2019-6

REPLY BY THE PRESIDENT OF
THE STATES' TRADING SUPERVISORY BOARD
TO QUESTIONS ASKED PURSUANT TO RULE 14 OF THE
RULES OF PROCEDURE BY DEPUTY JENNIFER MERRETT

Question 1

On the 27th March in a statement to the States of Deliberation from the President of the States Supervisory Board regarding the undersea electricity cable, the President stated that;

'The replacement cable project is now expected to cost £30m. It will be funded by long-term loans, some of which will be provided commercially and some of which – approximately £15m - the Policy & Resources Committee has agreed to provide using the States' bond proceeds.'

Further that;

'Funding such assets through borrowing means their cost is spread over the period they are available for both today's and tomorrow's consumers in a fair and equitable way.'

In the knowledge that the existing cable and its performance had an anticipated design life of 25 years and was installed in 2000, so has failed 6 years before its's anticipated design life , could the President please confirm how 'the period they are available for' (meaning the asset and the associated loans) were determined?

Answer

Following their consideration of the 2013 Budget Report, the States of Guernsey agreed[1] that Guernsey Electricity (GEL) should be permitted to borrow to finance capital expenditure and authorised the former Treasury and Resources Department (T&R) to provide guarantees for any third party borrowings. The Budget Report noted that one of the advantages of doing so was fairness, in that current consumers would be paying for the capital investments required to provide their services over the time that they consumed them. This was more equitable than the "save to spend" approach that had historically been adopted, where today's customers were paying to build a cash reserve to fund investments in the future for the benefit of tomorrow's consumers.

The projected life of the new GJ1 cable between Guernsey and Jersey is 25 years. A projection is, by its very nature, uncertain as it is based on an analysis of potential future events. In this case, GEL's analysis has been informed by a range of factors, including:

- Detailed forensic analyses of each of the failures that have occurred with the existing cable to understand the causes and ensure these are addressed in the design of the new cable;
- GEL's and the Channel Islands Electricity Grid's (CIEG's) experience and understanding of the performance of the other cables that form part of the wider grid;
- Industry wide developments in the design, manufacturing and installation technology for subsea cables, which have moved on markedly since the existing cable to Jersey was installed some 19 years ago.

GEL's confidence in its projection is supported by extended warranty terms for the new cable that it has been able to negotiate with the manufacturer as part of the procurement process.

[1] Resolution 14 of Billet d'Etat XXVI of 2012 – States of Guernsey Budget 2013

Question 2

Could the President please confirm the length of the long term loans and the period that the monies from the Bond have been lent over?

Answer

The new GJ1 cable will be funded by long-term loans, some of which GEL has arranged commercially with a third party and some of which has been agreed by the Policy & Resources Committee (P&RC) using the States' bond proceeds.

Approximately half of the project's costs will be funded with a loan from the Bond. As you will recall, the 2018 Budget Report[2] set out the formula for how the P&RC's Investment Bond Management Sub-Committee calculates the interest rate charged on such loans. This formula incorporates a credit risk score and an adjustment for prevailing interest rates. At the time of preparing the responses to these Questions, the indicative rate available to GEL was 3.625% (fixed for 25 years), but this will only be confirmed once GEL has determined a schedule for drawing down the loan facility available to it.

The third party lending has been agreed over a 10 year period, but at a rate which the lender has asked be kept confidential. However, I can confirm that the rate of interest is significantly less than that available through the Bond. GEL has been unable to secure third party loans at this rate for any more than a ten year period. So, whilst this loan does not match the length of the life of the cable, this is offset by the fact that there will be substantial savings in interest payments compared to the Bond rate for GEL and its customers.

Question 3

What is the total amount of predicted interest rate that will be payable for the life time of the loans?

Answer

The position in respect of interest rates is set out in my response to Question 2 above.

Question 4

Was any consideration given to funding the capital cost of the project from our capital reserves?

Answer

Following the States' consideration of the 2013 Budget Report (see my response to Question 1), there was a clear expectation that GEL would fund its capital investment programme through borrowing. This was reinforced in 2014 after the States considered proposals from T&R specifically in relation to a new subsea cable between Guernsey and Jersey. On that occasion, the States resolved[3] to *"…authorise the Treasury & Resources Department to facilitate borrowing by Guernsey Electricity Limited to finance the installation of an additional cable between Guernsey and Jersey by providing guarantees from the States of Guernsey for borrowing from third parties or by offering the Company a loan from the States."*

The STSB's mandate requires it to carry out its role within a framework of policies established by the States. There is no policy within the States allowing incorporated trading assets to access funding from the Capital Reserve, which is funded by all taxpayers and usually set aside for General Revenue projects. A distinction has historically been drawn between these projects and those of the incorporated

[2] Billet d'Etat XX of 2017 – The States of Guernsey Annual Budget for 2018 (section 7.50)
[3] Resolution 1 of Article X of Billet d'Etat XVI of 2014 – Guernsey Electricity – Guernsey-Jersey Cable Project

companies, where the practice is that investments should be funded through charges made to the consumer of their services, not all of whom will have made a contribution through taxation to the Capital Reserve.

In addition, you will recall that the Medium Term Financial Plan (MTFP) approved[4] by the States in 2017 assumed that capital returns (over and above any normal dividend payments, which are the subject of separate treatment) of £30m would be generated from the States' trading entities, both incorporated and unincorporated, over the lifetime of the Plan and that those returns would be appropriated to the Capital Reserve. The Plan made no allowance for funding of the States' trading entities' capital investment projects from the Capital Reserve.

For its part, the STSB's belief is that its trading assets should seek to fund their own capital requirements where the business itself has a clear need for making such investments for the direct benefit of its customers and to sustain and develop its normal operational activities. Such funding should be sourced in the most commercially effective manner and can include the use of cash reserves, loans or a mixture thereof. In this manner, the true cost of operating the business – including the use of capital - is transparent and properly reflected in customer charges. Borrowing for this purpose is a well-established practice. GEL's most recent investments in its new 2D and 3D generators at the power station and in the CIEG's N1 and N3 cable projects have involved a degree of borrowing. However, GEL is not unique and other examples of this approach include: Guernsey Water's replacement short and long sea outfalls at Belle Greve Bay; Guernsey Harbour's replacement of its cranes; Aurigny's acquisition of ATR and Dornier aircraft; and, Jamesco's acquisition of the two fuel tank ships. The funding arrangements for all of these investments have each included the use of loans (either full or partial) and cash reserves. Funding for the repayment of those loans comes from future customer revenue streams.

Taking all of the above into account, no consideration was given to funding the cost of the project from the States' Capital Reserve.

Question 5

The President stated that 'In considering tariffs, we should remember the States has previously agreed as long ago as 2012 that GEL would need to borrow in future to fund its long-term major capital investment requirements'.

The President further advised the States of Deliberation that in 2014;

'The States agreed to finance the installation of a new cable by either guaranteeing any loans that GEL might need from third parties or by offering the company a loan direct from the States.

Has the STSB or P&R agreed to guarantee the loan from the third party?

Answer

The STSB does not have the authority to guarantee loans from a third party. The States have, by resolution, only granted this authority to the P&RC (and its predecessor, the former T&R).

In the States of Guernsey's 2015 Budget Report[5], T&R reported to the States that, in accordance with previous States' resolutions, it had provided a guarantee for GEL's loan facility of up to £20million with HSBC for its investments in the aforementioned N1 and N3 cable projects. Subsequently, the requirement for a guarantee was withdrawn by the bank and the guarantee was cancelled.

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[4] Resolution 1 of Billet d'Etat XII of 2017 – The Policy & Resource Plan – Phase 2
[5] Billet d'Etat XXII of 2014

As I have explained in my response to Question 2, the new GJ1 cable between Guernsey and Jersey will be funded by long-term loans, some of which GEL has arranged commercially with a third party and some of which has been agreed by the P&RC using the States' bond proceeds. The third party lender has not asked the States to guarantee the loan it is providing to GEL.

Therefore, there are no States' guarantees in place at this time in respect of GEL's existing borrowing with third party lenders.

Question 6:

Does the President agree with me that the funding could be from any source but should be from a source that means that the cost to our community is kept at the very minimum especially with regards to for any capital investment projects?

Answer

Subject to the relevant policies agreed by the States, then I do agree that funding should be from a source that means the cost to our community is minimised. Indeed, the funding structure put in place by GEL for this project, which involves a blend of borrowing from the States and third party lenders, is designed to do just that.

Question 7:

The President advised the States that;

'GEL's business case for the new cable is based on an assumed tariff cost increase of 2.7% to fund the capital and interest payments involved. To put this into perspective, this equates approximately to an additional £29 per annum for an average Economy 12 customer. '

What would the assumed tariff cost increase be if the capital cost was funded from our capital reserves and how would that translate to the average economy 12 customer per annum?

Answer

As I have explained in response to Question 4 above:

- The States have not previously agreed a policy enabling the incorporated trading entities to access the Capital Reserve as a source of funding for their investments; and,
- The MTFP adopted by the States clearly anticipates that returns from the trading assets will be appropriated to the Capital Reserve, not vice-versa.

Notwithstanding the above, on the assumption that the necessary funds for the GJ1 cable project were able to be 'gifted' to GEL from the Capital Reserve without charge in the same manner as those funds are provided to Committees of the States when they access the Capital Reserve, then the project could be undertaken without necessitating the increase in tariffs flagged by GEL in its business case.

There would, however, be an 'opportunity cost' to the taxpayer of such an arrangement. The Capital Reserve funds are invested and, as such, grow in accordance with the States' investment returns. Over the last three years, I am advised that these returns have averaged 7% per annum, which is considerably in excess of the rate at which GEL is borrowing. Funding the cable project from the Capital Reserve would reduce the investment returns on funds which are held in that Reserve pending the start of those projects that are given priority by the States.

However, more importantly, using the Capital Reserve for this purpose would mean that this funding is not available for the current capital portfolio or for the pipeline programmes and projects approved in the MTFP. It is important that General Revenue undertakes capital investment both to ensure that public services have the infrastructure they need and to enable transformation in the delivery of services to help address the challenges being faced by our community and to drive economic growth.

Importantly, we should not forgot that GEL operates in a commercial and competitive marketplace in the generation, heating and transport sectors. There is a risk that 'gifting' the company the funds for its capital investment programme would be considered as anti-competitive behaviour by its competitors.

Question 8:

The President stated that 'this is a 'loan for a major capital project'.

Does the President support the current fiscal framework rule regarding annual capital expenditure averaging 3% of GDP per annum in the medium term?

Answer

Responsibility for determining the Fiscal Policy Framework rests with the States of Deliberation upon the recommendation of P&RC. The States resolved to approve the current Framework at its meeting on 12th October, 2016[6]. The voting records for that meeting confirm that both you and I voted to approve the Framework, although I would note that I was not a member of the STSB at the time.

I continue to support the Fiscal Rule set out in the Framework that actual capital expenditure should average 3% of GDP per annum in the medium-term. I note with interest that section 6.7 of the Framework states that this Rule should <u>not</u> encompass capital spending made by the States' incorporated and unincorporated trading entities, given that these should operate like commercial entities.

Question 9:

Would the President agree with me that when possible that capital projects should be funded from our capital reserves and by doing so ensure that the cost of the capital project does not incur any additional costs associated with the borrowing of the funds?

Answer

As I have explained in my responses to Question 4 and 7 above:

- There has been a clear historic expectation that GEL should fund its capital investment programme through borrowing;
- There is no policy within the States allowing its incorporated trading assets access to funding from the Capital Reserve;
- The STSB's mandate requires it to carry out its role within a framework of policies established by the States; and,
- In the case of GEL, funding its investment from the Capital Reserve could be considered as anti-competitive.

Responsibility for making recommendations to the States on policies for the use of the Capital Reserve properly rests with the P&RC and clearly does not fall within the mandate of the STSB. I have no doubt that any such recommendations made by that Committee would be based on a proper and full analysis of all the associated considerations.

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[6] Billet d'Etat XXVIII of 2016 – The Policy & Resource Plan – Phase 1

I believe the States would be mistaken in assuming that there is no additional cost to the tax payer in providing funding from the Capital Reserve to GEL for the GJ1 cable project. The prime intended purpose of the Capital Reserve is to fund capital investment to support the delivery and transformation of General Revenue services. Funding used elsewhere would necessitate a need either to replace those funds with alternative sources of revenue or a re-prioritisation of planned spending. In addition, whilst such funding could be provided 'freely' to the project, there is nevertheless an indirect cost to the taxpayer arising from the investment returns that would be foregone as a result. As I have explained in my response to Question 7, those returns have averaged 7% per annum over the last three years, substantially more than the costs of borrowing currently available to GEL.

Question 10:

In his statement the President stated that;

'In the circumstances, the STSB's view is that there should be no expectation of a dividend payment by GEL to the States and that any surpluses the company does make should be available either to reduce the impact on customers or for reinvestment in the business.'

My understanding is that all surpluses that GEL make are transferred to our capital reserves. Is this correct?

Answer

This understanding is fundamentally incorrect.

Until now, the STSB's policy has been that GEL should provide an annual dividend payment to the States equivalent to 25% of the Company's post-tax profits. The balance of any profits are retained by the business.

Those dividend payments that have been made to the States are classified in the States' Accounts as Miscellaneous Income accruing to General Revenue, not the Capital Reserve. As you will be aware, this income is reported[7] as such in the annual Budget Report approved by the States.

However, as I made clear in my Statement to the Assembly on 27th March, in light of the investment requirements now facing the company, the STSB's current view is that there should be no expectation of a dividend payment by GEL to the States and that any surpluses the company does make should be available either to reduce the impact on customers or for reinvestment in the business.

Question 11:

If so, could the President please state to how much has been transferred from the surpluses into our capital reserves in the last ten years?

Answer

GEL has made a total of £2,603,000 in dividend payments to the States over the last ten years. As noted in my response to Question 10, these have not accrued to the Capital Reserve, but to General Revenue.

However, in addition to the above, I should note that the 2016 Budget Report[8] included an assumption that a total of £10m of capital should be returned from the States' trading entities for transfer to the Capital Reserve. As you will recall, after considering the 2017 Budget Report, the States' subsequently resolved[9] that £4m of capital should be returned by GEL by way of a share buy-back arrangement (not a

[7] Billet d'Etat XXIV of 2018 – The States of Guernsey Annual Budget for 2019 –Appendix II - Note 3 Miscellaneous Income
[8] Billet d'Etat XIX of 2015 – The States of Guernsey Annual Budget for 2016 – Section 5.22
[9] Resolution 21 of Billet d'Etat XXVI of 2016 – The States of Guernsey Annual Budget Report for 2017

dividend payment) and then transferred to the capital reserve in partial fulfillment of this target. The balance of the £10m was achieved by a return of £6m in capital from Guernsey Post, also by way of a share buy-back approved by the States. For the sake of clarity, I should note that this requirement preceded and is separate to the aforementioned £30m capital returns target subsequently set for the STSB by the States under the MTFP (see my response to Question 4).

Question 12:

My very real concern is the cost to our community. The financial cost of the 2.7% increase on top of the predicted increase of an additional 6.8%. These increases to our community are compounded by the unexpected nature of the rises and the short notice in which they could be applied.

Did STSB know of or suspect that there could potentially be an additional increase in the cost to our community, with regards to the replacements of the undersea cable, when GEL advised them of the potential of a 6.8% increase?

Answer

GEL has not increased its tariffs since 2012. Over that period, inflation (RPIX) in Guernsey has increased[10] by 10½%. The combined increases now being anticipated are less than inflation over that period.

Whilst the STSB absolutely shares your concern about the costs to our community, it is important to consider such concerns within the wider context. As I explained in my Statement, as a result of the failure of the current cable, GEL is incurring additional generation costs of between £800,000 and £1million per month. Had GEL not taken prompt steps to replace the existing cable, then tariff increases that substantially exceed the 2.7% associated with the new cable would have been required to recover those ongoing additional generation costs. Put simply, the status quo was not an option and GEL's investment in the new cable will secure a more affordable supply of electricity than that currently available to the Island. As I set out in my Statement, a commercial settlement agreement has been reached by GEL with the manufacturer in lieu of the existing cable's historic performance. The terms of this agreement are confidential, but were negotiated robustly and with the best interests, financial and other, of the Island in mind.

When it considered the business case for the new GJ1 cable, including the impact on tariffs set out therein, the STSB was aware that GEL had applied to CICRA for a tariff increase to enable it to recover historic costs beyond its control in the period between April 2017 and March 2019. Those uncontrollable costs of £9.8m are related to the importation and generation of electricity, primarily arising from changes in the price of oil and exchange rate movements. CICRA has now published its Draft Decision regarding a proposed tariff increase of 6.8% to be in place for 3 years only from 1st July 2019. GEL is now awaiting publication of CICRA's final decision.

I should reiterate the point made in my Statement that, whilst the business case for the new cable assumed a tariff increase of 2.7% to fund the capital and interest payments involved, this will be subject to CICRA's approval. GEL has not yet made such an application to CICRA. The STSB assumes that CICRA will consult publicly on any such application as and when it is made before determining it.

Question 13:

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[10] Source: States of Guernsey Data and Analysis – 31st December 2012 to 31st December 2018.

Were CICRA adware of this additional increase of 2.7% when they considered the 6.8% proposed increase from GEL? (CICRA's draft decision document makes no reference to it: https://www.cicra.gg/media/597999/cost-pass-through-for-guernsey-electricity-limited-2019-draft-decision.pdf.)

Answer

As I have noted in my response to question 12 above, the two increases are in respect of entirely separate issues. They should not be conflated. One deals with the past and one deals with the future, as follows:

- The 6.8% is in respect of the recovery of historic electricity importation and generation costs by GEL that are beyond its control, primarily related to movements in the price of oil and exchange rates. CICRA's Draft Decision is to allow a 6.8% increase for a 3 year period only to enable GEL to recover those costs;
- The 2.7% is in respect of the future capital and interest payments that the business case for the new GJ1 cable anticipates will be required.

GEL has not yet made an application to CICRA in respect of the latter. The two matters are in respect of unrelated costs. Accordingly, I am advised by the Company that it had not made CICRA aware of the prospect of a 2.7% increase related to the cable. Of course, in the event that CICRA feels that it is necessary, it will have an opportunity to take into account the 6.8% increase (assuming it is confirmed) before determining any future tariff applications by GEL.

Question 14:

Will GEL be introducing any additional payment plans to assist member of our community who may struggle if these increases are finalised and when they are implemented?

Answer

GEL's policy is already to work with customers on an individual basis to develop payment plans where they are having difficulty in paying their bills. These plans are tailored to each customer according to their own circumstances. As such, it will not be introducing any additional payment plans.

Question 15:

Did STSB notified ESS of the potential need to increase income support and / or any other increase in benefit that may be needed to support member of our community when they became aware of this potential increase of a vital commodity to our community?

Answer

No, the STSB did not notify the Committee *for* Employment and Social Security (CfESS). However, remembering again that tariffs have not increased since 2012 and the total increases being envisaged are below the rate of inflation over the period since then, it is aware that GEL intends to engage with CfESS over how it might work with that Committee to assist it in supporting members of our community where necessary.

Question 16:

Do STSB consider these increases to be compatible with the successful Amendment 3 (https://gov.gg/CHttpHandler.ashx?id=104711&p=0) to the P&R Plan of 15 November 2016, which required that, in making the most of the States' commercial and semi-commercial assets, STSB should be *careful not to put a disproportionate burden on consumers, having particular regard to those on low incomes?'*

This question unfortunately excludes the full text of the relevant part of the amendment, so for the sake of completeness, I have set this out below:

> "Ensure that the States' commercial and semi-commercialised entities and other States' assets are maximised, making an appropriate return to the States but without placing a disproportionate burden on customers, many of whom are inevitably on low incomes."

A fundamental objective of the STSB is that the trading assets for which it is responsible are a group of well-managed, efficient companies that operate in the long-term best interests of Islanders. Accordingly and as I have indicated above, the STSB absolutely shares concerns about the additional costs to our community resulting from any tariff increases and carefully scrutinises any plans to do so. Against this background, it is important to reiterate the following points I have made in my responses to some of the questions above:

- The tariff increases are intended only to recover known and quantified costs being incurred by GEL arising from: movements in the price of oil; movements in the exchange rates (which effect the cost of both imported electricity, which is purchased in Euros, and of oil, which is purchased in US Dollars); and, the capital and interest costs associated with the loan required for the GJ1 cable. Whilst never welcome, the tariff increases are the first since 2012 and are less than the increases in RPIX since then;

- The tariff increases are not being driven by any intention or desire to maximise the value of commercial entities such as GEL or the returns they make to the States through dividend payments. Indeed, the STSB has made it clear to GEL that, for the time being, there will be no expectation of a dividend payment by the Company to the States in order to reduce the impact on customers; and,

- Maintaining the status quo by not investing in a new cable would actually place a greater financial burden on the community, given the much higher operating costs involved for GEL in the ongoing reliance on on-Island electricity generation that would then be involved.

Within the context of the above, I believe that the steps taken by GEL and the STSB are entirely consistent with the terms of the amendment.

Date of Receipt of the Question: 1st April 2019

Date of Reply: 15th April 2019