Memo

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To: SEC
Attn.: Management
Date: June 13th 2019
Regarding: Comments on ACM Method decision 2020-2029

Sender:

[redacted]

1. Introduction

With reference ACM/UIT/507415 the *Autoriteit Consument & Markt* (hereafter: “ACM”) has issued to Saba Electric Company (hereafter: “SEC”) a draft method decision on electricity and drinking water in the Caribbean Netherlands 2020-2029.

This method decision concerns the second regulatory period with regard to the tariffs for drinking water and electricity on the BES, which runs from January 1st 2020 until December 31st 2029.

The proposed basis of this method is a profit split, similarly applied in regulatory period 1, which is supposed to create an incentive for the utility company to operate efficiently, thereby safeguarding the consumer and at the same time allowing the utility company to make investments on a cost neutral basis, safeguarding the operations of the utility company.

SEC has requested Baker Tilly to provide comments on the draft method decision with regard to the electricity production and distribution on Saba. This memo is a reflection on the proposed draft method and should not be considered a legal- or financial advice.

2. The basic principle

The basic principle of the method decision is that ACM determines the maximum tariffs that SEC can charge to the consumer. The key element in this process is that the costs incurred by SEC in year *t* forms the basis of the tariff in the year *t*+2. The way we understand this:

((fixed operation costs + variable operation costs + fixed capital costs + variable capital costs) x inflation) + adjustments -/- (revenue -/- combined red) -/- (result / 2) = fixed usage tariff + variable usage tariff + connection tariff + reconnection fee = revenue in year *t*+2.

For example:
Combined Red in 2018 = USD 1.000.000
Green = 2% per year
Blue = USD 100.000 less costs because of sustainable energy solutions
Brown in 2018 = USD 1.100.000
Orange = (1.100.000 -/- 1.000.000) = USD 100.000
*Purple = (1.000.000*1.02)^2 -/- 100.000 -/- (1.100.000 -/- 1.000.000) -/- (100.000/2) = USD 790.400 = revenue in 2020.*

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Note that the fixed capital costs include a reasonable return for a utility company, based on the Weighted Average Costs of Capital (hereafter: “WACC”).

Because of the administration lag, the costs of the year *t* determine the tariffs in year *t+2*. Afterall, the costs of 2018 of SEC will not be known until 2019. Because the tariffs have to be determined on beforehand, 1 January 2020 is the earliest moment that the costs of 2018 can be taken into consideration.

The numbers in the margin of this memo are cross references to the paragraph in the draft decision to which the respective comments relate.

3. Commentary

7) AMC can make adjustments to the costs, for example if not all the costs incurred by the utility company are necessary. How will ACM decide which costs are necessary? This is contradictory with paragraph 56, 3rd and 4th bullet point concerning transparency.

In relation to step 3,b, SEC is both producer and distributor. It cannot charge ‘itself’ for production.

9) Considering that SEC is both producer and distributor, can SEC only adjust the variable usage tariffs twice per year (paragraph 10), but the other tariffs, being a producer, monthly?

53) In this paragraph as well as in paragraph 97, ACM details alternative procedures which would have been even more cumbersome, and then argues why it has not chosen these options, almost as to create goodwill with the utility companies. Why does ACM not consider and discuss less cumbersome alternatives with a motivation why those alternatives have not been chosen?

55) The second to last sentence of this paragraph is arguable, which will be detailed in our remark concerning paragraph 58.

56) Already the 3rd and 4th bullet point in this paragraph seem arguable as detailed in our comments at paragraph 7. We also doubt that this method is easy to understand for businesses and consumers, as becomes apparent in our attempt to explain the basis principle in the previous chapter of this memo, which only touches on the basics. In the last bullet point ACM proclaims that it does not want to decide *exactly* which costs can or cannot be incurred. Question remains to which extend *can* ACM decide this?

58) Scenario iii, where the utility company makes a profit as a result of lower costs could have detrimental effects on future income of that company because of a yoyo effect.

Following the example given by ACM, this would play out as follows (not considering the *t+2* lag)

Costs in 2019:		*1.000.000*	
Revenue in 2020:		*1.000.000*	
Actual costs in 2020:		*900.000*	*100.00 profit*
Revenue in 2021:	*900.000 -/- 50.000 =*	*850.000*	
Actual costs in 2021		*1.000.000*	*150.000 loss*
Revenue in 2022	*1.000.000 + 75.000*	*1.075.000*	
Actual costs in 2022		*1.000.000*	*75.000 profit*
Revenue in 2023	*1.000.000 – 37.500*	*962.500*	
Actual costs in 2023		*1.000.000*	*37.500 loss*
Etc.			

Although the yoyo effect eventually balances out, in the meantime SEC has to pre-finance the loss of 150.000, for which it is not able to form a buffer based on the profit sharing method, which means that an external loan has to be acquired, which means due interest, which will be part of tariffs (presumably), which will increase the costs for the consumer. We suggest allowing SEC to create a financial buffer before the profit split method enters into effect.

Also important to realize that a profit does not only follow from lower costs, it can also follow from higher income (donations, subsidies, higher volume in sales than anticipated).

Costs in 2019:		*1.000.000*	
Revenue in 2020:		*1.100.000*	
Actual costs in 2020:		*1.000.000*	*100.00 profit*
Revenue in 2021:	*1.000.000 -/- 50.000 =*	*950.000*	
Actual costs in 2021		*1.000.000*	*50.000 loss*
Revenue in 2022	*1.000.000 + 25.000*	*1.025.000*	
Actual costs in 2022		*1.000.000*	*25.000 profit*
Etc.			

A problem can occur when SEC combines a higher revenue with lower costs, as this will reinforce the yoyo effect.

62) The fact that new legislation is being drafted and that ACM in any case may adjust the method, completely removes the transparency and clarity as advocated in paragraph 56 and 61.

68) “ACM will not include costs that were not incurred by implementing the statutory tasks of the company.” Why not? How can ACM decide which costs, which incur on a day to day basis, concern the statutory task of SEC? Does this include costs of wage? It’s not a statutory task of SEC to employ personnel… this poor formulation leaves a lot of unclarity. Also ACM may calculate depreciation differently that the utility company. How this lines up with the statement that ACM does not want to step in the shoes of management (paragraph 56) is not entirely clear.

ACM will furthermore deduct additional revenues outside the tariff revenues from the costs.

For example:

Costs in 2019:		*1.000.000*	
Revenue in 2020 (+100.000 not from tariffs)		*1.100.000*	
Actual costs in 2020:		*1.000.000*	*100.000 profit*
Revenue in 2021:	*1.000.000 - 50.000 - 100.000 =*	*850.000*	
Actual costs in 2021		*1.000.000*	*150.000 loss*
Revenue in 2022	*1.000.000 + 75.000*	*1.075.000*	
Actual costs in 2022		*1.000.000*	*75.000 profit*

Etc.

Why this is considered reasonable is unclear. Why would SEC sell for instance assets, generate rental income or consultancy fees from for instance foreign electricity producers if she will be ‘punished’ by lower electricity rates in the next year, followed by a yoyo effect?

Same applies to paragraph 71 wherein is stated that ACM can adjust provisions.

74) ACM will be more willing to take incidental costs into account in the cost base however will act more restrictively when it comes to taking estimated future costs into account. This first part makes sense, however it is not clear why future developments will less likely be factored into operating costs. These future development costs are easier to predict than incidental costs (ACM acknowledges this in paragraph 73) because in many instances there is a (draft) contract in place already specifying the future development costs. That is not the case with the incidental costs.

91) Is a (provision for a) hurricane a major occurrence as mentioned in this paragraph or a force majeure as meant in paragraph 115?

100) Why should the fixed costs be calculated based on volume (of variable costs)? Is the fixed cost not easier to determine than the volume?

105) Regarding step ii, is SEC free to determine the technical categories it wishes to apply?

114) No profit sharing is applied to doubtful debts. ACM has decided that all the disadvantages of ‘underperforming’ will be borne by the utility company. The reasoning behind this is unclear, so is the feasibility (paragraph 56, first bullet point).

116) ACM may carry out a full retrospective calculation of part of the previously permitted revenues and apply corrections in the form of deductions from the tariffs of subsequent years. It basically means that a profit in one year can later be recaptured if ACM deems this profit ‘unfair’. We find this provision to be very unilateral in nature and clashing with the contents advocated in paragraph 6, promoting instead uncertainness and totalitarianism.

124) Considering that SEC is producer and distributor, it will fully have to absorb any increase in oil prices for (max) 6 months. The fact that a producer can fluctuate his price monthly towards the distributor offers little consolidation if both are one and the same company.

4. Conclusion

ACM's method should support feasibility, transparency, explainability and responsibility of the utility company.

The proposed method for regulatory period 2 is currently not profoundly transparent considering the discretionary powers of ACM. Although application of these powers is hopefully discussed with SEC on beforehand, the final decision will still lie with ACM. An example of unclarity is the costs that ACM deems necessary for doing business. Not only is this not transparent, ACM also steps in the shoes of the company's executives (paragraph 56 first and last bullet point).

Taking certain costs not into considering (bad debts) and allowing profits from the past to be recaptured if ACM deems this necessary hollows out feasibility of the method resp. responsibility of SEC.

ACM mentions in paragraph 88 that different islands may justify different treatments. Considering that SEC is fully government owned and that too high rates will trigger voters to protest, it seems that the consumers position is already safeguarded. Through political pressure, SEC is already incentivized to operate as efficiently as possible.[1]

Several provisions in this method may have a harmful effect which could be mitigated by allowing more market mechanisms to take effect or at least a less directorial approach from ACM, especially in the light of possible new legislation which partly reduced the role of ACM in the determination of tariffs.

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[1] As an alternative, the private sector could be emulated. Efficient operating could be stimulated by offering management or entire staff a bonus in the form of a percentage of reduced costs, insofar the profit resulting from this cost reduction permits. The remainder of the profit would become retained earnings that can flow back to consumer in the form of reduced or abolished fixed rates in year t + x, after SEC has built a financial buffer.