OFFICE OF UTILITIES REGULATION

Regulating Utilities for the Benefit of All

OUR Responds to Private Sector Criticism of JPS Tariff Determination

(KINGSTON, Jamaica; January 28, 2015): The Office of Utilities Regulation (OUR) is responding to private sector concerns about aspects of its Determination Notice regarding the Jamaica Public Service Company Limited's (JPS') tariff application.

The Private Sector Organization of Jamaica (PSOJ) recently issued a statement expressing *"grave concern*" about the OUR's Determination Notice which it said could be seen by future investors *"as actions by the regulator that are inimical to the viability of a business."*

Specifically, the PSOJ said it was disappointed with the OUR's rejection of JPS' request for revenue allowances to offset its foreign exchange losses arising from delayed payments to Petrojam, the rate of return set by the OUR, the significant arrears by the Government of Jamaica (GOJ), as well as system losses recovery.

The OUR arrived at its determination – which consists of forty four (44) decisions – after extensive consultation and review with all affected stakeholders. The methodology for the tariff review process and how the rates should be calculated is set out in the Amended and Restated All-Island Electric Licence, 2011 (JPS Licence). The OUR has adhered to that methodology while taking into account all relevant factors. Further, the OUR is committed to working in the national interest while ensuring a fair and equitable environment for customers and investors.

Revenue Allowance

The OUR, in its Determination Notice, has turned down JPS' request to include a separate revenue requirement item for foreign exchange losses incurred on business transactions. JPS has stated that foreign exchange fluctuations between the time of billing, collecting and settlement of its obligations, has resulted in financial losses to the company. The JPS proposal was to include an additional US$14M annually (to be adjusted at the annual review to account for any under or over recovery) in the revenue requirement to cover this exposure. The implication is that JPS would be recovering from all customers, including non-delinquent customers, who are not the cause of the exposure.

The basis for the OUR's decision was made abundantly clear in the Determination Notice:

1) It would be inconsistent with the provisions of the JPS Licence.
2) The JPS Licence now allows JPS to adjust its base foreign exchange rate on a monthly basis.
3) The problem facing JPS arises largely because of the size of the JPS receivables, which JPS explained is largely due to GOJ debt. The Office takes the position that JPS should exert greater effort to recover its revenues, especially with respect to the GOJ, which is also a significant shareholder of JPS.

4) The entire sum of the JPS receivables is included in the Rate Base and so JPS is earning a return on these receivables.
5) Reducing and minimising these exposures are within the control of the JPS.
6) JPS has the option to make all Independent Power Providers (IPPs) payments in Jamaican Dollars at an invoice exchange rate. Since these payments are also in arrears, JPS is aggravating its exposure by choosing to make these payments in United States Dollars.
7) In its most recent agreement with Petrojam, JPS created unusual exposure based on its agreed terms. JPS further aggravated this situation by steadily increasing it payables to Petrojam.

Rate of Return

The PSOJ has charged that while the OUR is properly empowered to determine an appropriate targeted Rate of Return (ROE) to be earned by JPS, *"it is difficult to understand the agency's ruling to reduce the target ROE from 16% allowed in the prior rate review to 12.25%."* The OUR wishes to clarify that it cannot, nor does it attempt to arbitrarily set the rates for utility services. In this regard, the widely used and accepted Capital Asset Pricing Model (CAPM) to determine the cost of equity for the utility companies it regulates was applied. This methodology was also used by JPS in its tariff submission and the only substantial area of difference was with respect to the computation of Country Risk Premium (CRP).

The Country Risk Premium is the difference between the higher interest rates that less stable and riskier countries pay and the imposed market interest rates for the government of a given benchmark country. The OUR took the view that the approach used by the JPS is without a sound theoretically foundation, and lacks adequate empirical support. The OUR therefore computed the CRP based on an assessment of the market, as the difference between the yields of the Jamaican risk-free asset, that is, the government bond, and the comparable mature market risk-free asset, the US government bond. Utilizing this approach, the OUR determined a CRP of 5.58% as at the end of December 2013 (the test year). Therefore, it is the methodology of deriving the CRP that has resulted in the difference between the ROE requested by JPS and what was determined by the OUR.

System and Financial Losses

The PSOJ is of the view that the current determination *"will mean significant continuing financial losses estimated at in excess of US$30 million being imposed on JPS, arising from the OUR's position that JPS should absorb the cost of fuel consumed and which the company is unable to recover because of the incidence of electricity theft in Jamaica.*"

The OUR acknowledges that high system losses is one of the major problems impacting JPS' operations. JPS' reported rolling twelve-month average system losses increased from 23.98% as at December 2009 to 25.87% as at December 2013. This worrying trend of increasing system losses has continued without abatement and JPS reported at month ending April 2014 actual losses figure of 26.35%. The OUR remains concerned about the high level of system losses and for this reason will continue to support the loss reduction activities geared towards arresting and reducing this problem. The OUR does not subscribe to the view that such losses are inevitable and must be borne increasingly by paying customers. (The details on the OUR's determination on system losses is outlined on pages 289-290 of the Determination Notice. This can be accessed on our website: www.our.org.jm.)

Notwithstanding this, the OUR, in its Determination Notice, increased the system losses target from 17.5% to 19.2%. The public should find it instructive to note that the system losses target in 2004 was 15.8%.

The OUR remains cognisant of the challenges facing the JPS. It is towards this end that the OUR has approved several funds to assist JPS in addressing some of its challenges.

The OUR accepted JPS' recommendation to continue the Electricity Efficiency Improvement Fund (EEIF). The amount for the EEIF shall be US$13M per annum. This initiative was introduced into the 2009-2014 JPS' Tariff Determination Notice, to fund loss reduction activities. The EEIF was set up specifically to augment and fast-track JPS' efforts to reduce overall system losses. The revenues for this fund will be recovered through a separate line item on customers' bills.

The OUR has also approved the establishment of a US$15M Bogue Plant Reconfiguration Fund (BPRF). This fund, which must be accumulated over a 12-month period, will allow for the reconfiguring of the Bogue Combined Cycle Gas Turbine unit to accommodate the utilization of gas-based fuels such as natural gas or alternatives, which are cheaper than automotive diesel oil now being used. More efficient fuel will see a significant cost saving which the OUR anticipates will be passed on to customers.

The OUR is convinced that the 12.25% after tax ROE (18.4% pre-tax) allowed on JPS non-fuel tariff is reasonable. Additionally, the mechanisms created through the EEIF and BPRF create an important incentive structure for JPS to enhance its profitability while lowering fuel cost over the short to medium term.

The OUR remains committed to its mission to contribute to national development by creating an environment for the efficient delivery of utility services to the customers while ensuring that service providers have the opportunity to make a reasonable return on investment.

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