variable cost of the marginal power station necessary to balance supply and demand; the so-called 'merit order'. During a large part of the year, this "marginal power station" is a coal or gas power station, usually a German one. The price of natural gas is dependent on the price of oil in Europe because a large proportion of natural gas (more than 50%) is

imported through long-term contracts from Russia, Norway or Algeria. Long-term contracts include escalation clauses between oil product prices and gas prices. Hence a high price for oil means high prices for natural gas and indirectly high prices for electricity, albeit there are a number of other factors such as carbon trading, variation in supply and demand over time and outage patterns in networks that impact the correlation.

In the past, regulated French tariffs were fixed according to the cost of a nuclear kWh because nuclear power stations were the marginal power station during a large part of the year. France is now a large exporter of electricity during off-peak periods, but it has become a net importing country during peak periods and increasingly during midway periods. Consequently, in the European wholesale electricity market, and in a context of large interconnections between France and Germany, the French nuclear power stations are no longer the marginal power plants, except when electricity demand is very low. Instead the price of the European kWh is now largely dependent on the cost of gas turbine power stations, generally German ones. If nuclear generation was higher in Europe, in Germany at least, nuclear power stations could be the marginal supplier during a larger part of the year. But, because of a lack of investment in nuclear energy, gas and coal power stations have become "kWh price makers".

While liberalization of the European electricity market is in itself not the sole reason for higher prices, the development of interconnectors, which is a natural consequence of the liberalization process, is a factor. Electricity liberalization is now being contested by some European consumers who hold it responsible for electricity price increases. While at the advent of liberalization oil, gas and coal prices were low; today, the price of oil is high and that is the main reason why the market price of electricity is much higher than the former regulated price of kWh, even in countries such as France where the nuclear share of electricity generation is very high (78%). The impact of the rise in the price of oil can be seen locally across both electricity and gas markets, where prices have been forced to rise:

FUEL PRICE TRENDS IN JERSEY



Source: J.E.C.

This has been fortuitous for electricity companies operating a large proportion of nuclear power plants, such as E.D.F. in France, which can now sell at a profitable price (the cost of a kWh generated by a gas turbine), the kWh produced by cheap nuclear power stations. The gap between these two prices may be considered as a "nuclear rent" and it has been argued that such a mark-up constitutes unjustified windfall profits.

Consumers in France however, have been somewhat sheltered by recent increases in wholesale market prices. Despite the French Regulatory Commission refusing to allow opted-out customers to revert back to regulated tariffs, and planning to abolish all regulated tariffs from 2010, the French Parliament has nevertheless conceded to consumer lobby groups and voted a law in December 2006 which established an "optional return tariff" valid for 2 years (TaRTAM). Although temporary and higher than the previous regulated tariff (by approximately 23%), this new regulated tariff remains below the market price. The J.E.C. did attempt to negotiate access to this protected market in 2008, but were excluded on the grounds that the tariffs were only available to customers in French territory paying French tax[1].

The European Commission has declared that this regulated return tariff distorts competition and has recently begun legal proceedings against France (and other countries such as Spain) to demand the removal of these tariffs. It has argued that these tariffs are too low, as they are calculated on the operating costs of power stations that are already paid off, and they do not reflect the kWh production costs of new replacement power stations, therefore reducing the reinvestment which is required to ensure future security of supply[2].

In summary therefore, increasing interconnection between the German and French spot electricity markets allows the German consumer to make the most of lower prices during off-peak hours when the French price is the leader price and France is a net exporter of electricity. However, faced with that increased interconnection, the French consumer who has signed a market price contract is forced to pay for his electricity at a higher price during full hours and peak hours, when the German price is the leader price in the market and France becomes a net importer of electricity. A consequence of this is that consumers from the countries with low cost production such as France will never take advantage of the low level market price that they would have benefited from if their national markets were not integrated into the single market.

Tariff comparisons with other areas

Comparing situations across multiple jurisdictions is never an exact science as data often comes from a variety of sources which makes it difficult to use a single methodology to compare tariffs on a like-for-like basis. While the J.E.C. has made tariff comparisons from time to time, it only provides a snapshot view which quickly alters, or the comparative data has a degree of "lag" as statistical information has yet to be updated in terms of core pricing or foreign exchange. In addition the complexity of tariffs (particularly in highly competitive markets like the U.K.) makes defining an "average" customer a complex task. Such difficulties help explain why typically the

[1] 'J.E.C. Blocked in bid for cheaper electricity'. Jersey Evening Post, 22nd August 2008.
[2] France may find its own way to electricity market liberalisation. Utility Week. Siân Crampsie 12th June 2009. See **Appendix 2**.

J.E.C. has not published tariff comparisons even when its prices were substantially lower than in other areas.

The current position at time of writing was as follows –

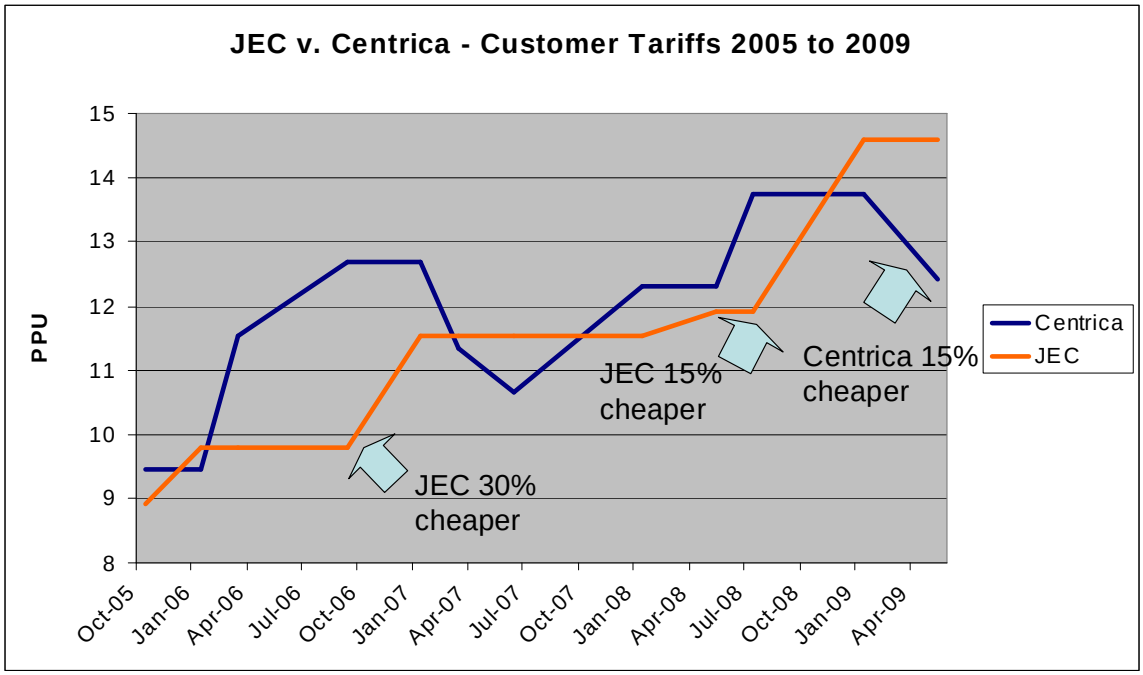
Tariff comparisons - July 2009 Medium domestic consumer Average pence per kWh			
JEC		14.59	
EU 15 Median *		15.01	2.9%
UK*		13.94	-4.4%
France*		10.71	-26.6%
Guernsey**		14.95	2.5%
Isle of Man**		15.19	4.2%
Centrica**		12.43	-14.8%
* Eurostat website - report issued 16 July 2009			
** from Company websites			
€/£ exchange rate of €1.15 used where applicable			

EU15 average data is obtainable from the Eurostat website (http://epp.eurostat.ec.europa.eu) and the U.K. Government website for the Department for Business Innovation and Skills (www.berr.go.uk) which updates information every 6 months. This provides a reasonably constant baseline as the J.E.C. imports electricity from the E.U. marketplace, albeit the data cannot be easily weighted to account for differences in size, scale or efficiency. The J.E.C. use this information when considering cost and impact for a typical household consumer (defined as using between 2,500 and 5,000 kWh p.a.).

Included within the EU15 statistics is data for the U.K. and France which are natural comparators, given the Island's links with both jurisdictions. It is important to remember, however, that neither market offers a truly equal comparison as customers in France still pay a price underpinned by Government subsidy that is not available to the Jersey public, while the U.K. market is fully competitive and integrated, allowing inclusion of data from "dual fuel" offerings, where consumers receive both gas and electricity as a package. This explains the otherwise huge disparity with prices in France, but contrasts reasonably favourably with the aggregate cost in the U.K.

The last set of figures in the table comes from Centrica, which is the largest electricity supplier in the U.K. and claim (currently) to be the cheapest for electricity. The J.E.C. monitor Centrica[3] directly, as well as the aggregate U.K. price to offer further comparison to offset the complexity of U.K. tariffs and the lack of transparency on U.K. supplier websites. The following chart demonstrates such movements over recent years –

[3] Centrica are presently the only U.K. supplier to consistently publish all their tariffs. (http://www.britishgas.co.uk/pdf/Standard%20Electricity%20prices.pdf).



Based on the period outlined, it is estimated that in monetary terms a J.E.C. customer would have paid 6% less in total than a Centrica customer, but this figure will naturally vary according to base dates utilised.

Turning to Guernsey and the Isle of Man, the comparisons are more straightforward. Data from their respective websites (www.electricity.gg and www.gov.im/MEA/) provides their standard rate charges per unit and daily standing charges, spread over 3,750 units (being the Eurostat definition of an average domestic customer). There are some nuances (5% VAT in the Isle of Man, compared to 3% GST in Jersey), as domestic customers suffer indirect taxes as an additional cost unlike commercial customers who can generally recover such taxes. In addition, Manx Electricity do not bill the daily standing charges that results in a reduction of around £50 per annum (1.2p per unit) because the Manx Government underwrite this as a subsidy. If this was removed, i.e. to be like-for-like with Jersey, the price differential between the two Islands would move to around 12%.

Although it is a worthwhile exercise to compare where tariffs in Jersey lie against elsewhere, it is worth nothing that when comparing the J.E.C. with Centrica, for example in the U.K., there is no legitimate reason to expect the J.E.C. tariffs to be lower on an ongoing basis as the scale benefits of having 15 million customers against the 47,000 in Jersey is a large price driver.

Power and foreign exchange hedging policies

In asking the J.E.C. for data to establish its pricing policy, the Department needed information on how the J.E.C. power and foreign exchange hedging policies function, and what impact that has had on tariffs in recent years. This is quite a complex area where some background provides a useful context.

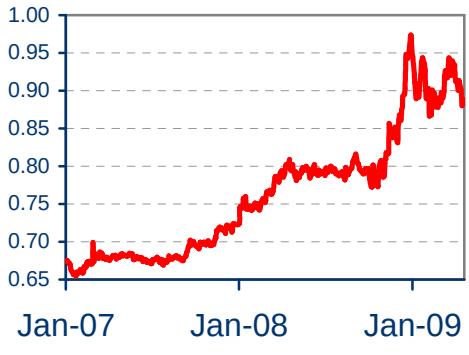
The J.E.C. has a 15 year framework agreement with E.D.F. that began in 1997 when the second interconnector to France was being built. The company's key aim, along with its partner Guernsey Electricity, was to ensure that the Channel Islands could access a reliable electricity supply from Europe at a reasonable cost. This contract had review points in 2002 and 2005. The J.E.C. generally made tariff decisions in the autumn of each year, with a tariff decision being communicated in the last quarter and a movement (if applicable) from 1st January.

In the 10 year period from 1996 to 2005, the average price of a unit of electricity in Jersey moved up 13% from 6.4p per unit to 7.3p per unit. This was a relatively small rise over time, in stable increments, and still around 25% less than the prevailing RPI in Jersey during that same 10 year period. In 2006 however, the J.E.C. migrated from a "cost plus" contract to a market-based arrangement due to the opening up of the French marketplace to competition (as noted previously). Such competition in the supply chain has not been beneficial to Jersey customers; instead it brought significant volatility into the equation, albeit the level of price movements seen in world markets since was not anticipated, either by the J.E.C. or other utilities. In 2005 it had been felt that competition in France would be healthy, as evidence from elsewhere had demonstrated that competitive markets generally drive prices downwards. However, the French and other European markets have been dysfunctional to date with liquidity being limited and subsidies rife.

In the period since 2005 when the J.E.C. moved to a market-based contract, the hedging policy has been refined and developed in conjunction with Utilyx, a U.K.-based power consultancy and Guernsey Electricity (with whom the J.E.C. jointly purchase power in order to add some efficiency of scale). A formalised policy now exists that is signed off initially by a Risk Management Committee consisting of representatives of the J.E.C., Guernsey Electricity and Utilyx, and then by the relevant Boards in both Jersey and Guernsey. This provides a robust framework to purchase power from E.D.F. that is consistent with that employed by other utilities before they set tariff prices for customers. In addition, the J.E.C. has a further complication that U.K. utilities do not encounter – having to purchase electricity in Euros rather than Sterling, and therefore the company has another hedging policy in respect of settlement of its estimated electricity liabilities.

Electricity Euro Price for Delivery in 2009

Euro/Sterling Exchange Rate



Source: J.E.C.

As can be seen from the graphs above, the relative cost of imported electricity has increased at a time when sterling has weakened comparatively against the euro. While this scenario is more challenging than the norm, the company has had to deal with both currency and cost variation for some time. For this reason the company purchases both power and Euros on a rolling purchase basis and typically seek to fix the price it pays to E.D.F. 12 to 18 months in advance, using Powernext Futures as the benchmark, this being the wholesale electricity trading exchange in France. The company, therefore, buys regularly at market prices at various points in time. It thus buys power in the Futures market for part of the year ahead and two years ahead and has, for example, been buying power in 2009 for delivery from 1st January 2010 and 2011.

Settlement to E.D.F. is required on a monthly basis and so the company has also entered into forward contracts to buy foreign exchange at set prices in future years on a rolling basis. This means that when the company makes a tariff decision it should have a reasonable estimate of how much it will pay for wholesale electricity in the following year and, therefore, seeks to offer customers relatively high stability of pricing for at least a year. In the last 3 years since the full opening up of the market-place, the J.E.C. electricity price fixings in the Futures markets have been on average very close to the average of the Futures markets that prevailed in the year of purchase, i.e. the core prices that drove tariff rises were at market levels. The figures below show the base performance of wholesale purchases (excluding transport charges, supplier margins and time of day coefficient calculations that are used by the J.E.C. in determining the final end price that is paid each month) –

Calendar 2007 bought at av. €57.71 versus market €56.38

Calendar-2008 bought at av. €54.95 versus market €54.44

Calendar 2009 bought at av. €75.23 versus market €74.12

Calendar 2010 bought at av. €51.38 versus market €52.31 – **TO DATE**

(Source : Utilyx)

In terms of foreign exchange hedging, company policy is to cover future expected liabilities rather than seek to make for-ex profits. In other words the J.E.C. does not bet for or against the Euro, but keeps as its core aim to provide stability and price certainty. The table below shows its performance over the last 6 years –

	Average	**Average**	
	Achieved	**Spot Price**	
	Euro rate	**Of Euro**	**Gain/(loss)**
	€	**€**	**£m**
2004	1.55	1.47	0.8
2005	1.44	1.45	(0.1)
2006	1.42	1.47	(0.7)
2007	1.43	1.48	(1.0)
2008	1.42	1.31	2.8
2009	1.32	1.13	7.0
	FX gain		**8.8**

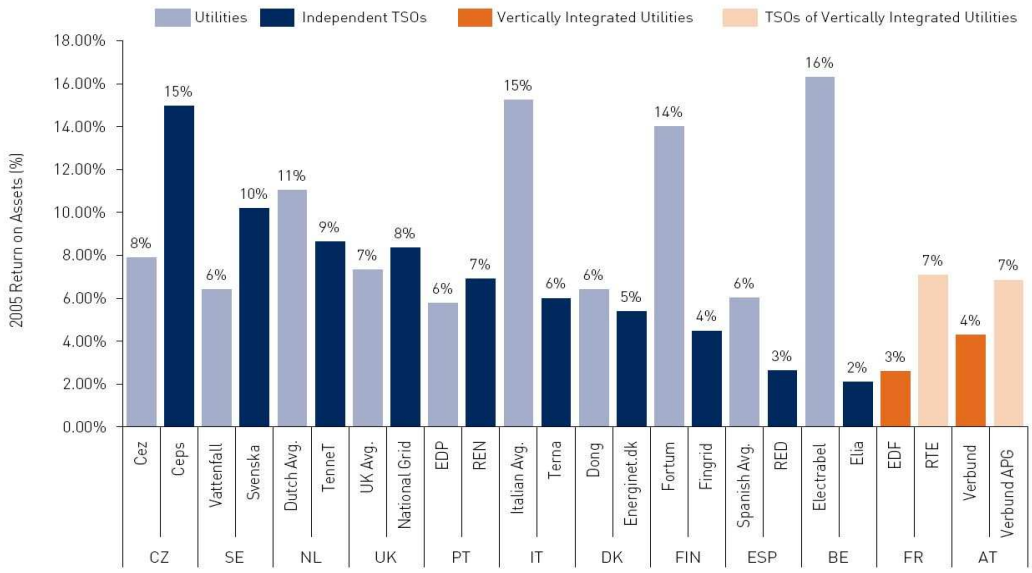
The fact that the J.E.C. made overall gains in foreign exchange is fortuitous, but the table above shows that J.E.C. customers have gained over the period by, in effect, paying less for electricity than if the J.E.C. had merely paid for its importation bills by the prevailing rate each month. It should be noted of course that this could have just as easily been negative trading, but the J.E.C. would have still delivered its foreign exchange hedging policy goals. In considering the measure or relative success of the company's hedging programme, therefore, it is important not to lose sight that it is to provide reliable data about future payments and liabilities, not to win on the trading exchange. While the company could, in principle, buy Euros at spot prices to satisfy its monthly E.D.F. bill, this would inevitably add to tariff uncertainty and force the company to impose quarterly adjustments or otherwise smooth out the changes. As it stands, the company policy appears reasonable and robust and, albeit fortuitous, it does not seem to have adversely affected the need of the company to adjust prices.

Present needs and future expansion

The present needs of the company have been determined by reference to the J.E.C.'s published Annual Report. It shows the company seeks to deliver a return from its Energy business of between 6% and 7% on its investment in infrastructure assets. This compares reasonably with the 6-8% return on assets typically needed to support ongoing investment in infrastructure. The actual return for 2008 was 6.2% and the target for 2009 is between 6% and 7%.

The States has not traditionally sought to influence the electricity market directly and has been content to keep its shareholding in the company both as an investment vehicle and an insurance policy should the need to intervene arise. The implementation of an Energy Policy for the Island has influenced the medium- to long-term planning process within the J.E.C. (and also within the Island itself), but looks more broadly at key issues such as emissions, the carbon footprint of all fuels and energy efficiency, rather than merely pricing. That said, the J.E.C. delivers important benefits in line with this and other States policies of a reliable imported supply backed up by La Collette (a critical requirement for resilience) and continuous network investment.

Profit in the Energy Business has increased over the last 2 years because in 2007 the company absorbed some of the cost increases it faced at that time. This had the effect of holding profits low in 2007 and hence drove a higher percentage increase from 2007 to 2008. The data supplied by the J.E.C. shows that profit returned to the level of 2005, a level consistent with other utilities at 6–8% return on assets. The chart below shows information from Datamonitor of typical returns on investment by electricity utilities in Europe. This shows an average around 8% expected return which indicates that the J.E.C. return is not inconsistent with the market. If anything, returns are on the modest side.



Source: Datamonitor *TSO's are Transmission System Operators

The J.E.C. interim Report 2009 states that group turnover was 9% higher than 2008, but profit before tax was down 22% over the same period. Profits in the Energy Division are down 15% because of a 40% rise in the cost of imported electricity. Notwithstanding the company's decision to raise tariffs by 24%, earnings per share fell by 31%. The Report also shows that electricity revenues were up 13% on the previous year, with a 2% rise in unit sales volume, but that energy profits fell from £4.4 million to £3.7 million as the price rise did not match the increase in import costs. In other words, the company absorbed a percentage of the price rise rather than pass it all on to consumers, a cost to the company of over £1 million and a saving to consumers of 3% beyond the actual price rise. The notes to the condensed Interim Accounts also outline related expenditure of which the most important is property plant and equipment. Here it was reported that the company spent £5.9 million in capital expenditure.

The company needs to create the capital reinvestment to ensure that the Island's electricity infrastructure is well maintained and updated as required. Jersey Electricity has invested around £100 million over the last 10 years, and capital expenditure going forward over the next 10 years will need to exceed this to deliver essential new and replacement infrastructure capacity. Of this investment, one of the most important over the next 4 years is the circa £50 million to be invested in a third interconnector to France. This is needed in order to meet the demands of future customer requirements and to provide infrastructure resilience, given that the first interconnector is now almost 25 years old. As it is, the Company will need to borrow up to £20 million to help finance capital investment over the next few years. The strategic importance of multiple electricity and data cable links cannot be over-emphasized. The Island competes in an ever more demanding economy where a reliable electricity supply is a must. In order to maintain the Island as a viable finance and e-commerce centre, it must reinvest, not just in the maintaining of its existing links, but in an expansion and modernisation programme. Co-operation between utility providers may offer more flexibility with regard to financing options (cost sharing between the J.E.C. and the telecommunications providers for example), but the programme must go ahead.

Future expansion

There are 4 essential elements to Jersey Electricity's investment programme –

- Regular replacement of low and medium voltage equipment that has come to the end of its natural life. Most of the equipment being replaced was installed in the 1960s.
- Replacement of the high voltage network. This includes major primary substations like the £13 million Western Primary which was recently built to replace a failing Les Quennevais sub-station. Going forward, the construction of 2 new primary substations at La Collette and West of St. Helier are planned over the next few years to replace old 1960s facilities and provide important network resilience.
- Replacement of the first interconnector with France, which is coming to the end of its life, and the installation of a new third interconnector to accommodate new demand for electricity and to provide security of supply in the event of a failure of any one of the other cables.
- Investment to connect new developments. Whilst a developer always pays a contribution to this cost, a significant portion is covered by the Company. Such developments would either not happen or would have to be fully funded by the developer or the States. Large capital projects, such as data centres, are important examples.

The company's recent and future capital investment programme is highlighted in a graph as **Appendix 4**. The Department agrees that this is necessary and proportionate investment and that within the current commercial operating mode it is reasonable for the company to seek to finance the projects both directly and indirectly through its tariffs. Given the current economic situation alternatives do not abound. The States could choose to sacrifice its dividend either through price subsidies or as a capital loan to the company, but this would not be of the required scale to achieve the necessary impact. The company is already seeking to borrow on the market, but this has to be financed through accepted levels of return. To that end, the balance must lie between what the Island needs by way of infrastructure investment and what the public and other customers are prepared to pay. The Proposition P.41/2009 seeks to impose an arbitrary tariff and level of return that would jeopardise this investment, but does not provide the rationale for doing so. In considering the public interest, the Minister is guided by the Law to consider infrastructure investment and capital needs of the company, amongst many other things. It seems likely that a reduction of 20% would at the very least put off that investment for some time, and potentially place the company into a position of being unable to cover its operating costs. This, in turn, would lead to an inability to borrow and pay the interest due, in which case the company would likely have little choice but to raise prices again or, if political intervention demanded it, stop most investment.

Risk

Suspension or delay of the capital investment programme will result in a less reliable electricity supply and an inability to respond to the predicted growth in demand. Equipment and supply failures will likely occur more frequently, albeit their frequency and speed of restoration will vary. The impact for all types of business, but

particularly the finance industry, given its role in the Island's economy, would be significant. Even in a situation where power levels are sustainable it would not allow the company to deliver on expectations for growth. This has potentially negative consequences for businesses, as they choose the jurisdictions in which to locate and where economic recovery and expansion are planned. Furthermore, it should not be forgotten that the lead-times for these capital projects are quite long. For example, the design and construction of a new cable to France takes 5–6 years and for a new primary substation around 3–4 years. Emergency repair of an interconnector can take 12 months or longer, depending on the availability of resources and weather conditions.

In the event that the company had not implemented its price rises (or should it be forced to implement the 20% reduction proposed in P.41/2009), it would move the financial position from one of a £6 million profit into a £9 million loss, albeit the exact figures would be variable according to the trading climate at the time. The J.E.C. has estimated the following projection at the request of the Department –

	£ million
No dividend paid as J.E.C. is loss-making	*1.8*
*GST on £15m@3% (assume half not reclaimable by customers)**	*0.2*
Tax on profits paid in 2008 not repeated	*0.9*
*Tax reclaim by J.E.C. for £9m losses @20%***	*1.8*
	4.7
Reduced electricity cost to States Departments of 20% decrease	*1.2*
Net reduction in cash received p.a. by States of Jersey Treasury as a result of a 20% decrease in J.E.C. electricity prices	**3.5**

**domestic/small commercial customers cannot reclaim GST*
*** losses assumed capable of being carried back and tax refund receivable by J.E.C.*

In addition it is worth noting that the J.E.C. made a voluntary donation of £0.5 million in 2008 to encourage energy efficiency initiatives in Jersey. The prospect of any potential future donations of a similar nature would be eliminated by a tariff reduction as advocated.

It is thus highly likely that limiting capital to the J.E.C. will impact negatively on their ability to invest in energy efficiency or renewable programmes. Overall halting, suspending or delaying investment would not only be a drag on economic growth and potentially risk electricity supply to local people and businesses, it would also risk Jersey's reputation for being a secure jurisdiction in which to do business. This level of risk, whether perceived or actual is not acceptable.

Efficiency

In making any determination of the company's pricing policy, some consideration has to be given to its operating efficiency. Over recent years Jersey Electricity has improved its operating performance, and during the last 14 years, staff numbers in the Energy Division have reduced by a third from 290 to 192. During the same period –

- Electricity volumes have increased by 37%;
- Reliability has improved and is one of the highest in the developed world (average customer minutes lost in 2008 of 5 compared to 80 in the U.K.);
- Lost-time accidents have improved to a level in 2008 of just 2; and
- Customer Service levels have consistently exceeded standards set by U.K. authorities.

Reduction in headcount numbers

Headcount numbers in the J.E.C. core Energy business have fallen by a third from 290 FTEs in 1995 to 192 in 2008[4]. These figures are published in the J.E.C. Annual Report and Accounts. The Department asked the company to justify not just headcount, but also salary costs, given that any saving in low-paid staff could have been more than levelled by salary increases amongst management. The J.E.C. informed the Department that the staff who left the Energy business over the period concerned were a mix of senior managers, managers, supervisors, clerical and shop floor staff. Around 70 staff were made redundant, with the remaining 30 or so coming from natural wastage (non-replacement when staff retired/resigned).

To provide a "like-for-like" comparison on the payroll bill between 2008 and 1995 in order to provide comfort that costs, as well as headcount, have fallen, a higher level exercise was performed. The company adjusted for the headline pay-rises that took place over the 14 year period concerned and removed the base inflationary impact. They were then able to demonstrate that manpower costs are between 10% – 15% lower in real terms now than in 1995. The primary reason for a differential against headcount reductions is that many of the remaining staff were re-trained and their job scopes enlarged to ensure that a more flexible workforce emerged from the rationalisation process. For example, a number of the meter-reading staff can also operate generating plant at La Collette on an "as required" basis. By the very nature of this restructuring, a number of roles then commanded a higher salary level than previously existed.

The ability to pay reasonable dividends

Over the year, the Company increased dividends to the States by 27% (£300k) from £1.1 million to £1.4 million. Shareholder return, however, is often measured by the dividend yield, which is a measure of the dividends received by investors divided by the value of their investment. The dividend yield of the J.E.C. of 3% is still low compared with similar utilities, which are typically at around 5–6%. The ratio of the dividends paid to profit is also low for Jersey Electricity at around a quarter compared to about a half for U.K. listed utilities. By way of comparison, on Island both Jersey Telecom and Jersey Water have more generous dividend policies at around a third of

[4] It should be noted that Guernsey staffing reflects the full operation of their power station, however, to enable some comparison, the following table illustrates staffing levels of Guernsey Electricity Company (see page 23 for full 'Key Statistics'):

Year	**2006/2007**	**2007/2008**	**2008/2009**
Employees	233	233	229
Customers	28,685	28,791	28,934

their profit. This is clear evidence that shareholders of Jersey Electricity are receiving at best only a modest dividend compared to shareholders of other utilities.

This is borne out by consideration of external data sources. The Financial Times on line noted that –

> *"2008, cash reserves at Jersey Electricity fell by 7.54m. However, the company earned 14.95m from its operations for a Cash Flow Margin of 18.25%. In addition the company used 20.07m on investing activities and also paid 2.43m in financing cash flows.*
>
> *Year on year Jersey Electricity grew revenues 7.96% from 75.87m to 81.91m while net income improved 29.78% from 7.57m to 9.82m.*
>
> *Jersey Electricity uses little debt in its capital structure as supported by a debt to capital ratio of 0.00%."*

Name		Revenues (TTM)	Net Income (TTM)	Market Cap	Employees
Burgenland Holding AG	AT	5.84m	5.67m	106.72m	0
Dniprooblenerho EK VAT	UA	--	--	109.37m	8,224
Khmel'nyts'koblenerho EK VAT	UA	--	--	86.50m	3,714
Kyivenerho VAT	UA	--	--	103.20m	14,297
Koncar-Elektroindustrija d.d.	HR	348.82m	11.86m	103.08m	4,274
Ayen Enerji AS	TR	41.59m	19.69m	106.25m	179
EnergyO Solutions Russia AB	SE	284.51m	289.48m	127.99m	5
EnerTad	IT	37.64m	23.58m	97.24m	72
Jersey Electricity	U.K.	86.11m	7.94m	105.71m	341*
PEP	PL	21.83m	9.56m	106.40m	195

FT.com August 2008

*Figure represents the Jersey Electricity Group

Other utility comparators show that the dividend cover of the J.E.C. is quite high, as demonstrated below –

Company	Dividend Cover1	Company	Dividend Cover1
National Grid	1.1	Dee Valley	0.4
United Utilities	1.1	Severn Trent	0.8
Scottish & Southern	1.6	Northumbrian Water	1.6
International Power	3.9	Pennon	1.8
Centrica	1.8	Drax	2.3
Avg U.K. Listed3	**1.6**		
Jersey Water	3.2	Jersey Post	3.0
Jersey Telecom	1.5	**J.E.C.**	**4.3 times**

1. Ratio of earnings per share/net dividend per share paid;
2. Excluded high and low datapoints;

Dividend Yield

Company	Dividend Yield 1	Company	Dividend Yield 1
	5.3%	Scottish & Southern	5.8%
Dee Valley	5.9%	Severn Trent	6.3%
Drax	10.3%	United Utilities	6.6%
International Power	4.8%	Pennon	4.4%
Northumbrian Water	5.2%	J.E.C.	3.4%
Avg U.K. Listed	**6.6%**		

1. Ratio of gross dividend over share price; no publicly available share price for JT and JW so no data. Source: Financial Times, 18th – 20th July 2009

Dividend cover shows a company's pre-tax profit which covers the dividend it pays, whereas yield is the gross dividend/share as a percentage of the company share price. The J.E.C.'s aim is to move its dividend level to a market value over time. It is also fair to note that the requirement for the J.E.C. to invest more heavily in infrastructure assets over the short- to medium-term than U.K. equivalents is a factor. U.K. listed companies on average distribute about 60% of their profits to shareholders and hold onto 40% for future investments. The J.E.C. in 2008 had a cover ratio of about 4 times which is high, but a low yield from its profits of around £10 million, paying out £2.5 million. If it was following the U.K. average, the J.E.C. would have had to pay out up to £6 million in dividend. The net consequence of this is that comparatively, the tariff raised from customers is being used to finance capital investment and is not being given over to investors. This comparison would tend to justify assertions by the company that its pricing formula, when weighed against its needs for capital investment, and given its quite reasonable levels of dividend yield and profit, is robust and proportionate.

The Guernsey Electricity Company

The situation in Guernsey is an interesting parallel, but does not make for an ideal comparison because of the different shareholding and principles underpinning the Guernsey Electricity Company. Formed in similar fashion on 6th August 1898 as the Edmundsons Electricity Corporation, the company was granted the concession to build

and operate the electricity supply system in Guernsey. On 20th July 1907 the Guernsey Electric Light and Power Company Limited acquired the concession from Edmundsons Electricity Corporation, and on 1st July 1933, the States of Guernsey terminated the concession, acquired the undertaking and delivered it to the States Electricity Board to administer in trust.

Guernsey Electricity Limited is now a limited liability company wholly owned by the States of Guernsey, and the company is the sole provider of electrical energy to the Island of Guernsey operating under the Electricity (Guernsey) Law 2001. Unlike Jersey, where arms-length regulation operates through the Competition Law, the Guernsey company is subject to price regulation by a dedicated regulator, the Office of Utility Regulation. In parallel with Jersey, Guernsey generated its own electricity until 2001, when it was able to benefit from the cable link to France and the opportunity to import units from the European Grid.

Guernsey Electricity: regulatory issues

The ability of consumers in Guernsey to potentially benefit from price regulation has not been the panacea that might be expected. Disagreement between the regulator, the company and the States concerning the relative value of the company's assets and the appropriate return on investment led to the appointment of Sir Ian Byatt, David Newbery and Chris Bolt as independent consultants. Their report[5], finalised in August 2006, identified a number of issues that were not wholly consistent, particularly with regard to the financial models used by the company for price setting, and the regulatory accounts where the average cost of capital was determined by the regulator.

The role of the States of Guernsey has also been a much more proactive one than has been the case in Jersey. The Guernsey Treasury and Resources Department have prepared a Financial Framework for the company, based on the States' policy of 'Save to Spend'. This determines what the company's cash reserve will be, having taken into account future projected capital investment. While it is not an efficient financial vehicle for a sector where normal levels of gearing stand at 50–75%, nevertheless as Byatt points out (p.5) it is a policy that has been consciously chosen by the States. The States also determine the level of return to the shareholder, which by virtue of the policy is quite modest.

Byatt notes that it is recognised in the Financial Framework that setting prices to reflect the specified objectives for the cash reserve and for dividends will "result in an accounting loss being recorded for some years and an accounting profit for other years" but that over 10 years this should balance out. The outcome however, according to Byatt, has been that the objectives of the various parties have not been fully consistent with each other. The company has stated that losses are de-motivating and inimical to efficiency, while the O.U.R. has voiced concerns that easy access to cash could lead to the development of otherwise uneconomic capital projects. Guernsey Gas, a major competitor in the local energy market, has stated that this has resulted in market distortion because of under-pricing in electricity.

[5] **Guernsey Electricity: Regulatory Issues: Report by Sir Ian Byatt, David Newbery and Chris Bolt.** Final draft 18th August 2006, http://www.regutil.gg/docs/Annex%20A%20%20Independent%20Expert%20Panel%20final%20report.pdf

The impact of these potentially disharmonised set of policies is reflected in the company's Annual Accounts. As can be seen in the discrepancy between accounting years 2007/8 and 2008/9, Guernsey Electricity's level of profitability is effectively reversed, in large measure because of the large rise in the European wholesale market described previously. The constraints on the company, identified by Byatt back in 2006, do not seem to have been fully reconciled, and the same arguments regarding appropriate levels of gearing, pricing, investment and return continue to be played out in the media (*see* **Appendix 3**).

Key Statistics

	2006/2007	**2007/2008**	**2008/2009**
Turnover	£32,505,000	£38,111,000	£39,379,000
Profit/(Loss) pre Tax	£328,000	£1,160,000	(£1,599,000)
Employees	233	233	229
Customers	28,685	28,791	28,934
Units Generated (MWh)	158,175	110,655	173,523
Units Imported (MWh)	197,020	257,093	210,440

The Chairman's statement in the Guernsey Electricity Report and Accounts (2008/9) notes the following –

> *"This is the fifth year in succession that we have reported a normal operating loss. A key issue concerning my Board is that the company has no control over the level or timing of any tariff changes. The effect of keeping pricing too low compromises future investment and by so doing jeopardises the future security of supply".*

This is echoed by the statement of the Managing Director –

> *"The company's financial results are beyond our control and our poor financial performance is not compatible with an electricity company that can guarantee security of supply and steady economic tariffs for the long term. This is a matter of major concern within the company".*

The evidence of practice in Guernsey would tend to support the statements by the J.E.C. that reducing price threatens security of supply, not least because the States of Jersey has to date not shown a desire to interfere in the marketplace. Given the lack of a dedicated utility regulator, it seems unreasonable to assume that the States (of Jersey) has the knowledge or experience to justify price intervention, not least when the effects of such interference are not ultimately borne by the taxpayer alone. While the States of Guernsey can afford the luxury of determining pricing because of its 100% stake in Guernsey Electricity and has the O.U.R. to assist it, the States of Jersey would be intervening in the operation of a commercial company that it does not control, notwithstanding a majority stake. Such intervention would send a negative message into the marketplace and potentially destabilise the company's share price.

Conclusion

As noted at the beginning of this report, this investigation has been undertaken by the Economic Development Department using the terms of reference defined in Appendix 1 which are, in large measure, driven by the requirements of Article 22(2)

of the Electricity (Jersey) Law. This review does not represent an investigation under that Law, but has been undertaken in order to better inform the States regarding the matters which it would have to take into account should a dedicated review be undertaken as a consequence of P.41/2009. Officers of the Department have responsibility for the maintenance of the Law and have a good understanding of the operation and governance of the J.E.C., but they are not specialists in electricity markets, nor do they have the relevant expertise to address those parts of the terms of reference that address impacts on R.P.I., social economic groups and so on. Consequently those areas will be considered by the Economics and Statistics Units of the Chief Minister's Department.

This report has assessed the general financing of the J.E.C., together with its levels of income and expenditure, levels of cover and yield. It has compared the policies of the company with those in other jurisdictions, and has observed the general pressures on the company caused by the recent increases in the price of oil, together with the weakening of sterling on the international exchange. It has demonstrated that the company is largely unable to significantly influence these external causalities, but that it has taken measures to improve internal efficiencies, as well as to hedge on both the European power exchange and against the euro. This hedging however, is driven by the company's policy of meeting its operating costs and financial obligations, not to speculate. Consequently it is the conclusion of this report that the J.E.C. has acted prudently and has put the focus of its cash-flow/investment policy into securing the necessary funds to guarantee the integrity of the existing network and to provide for future capital investment. This capital investment is necessary in order to both guarantee security of supply and provide the full resilience that the Island requires as a major offshore centre. Such a policy is, in the Department's opinion, fully consistent with the overarching public interest.

The Department believes that future work should be undertaken to ensure clarity and transparency of objectives of the business over time, and this is a process that the company should develop in co-operation with the Minister for Treasury and Resources and the Minister for Economic Development in order to clarify the trade-offs between policy, regulation, customer needs and shareholder interests.

PART II

Economic impact of electricity price rises[6]

The proposition (P.41/2009) asks the States whether the Jersey Electricity Company should be required by the Minister for Economic Development to lower its prices by 20%. This would be equivalent to reversing the 24% increase that took effect in January of this year and then reducing prices by a further 0.8%.[7]

The report that accompanies the proposition raises a number of economic concerns in order to support the proposal.

Inflation

The direct impact on inflation of electricity price increases – the 'first-round effect' – is relatively straightforward to estimate. This is a one-off increase in the level of one price, which raises the RPI temporarily before dropping out after 4 quarters. The Statistics Unit has estimated that a 24% increase in electricity prices would raise the price of an average basket of goods and services by 0.5%. Provided that this increase does not then feed-through into higher wages and prices for other goods, then the increase in R.P.I. will be temporary, and not inflationary, since inflationary pressure comes from demand in the economy exceeding supply, and a one-off increase in electricity prices does not fundamentally alter that balance.

There may be a degree of pass-through to other prices, but obtaining a quantitative estimate of these 'second-round effects' is difficult. To disentangle the effect of energy prices on other prices one must control for all of the other factors that are changing them at the same time, which is not a straightforward exercise.

However, given the relatively low electricity-intensity[8] of the Island's economy, second round effects on prices are likely to be small. A high proportion of goods are imported to Jersey, and local electricity prices will be a very small fraction of the cost of these goods. For goods and services produced locally, there will be some effect on costs, and some of this may well be passed onto prices, however again the impact is likely to be relatively small. Furthermore, what is of interest is competitiveness, and thus the relative price of electricity elsewhere, and the evidence is that Jersey electricity prices are not significantly out of line with similar jurisdictions.

Distributional effects

Rises in electricity price have a disproportionate impact on those on lower incomes because expenditure on electricity as a proportion of income tends to decrease with income. The Statistics Unit estimates that a 24% increase in electricity prices would raise the cost of an average basket of goods purchased by pensioners by 0.7% and the cost of the average basket of goods purchased by those on low incomes by 0.8%.

[6] Report from the Economics Unit.

[7] Normalising prices before the 24% increase to 100: the January price increase pushed prices up to 124, 20% of 124 is 24.8, so the net change would be a fall of 0.8%.

[8] That is, each pound of economic value generated in Jersey uses less electricity than it would in the U.K. This would suggest that electricity price rises should have less of an effect on the economy than an equivalent rise would have in the U.K.

Assuming that consumption does not change significantly, the Statistics Unit also estimates increase expenditure on electricity by the amounts shown in Table 1.

Table 1: Average expenditure on electricity by income quintile, before and after a 24% increase in electricity prices

	Income Quintile					
	1 (Lowest)	2	3	4	5 (Highest)	All Households
Expenditure before	£491	£450	£613	£811	£1,009	**£668**
Expenditure after	£608	£558	£760	£1,006	£1,251	**£828**
Increase in expenditure	£118	£108	£147	£195	£242	**£160**
Increase as % of total expenditure	0.7%	0.5%	0.4%	0.4%	0.3%	**0.4%**

The table shows that an increase in electricity prices is slightly regressive, in that to consume the same amount of electricity as before the price increase, households with lower incomes must increase their expenditure on electricity by a larger amount relative to their overall expenditure than those on higher incomes.

Wider economic impacts

The impact on inflation is difficult to estimate, but it can reasonably be assumed that they are small. As a consequence, the effects on competitiveness and the health of the rest of the economy can also be expected to be relatively benign.

The important thing from an economic perspective is that resources are being used in the most efficient and productive way, which should in turn lead to a competitive and successful economy. Artificially low prices of electricity will not help from the perspective of either efficient investment or of environmentally sustainable policies.

Arbitrary changes in prices could jeopardise the present needs of the company and/or the future services provided by the company. For example, if the J.E.C. were unable to make the necessary investment because it does not have the funds or the ability to raise these funds in the capital markets, then the price of electricity may have to rise further in the future.

Given that this is the case, while these other economic impacts are of interest, they are to some extent secondary to the issue of whether the prices set by the electricity provider are optimal. Furthermore, any concerns about these other economic impacts can usually be addressed in other ways: for example, distributional concerns and the effects on the public finances can be addressed through changes in taxes and benefits or targeted subsidies.

APPENDIX 1

Terms of Reference for a Review of the Electricity Market in Jersey

Introduction

This review has been commissioned by the Minister for Economic Development, at the request of Senator Alan Breckon, in light of concern that the recent increases in electricity prices in Jersey are not in the best interest of the Island.

Under Article 22 of the Electricity (Jersey) Law 1937 (hereafter, the Law), should it appear to be in the public interest, the States may, by Regulations –[9]

- determine the tariffs to be made by the Company in respect of electricity it supplies; and
- specify the manner in which the tariffs are to be assessed and make provisions incidental thereto.

Any Regulations made under this Article have a 12 month 'sunset' clause, unless they are renewed by the States.

The purpose of the review is to make available information from the J.E.C. on the justification of the recent price rises and to assess their economic effects, with the aim of adding to the debate about whether recent rises in electricity prices are in the best interests of the Island.

Issues to be addressed

As a starting point, the review should set out the relevant considerations and explain the relationship between them, including, but not limited to – the viability of electricity providers, distributional and fairness concerns, and any consequences for the wider economy – for example on competitiveness and States' finances.

Article 22 of the Law states that, in determining appropriate electricity tariffs, the States must take account of the following –

- the present needs of the Company and the future expansion of services provided by the Company;
- the ability of the Company so long as its undertaking is managed efficiently to pay –
    - interest on and reimbursement of any debentures, loans or other borrowing of the company,
    - a dividend on the preference shares issued by it at the rate fixed under the terms of issue of such shares, and
    - a reasonable dividend on the ordinary shares issued by it;

[9] Under Article 35 there is a provision that the States may delegate the power and duty of representing the States in all or any matter arising out of the Law and of safeguarding the public interest generally.

- any capital expenditure which the Company may reasonably be expected to incur during the next 5 years and the desirability of the Company's charging such expenditure, or any part thereof, to revenue;

- the ability of the Company to pay all proper expenses of, and connected with, the working, management and maintenance of the Company;

- the provision of any contributions, whether set apart out of revenue or otherwise, which the Company may lawfully carry to a reserve, contingency or amortization fund;

- the ability of the Company to make good depreciation, whether or not provision therefore is made by a reserve or contingency fund; and

- the ability of the Company to meet all other costs, charges and expenses, if any, properly chargeable to revenue.

Consequently, the review must address all of these issues. Furthermore, in order to address concerns about the effects on the wider economy, the Review will also consider the 24% electricity price rise in terms of –

- the effect of upon the RPI, both immediately and in the medium term, and any effects that this may in turn have on competitiveness;

- the impact on different socio-economic groups, but particularly the elderly;

- the effect upon the fiscal position of the States of Jersey, both in terms of income and expenditure;

- any other impacts on the wider economy.

Deliverables

The primary output of the review will be a written report, to be laid before the States before a date to be agreed.

Governance, resources and timescales

The review will be overseen by the Minister for Economic Development and managed by the Economic Development Department. The review will involve submissions by the J.E.C. and the States' Economics Unit, supported by input from the States' Statistics Unit. Additional analysis may be commissioned from others as required.

The successful outcome of the review depends in large part upon the availability of resource within the Economics Unit and the Statistics Unit. It will also require the co-operation of the Jersey Electricity Company. Once these have been agreed, timescales for delivery can be drawn up, although it is proposed that the review begin as soon as possible and conclude by the end of August.

APPENDIX 2

France may find its own way to electricity market liberalisation.
Utility Weekly – Siân Crampsie – 12th June 2009.

France looks set once again to shun further liberalisation of its electricity market, but a commission led by Paul Champsaur believes it has found a way to promote competition with regulated prices. France's complicated electricity pricing system looks set to be overhauled following the publication in April of a government-commissioned report.

The report – released by a commission led by Paul Champsaur, former chairman of the French regulatory telecommunications authority – proposed changes to the wholesale market to promote competition between players, and could have a major impact on state-controlled electricity giant E.D.F. It came just weeks after the European Commission announced that it was widening an ongoing investigation into France's regulated tariff regime. The Champsaur Commission assessed the current arrangements and investigated how the market could be further opened so that suppliers – and consumers – could benefit from the country's low-cost nuclear generation fleet.

While the Champsaur report said that the tariff system for small consumers should remain unchanged, it recommended that all suppliers in the market be given access to the low-cost electricity generated by E.D.F.'s fleet of nuclear reactors at a regulated price. This tariff should be set at the average cost of production, incorporating maintenance costs, costs for the life extension of existing nuclear plants and of constructing new nuclear plants as they arise. This system for wholesale tariffs, if implemented, would replace the current arrangements, which have been criticised for being complex and detrimental to competition. Consumers would still be allowed to switch suppliers on the liberalised market, in line with E.U. law.

Level playing field

Champsaur said that his recommendations would create a level playing field because E.D.F.'s competitors currently have to buy electricity on the liberalised wholesale market, where prices are set by coal and gas plants that only represent around 10% of French production, and which are more costly to run than E.D.F.'s 58 nuclear plants. Suppliers would be able to buy enough baseload electricity from E.D.F. at the regulated price to meet their needs in France only – thus ensuring that the low-cost benefit of the nuclear fleet did not stray beyond France's borders.

The mechanism would also give large industrial consumers the freedom to choose supplier without losing the benefit of a regulated tariff.

This fact raises the possibility that E.D.F. – which currently dominates the market – would lose market share to competitors such as Poweo, Direct Energie and GDF Suez. However, it would be likely to benefit financially from the proposed new system, according to analyst firm Citi Investment Research. A key impact of Champsaur's proposed system would be an increase in prices as tariffs were set at an efficient level to allow costs to be recovered. "We see tariffs moving more towards the €40–50/MWh mark over a seven to eight-year period, compared with current levels that are in the mid-€30/MWh range," said Citi analyst Sofia Savvantidou.

This would allow E.D.F. to generate more cashflow and invest in the crucial life extension and new-build projects that it has so far announced, and would be likely to outweigh any loss of market share through switching. “There is not a strong switching culture in France,” said Savvantidou, adding that the level of switching in the industrial sector as a result of the proposed changes would depend on “how aggressive” E.D.F.’s competitors were.

Half-way house

E.D.F. will also benefit from the end of the Tartam tariff. Tartam – Tarif Réglementé Transitoire d’Ajustement du Marché – was implemented in 2007 and is due to expire at the end of 2010. It was created by the French government as a half-way house between cheap regulated tariffs and the higher liberalised prices for industrial consumers who wanted to renege on their decision to opt for free market electricity.

The Tartam system is costly for E.D.F. because the company has to not only offer the tariff but also pay into the fund that subsidises it. E.D.F. reported this year that in 2008 Tartam reduced its profit by €783 million after tax, and estimated that the pre-tax cost of the Tartam regime would be €2 billion between 2006 and 2010.

Citi research has indicated that in 2011, the proposed new tariff system would have a post-tax impact of €995 million on E.D.F. E.D.F.’s competitors, which have so far struggled to make major gains in market share, were also reported to be satisfied with the proposals. “It’s what they wanted from the beginning – access to nuclear prices,” said Gaby Goldmann, general manager of the Paris office at NUS Consulting. “Everyone seems to be happy.”

But it remains to be seen whether the European Commission will be happy if the proposals are implemented. Its competition authorities have been investigating French tariffs since 2007 because of concerns that systems such as Tartam give large players an advantage. The Champsaur Commission was widely seen as an opportunity for France to pave the way for liberalisation and bring it in line with the spirit of E.U. law. In this sense, France’s critics will be disappointed by the proposed continuation of heavy regulation, but Champsaur said he believed that his recommendations would satisfy E.U. law.

“These proposals show that France is moving forwards and encouraging competition,” said Citi’s Savvantidou. “Given the current economic crisis, competition is probably not a high priority. This report will go a long way to appeasing the European Commission.”

APPENDIX 3

Guernsey Electricity accused by OUR of contradicting itself

By Thom Ogier

GUERNSEY ELECTRICITY should have plenty of money to fund its future capital projects, as long as the company is run efficiently, the regulator has said.

John Curran, director general of the Office of Utility Regulation, responded after Guernsey Electricity claimed prices would have to rise to pay for projects that are needed to secure supplies to the island.

The States-owned utility announced yesterday that it had suffered a loss of £834,000 for the year ending 31 March.

It said its future plans, to invest in an extra cable link and to buy another on-island diesel generator, were in danger if the company was not making sufficient profit.

But Mr. Curran said that the OUR had taken these projects into consideration when it set the current price control in 2007.

'In 2007, we looked forward 10 years to see the level of cash Guernsey Electricity was going to need to fund future capital expenditure,' he said.

The company currently had between £14–£16m. in its 'save-to-spend' reserve and he said that the amount would be plenty to get the projects started – possibly in 2010/2011 – and more money would be added to the account through continued revenue to fund their completion.

'We profiled that and set tariffs so that, as Guernsey Electricity needed the money, it would become available,' he said.

'We set the price control in such a way that if the company is run efficiently it should have no problems meeting its capital expenditures.'

It was agreed in 2007 that there would be no price increase during 2008 but there would be a rise this year.

Electricity prices went up by 17% from 1 April.

'The 17% rise equates to about an extra £5m. and is for the recovery of the actual cost that Guernsey Electricity has already incurred because of the volatile energy market,' Mr. Curran said.

He added that the utility had been given every opportunity to ask for an additional price increase in 2008, but it had failed to do so.

'If their concern that prices need to go up is real I would be surprised that they have not come to ask us for a price review,' he said.

Mr. Curran accused Guernsey Electricity of making contradictory comments about the state of its finances.

‘We met with Guernsey Electricity last week and they assured us there was no risk to the save-to-spend reserve,’ he said.

‘What they are saying publicly is different to what they are telling us in private.’

Guernsey Electricity said it reported a loss despite meeting all operational expenditure targets set by the OUR.

Mr. Curran said that he was not in a position to say whether the company had been working efficiently.

‘In 2007, we identified savings that could be made,’ he said.

‘We will be reviewing whether they have been implemented next year and we will look at whether there are more savings that could be made.’

Article posted on 2nd August, 2009 – 11.44am

Guernsey Gas echoes GE’s calls for price hikes
By Joel de Woolfson

GUERNSEY GAS has lent its weight to calls for electricity prices to rise.

The company criticised the Office of Utility Regulation for its role in controlling prices after Guernsey Electricity announced losses of £834,000 for the year ending 31 March.

Paul Garlick, Guernsey Gas managing director, said the States-owned utility was being forced by the OUR to sell electricity for less than it cost to produce it.

‘We have tried to warn people about this,’ he said.

‘Guernsey Electricity is making a loss, which will be a burden on the taxpayer in the future.’

He said that, as a competitor, it was unfair for his company to battle against a ‘loss-making monopoly’.

‘Guernsey Electricity’s managing director said in a radio interview in May that they were being forced to sell electricity for certain tariffs below costs,’ he said.

‘Even if you are going to operate Guernsey Electricity as a States-owned, loss-making monopoly, we do not see any gain in them selling electricity below cost on some tariffs.

‘They are not making any money – they say it’s unsustainable, we say it’s unsustainable and we think it’s not fair from a competition point of view.’

Mr Garlick said the blame lay squarely with the OUR.

‘The OUR wants one thing – low tariffs – because they think that is what they are judged on,’ he said.

'We are completely backing Guernsey Electricity wanting price increases.

'The way it is at the moment is absolute madness.'

Article posted on 3rd August, 2009 – 2.00 p.m.

Guernsey Gas questions electricity pricing **Friday 15 May 2009**

The head of a Guernsey utility company has asked States Deputies to look closely at the Island's electricity pricing policy.

Managing Director of Guernsey Gas, Mr. Paul Garlick, is calling on Deputies to question the low cost of some electricity tariffs: "Guernsey Electricity's Managing Director confirmed in a BBC Radio Guernsey report that electricity was being sold below the cost of generation. How mad is that?" He added: "On the face of it, low electricity prices may seem attractive, but we think that the bigger picture is being overlooked. Someone else, namely other Guernsey Electricity customers and the tax payer, is picking up the bill and that can't be right." An independent panel of experts employed by OUR warned of such practices in 2006.

Mr. Garlick said that the situation has arisen out of incongruous political and regulatory decisions, which have forced Guernsey Electricity to sell at tariffs below commercial or sustainable levels. He claimed that this is damaging: 'What political or public objective is served by selling electricity at too low a price? It encourages waste, discourages efficiency and is financially detrimental to the Island. Also, businesses and householders may be making long-term choices about fuels on a false economic basis, as local tariffs are unsustainable in the longer term.'

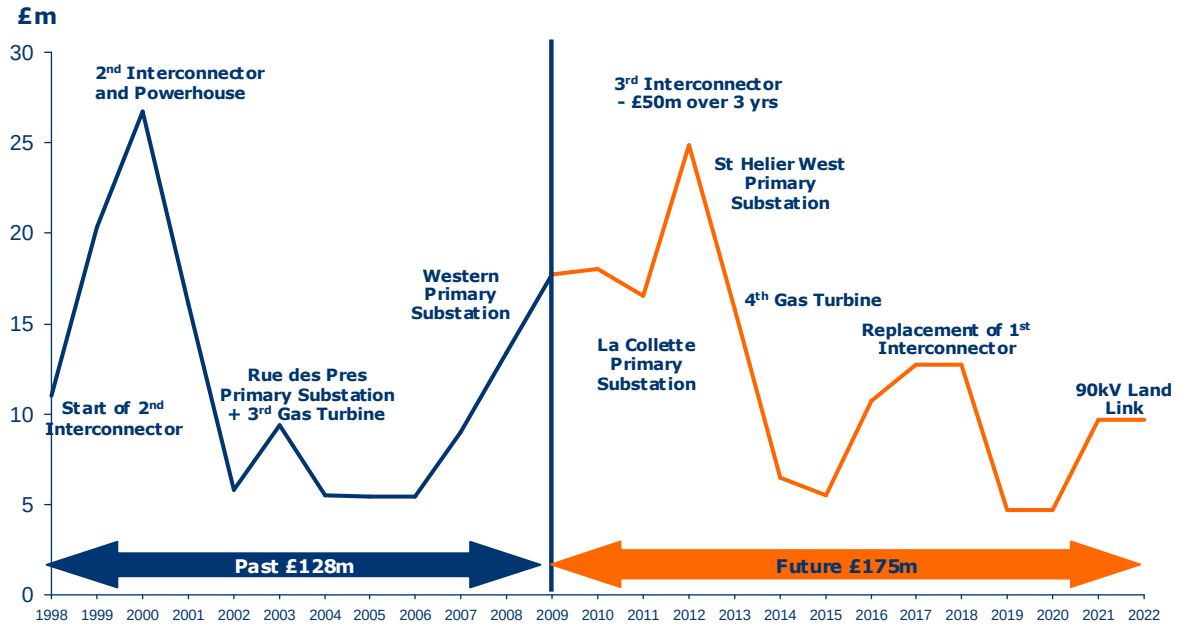
The Office of Utility Regulation has decided to increase Guernsey Electricity tariffs to commercial levels over a period of around 20 years. Mr. Garlick said that this needs to happen faster: 'Meanwhile, the taxpayer effectively has £93m of fixed assets plus £16m in cash tied up in a loss-making business. The alternative is to rebalance and migrate Guernsey Electricity's tariffs to commercial levels more quickly, generating operating profit of around £6m per year for the States of Guernsey, namely the taxpayer, and releasing much or all of the £16m cash balance.' He said that the States of Guernsey could then utilise these resources effectively, to deliver agreed strategic objectives or cut taxes.

Guernsey Electricity's regulated accounts show that the company makes losses in all of its business activities, which consist of generation, conveyance and supply and non-core. Mr. Garlick said this infers that many local businesses face unfair competition: 'Guernsey Electricity operates in a range of sectors, including plumbing, mechanical building services, appliance retailing, fire alarms and building insulation, to name just a few. How many local businesses are being forced to compete against this loss-making, States-owned company?'

Guernsey Gas also says the OUR's creating an anti-competitive energy market. The regulator's denying both claims and say Guernsey Electricity does make a profit and there's no evidence to suggest their competitors are being unfairly disadvantaged.

http://www.ifcfeed.com/guernsey-articles/Guernsey-Gas-questions-electricity-pricing.aspx

JEC needs profit to invest in essential infrastructure



Infrastructure investment of £14m per year for next 10 years (borrowing will reach £20m)

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