

Jersey Electricity

Annual update

Continuing dividend growth forecast

Jersey Electricity's (JEL) strong financial position and forecast cash flow should underpin 5% per year growth in the dividend per share. Although JEL faces wholesale cost rises, lower unit demand and a fluid regulatory situation, we believe that, given its strong position on pricing and service standards, it is well positioned to withstand these pressures. Our latest valuation analysis indicates increased upside potential from current levels.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
09/17	102.1	13.5	34.6	14.20	13.5	3.0
09/18	105.9	15.3	39.5	14.90	11.8	3.2
09/19e	105.9	12.8	32.9	15.65	14.2	3.4
09/20e	109.2	14.0	35.9	16.43	13.0	3.5

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

FY18: A year of strong achievement

JEL performed strongly in FY18. Revenue rose 4% to £105.9m, and profits increased by 13.3%, to £15.3m. The Energy business recorded a 2.4% increase in revenues and a 15.2% rise in operating profits, helped by 2% growth in units sold. Net debt fell by £7.7m, to £14.3m, and the DPS increased 5%, to 14.9p for the year. The customer satisfaction survey showed continued upward momentum and independent consultants, NERA, also validated, in principle, JEL's decision to impose a standby charge on renewable generation connected to its network.

Cash flow to underpin returns

JEL remains in a strong position financially and provides low tariffs and high service standards to its customers. Rising wholesale prices, a weak £/€ exchange rate and falling unit demand will put pressure on pricing and profits, and we forecast a modest reduction in profitability in FY19 from the record levels achieved in FY18. However, we believe JEL is well placed to adapt to these pressures and we expect continuing c 5% pa increases in DPS, facilitated by high levels of dividend cover, a modestly geared balance sheet and strong cash flow.

Valuation: Increased upside potential

Our updated valuation (the average of peer group multiples, using cover-adjusted yield/DCF/SOTP), indicates a valuation of c 560p (+2.5%) versus 546p last year. In particular, the increased SOTP valuation (from 552p to 592p) has been driven by a growth in regulatory assets and reduced debt. Despite a recent rise in the share price following the better than expected FY18 results released in December 2018, the shares offer 20% upside to the average of our valuation, with the prospect of growing income from the dividend.

Utilities

14 March 2019

Price **467.00p**
Market cap **£143m**

Net debt (£m) at 30 September 2018 14.3

Shares in issue 'A' shares and ordinary shares 30.6m

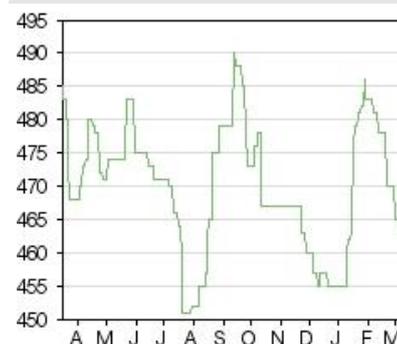
Free float of 'A' Shares 99%

Code JEL

Primary exchange LSE

Secondary exchange N/A

Share price performance



% 1m 3m 12m

Abs (3.7) 1.3 (5.5)

Rel (local) (4.8) (4.2) (4.9)

52-week high/low 490.0p 451.0p

Business description

Jersey Electricity is the sole supplier of electricity to Jersey. It also operates businesses in retail, property and business services on the island.

Next event

Interim report May 2019

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Jersey Electricity is a research client of Edison Investment Research Limited

Investment summary

Company description: Electricity supplier to Jersey

JEL is the sole supplier of electricity to the island of Jersey. The electricity business is responsible for generating around 80% of group revenues and operating profits. JEL also operates a range of other businesses including property rental, retailing and business services. The government of Jersey (States of Jersey, SoJ) remains the largest shareholder with 62% of the ordinary share capital and 86.4% of the voting rights.

Valuation: Increased

We have updated our valuation analysis to reflect JEL's reported FY18 figures and movements in market multiples. The average of our analysis (multiples/DCF/SOTP) indicates a valuation of c 560p (+2.5%) versus 546p last year. The valuation change reflects higher comparable peer group multiples, higher forecasts and a stronger balance sheet.

Financials: Strong cash flows underpin DPS growth

- Returns. After JEL achieved a return above its 6–7% target (operating profit/regulatory assets) in FY18, we expect profitability will decline in FY19. Tight control of administrative costs will continue but we anticipate that higher wholesale electricity price costs will exceed retail price rises and that units sold will decline from the high levels achieved in FY18.
- Capex. Although JEL's substantial investment programme is largely complete, we still expect annual capex of c £17m for FY19 (FY18 £14.8m – 10-year average c £19m).
- Balance sheet. We forecast that strong cash flow will underpin dividend increases (+5%) and allow indebtedness to decline, from £14.3m in FY18 to £11.1m in FY19.

Exhibit 1: Changes to forecasts									
	EPS (p)			PBT (£m)			DPS (p/share)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
2019e	35.3	32.9	-6.8%	13.8	12.8	-7.2%	15.65	15.65	0%
2020e	N/A	35.9	N/A	N/A	14.0	N/A	N/A	16.43	N/A

Source: Edison Investment Research

Sensitivities: Regulation, costs and security of supply

- Regulation. Given the absence of concrete proposals from the SoJ for changes to the regulatory system, it is difficult to quantify potential sensitivities for JEL. Modelling adjustments to the current allowed returns is more straightforward. With a regulated asset base of c £180m, each 0.5% reduction in allowed return would reduce operating profits by c £0.9m, equivalent to c 5.5% of FY18 total operating profit.
- Interconnector failure. Failure of one or more of the interconnectors could require the use of on-island generation. This would increase both greenhouse gas emissions and costs to JEL. Under the current regulatory settlement JEL would be free to recoup the additional costs but could be constrained from doing so by political sensitivities.
- FX/wholesale pricing. The impact of higher French wholesale prices and weaker sterling versus the euro, as is currently the case, increases electricity purchase costs for JEL. Once again, although additional costs for JEL can be recouped from customers by raising tariffs, this could invite additional political scrutiny. JEL's prices remain well below EU-15 averages.

FY18 results: A record year for JEL

JEL reported a strong financial performance in FY18, with record revenues and profits. Revenue rose 4%, to £105.9m, whereas profits increased 13.3%, to £15.3m. Net debt fell £7.7m to £14.3m and DPS increased 5% to 14.9p for the year. The DPS was covered 2.7x times by earnings.

As can be seen from Exhibit 2, the core energy business continues to account for the bulk of group profits (>80%) and performed strongly in FY18, with operating profits +14.5% (+£1.8m) to £13.4m. For the first time in recent years JEL benefitted from an increase in unit sales (+2.1% to 634m kWh, thanks to cold weather and customer switching) and a tariff increase (2% implemented in June). Overall revenues rose 2.4% (+£1.9m), of which the tariff increases accounted for £0.4m. Higher revenues and gross margins (in part thanks to reduced levels of on-island generation) coupled with reductions in maintenance and manpower costs all contributed to the rise in operating profits. We estimate the five-year rolling average return on assets in the energy business (c £180m) to be slightly in excess of 7% (see Exhibit 3).

The property business benefited from a revaluation (+£0.3m) to its investment portfolio (Powerhouse retail site plus 29 private houses/flats) and ongoing rent reviews, the latter of which contributed to a 3% rise (£0.1m) in revenues and, thanks to lower costs, a £0.2m rise in profits. JEBs, the contracting arm, suffered from declining margins and exceptional costs, which resulted in to a loss of £0.2m. Retail, despite strong competition in the sector, increased both sales (+5.4% +£0.7m) and profits (+11.0% + £0.1m) and has grown in each financial year since 2014. JEL continues to exit peripheral product lines and is increasingly focusing on premium 'smart technology' products.

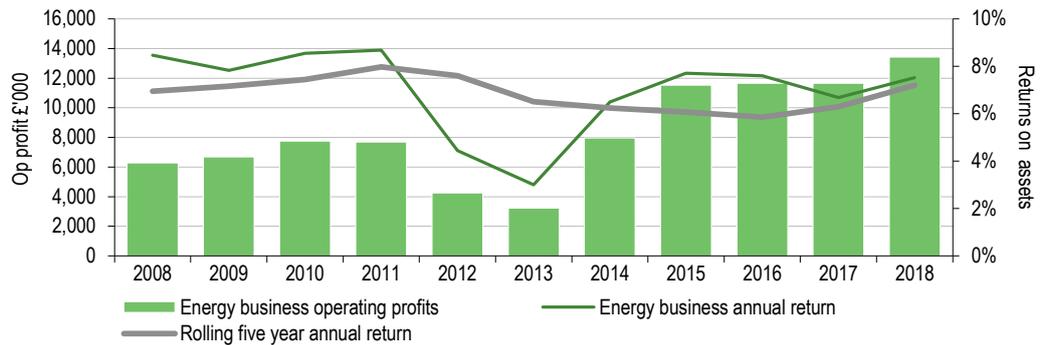
Exhibit 2: JEL operating profit by division

£'000s	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Energy	6,277	6,679	7,742	7,678	4,240	3,229	7,952	11,514	11,650	11,651	13,418
Building Serv.	274	176	240	220	30	10	(44)	(58)	134	131	(245)
Retail	450	292	465	476	64	18	(86)	334	452	731	812
Property	953	1,263	1,858	1,652	1,609	1,609	1,415	1,562	1,683	1,645	1,813
Other	540	404	1,539	840	708	623	659	592	695	525	586
Total	8,494	8,814	11,844	10,866	6,921	5,753	9,896	13,944	14,614	14,683	16,384

Source: Jersey Electricity, Edison Investment Research. Note: Operating profit is shown before exceptional items and profit from property revaluations.

Net debt fell from £21.9m in FY17 to £14.3m in FY18, with a year-end cash of £15.7m, versus £30m of long-term debt. This year-end cash was £2.6m higher than our forecast due to better than expected cash flow. Operating cash flow was £1.9m ahead of our projections and lower capex (by £0.7m) accounted for the rest of the outperformance. Operating cash flow was largely driven by better than expected profitability (£1.7m) although income tax paid was also £0.2m lower than anticipated. The debt figure of £14.3m is modest for a stable utility business such as JEL, equating to net debt/equity ratio of c 8%. Interest cover for FY18 was c 11.6x.

Exhibit 3: JEL energy business – operating profit and estimated return on assets



Source: Jersey Electricity, Edison Investment Research

Well placed to meet challenges

Financially and operationally, JEL performed strongly in FY18. It has also been encouraged by the recent support it received for the implementation of its renewable standby charge from independent consultant NERA. Longer-term regulatory uncertainties persist and rising wholesale prices and exchange rate movements will put upward pressure on retail prices. In the short term, we expect a modest reduction in profitability; however, over the long term, having substantially completed a 10-year investment programme and with a strong balance sheet and high customer service standards, we believe JEL is well placed to continue to deliver steady returns for its shareholders.

Regulatory update: Standby charging

When we last wrote on JEL at the beginning of 2018, we highlighted the regulatory debate that was taking place on the island, arising initially from JEL's decision to impose standby charges on embedded generation. Following widespread discussions, five propositions were brought forward in the SoJ relating to the regulation of the electricity industry, of which four were duly passed and are set out below.

- a) That the Minister for Treasury and Resources should request JEL not to impose standby charges on commercial customers that generate their own power until the opportunity had been provided to a qualified body to research the implications of the charge and report back to the SoJ.
- b) That the Minister for Treasury and Resources should appoint a qualified body to undertake research into the implications of the standby charge for the competitiveness of generation and supply in Jersey.
- c) For the Council of Ministers to bring forward proposals to update the Electricity (Jersey) Law 1937 and thereby open up a debate on locally generated renewable electricity targets.
- d) A request for the Minister for Economic Development, Tourism, Sport and Culture to bring forward an Action Plan by 31 March 2018 setting out a strategy for the development of the renewable energy sector in Jersey.

In accordance with provisions a and b, the consultants, NERA, were appointed in the summer of 2018 and they recently delivered their conclusions in a report, *Review of Jersey Electricity's Proposed Standby Charge for Commercial Embedded Generators*. As part of its assessment of the proposed standby charge, NERA considered whether JEL's proposed charge is; fair and reasonable; cost reflective; consistent with charging mechanisms in competitive markets; sends accurate signals to customers regarding the value of embedded generation and is proportionate to

the level of embedded generation in the Jersey electricity system. However, the review did not assess the economic rationale for the provision of support to renewable generation, either by JEL or SoJ, as it was deemed to lie outside its scope.

Rationale for standby charge. JEL's standby charge attempts to address the central problem that if customers reduce their purchases from JEL as a result of the installation of embedded generation, they do not simply deny JEL a margin on the provision of units of electricity to its customers but also remove the contribution that the sale of each unit of electricity makes to the covering of JEL's fixed costs. NERA states that this internationally recognised problem is known as 'inefficient grid bypass.' As do many utilities, JEL charges a straightforward p/kWh charge for each unit consumed, which is required to cover both its variable and fixed costs. JEL's need to cover its fixed costs means it would have to charge other users more. NERA calculated that for every 10MW of solar photovoltaic (PV) panels installed in Jersey, other customers (based on JEL's proposed standby charge of £3.25/kW per month to all new commercial customers choosing to install embedded generation of up to 50kW of capacity) would need to pay collectively c £390k per year, equivalent to an increase of £4.56 in annual bills (average annual bills c £1,628). However, NERA notes that if JEL were to incur additional costs associated with the system management of intermittent generation this figure could rise further.

Assessment of JEL's proposed standby charge. NERA concluded that there is a commercial justification for some charging reform to address the potential for 'inefficient grid bypass' and commented that JEL's proposal 'bears some similarity to reforms in other jurisdictions.' NERA did, however, identify 'some minor problems with the details of JE's (sic) calculation, rather than with the design of the charge.' NERA's adjusted calculation, which assumes a higher proportion of self-consumption by embedded generators (85%, versus 50% assumed by JEL) resulted in a standby charge of £5.48/kW per month, underlining the conservative nature of JEL's calculation. In our view, it is more important that NERA recognised the commercial justification for JEL's charge than the minor differences of methodology it highlighted. JEL has indicated that it will also review Standby Charges for CHP systems and other technologies and has also stated that it is happy to undertake a longer-term review of its tariff structure.

Regulatory update: Beyond standby charging

As part of its review of the standby charge NERA stated that, 'it is beyond our scope to consider whether sector-specific regulation is required to ensure that the conduct of JE promotes the economically efficient development of the energy system on the island.' However, NERA added that 'regulatory mechanisms in place in the electricity sectors of other jurisdictions may offer lessons to JE and SoJ in relation to the process for setting tariff structures'. We are not aware of any proposals being brought forward, in line with proposition c) above, to update the Electricity (Jersey) Law 1937. Any revision to the Electricity Law would implicitly generate a debate on the form of future regulation. Nor are we aware, as yet, of any proposals to introduce locally generated renewable electricity targets or subsidies.

For the foreseeable future, therefore, the current arrangement of self-regulation appears likely to persist. Fundamental to the regime of self-regulation JEL aims to earn a return of 6–7% (pre-tax) on its energy business (net of customer contributions) on a rolling five-year basis (see Exhibit 3) while ensuring that its tariffs remain within +/- 10% of the EU-15 average (inclusive of all taxes). Currently JEL's five-year rolling return is slightly above the upper end of its target range but customer tariffs, despite considerable upward pressure arising from movements in wholesale markets and exchange rates, remain comfortably below EU-15 averages (Exhibit 5). In due course, some changes to the current regulatory regime may be implemented, but with high standards of customer service, JEL is in a strong position to adjust to potential changes.

Customer service and the investment programme

JEL's annual customer survey conducted by independent group, Island Global Research (this year employing a revised methodology), showed that JEL had achieved a small improvement in its overall rating (65% vs 64%), continuing a trend evident over the last few years. As revealed by the survey, the three most important elements of customer service in order of priority were: running costs and price stability, security of supply and environmental performance.

JEL's excellent record in each of these three key areas of customer service can, in our view, be attributed to its investment in, and maintenance of, its asset base. Over the last 11 years JEL has invested c £19m per year in its energy assets, spending a cumulative £210m and in FY18 invested £14.9m, including £1m upgrading the Normandie 2 interconnector on the French side, allowing for an increase in capacity. These figures compare to the current annual depreciation charge of £11m and an anticipated total 10-year plan for the period 2008–2017 of £100–150m (as expected in 2008).

Exhibit 4: Capex

£m	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Average
Capex	13.6	12.8	8.4	15.6	18.5	25.7	39.9	13.2	32.4	15.1	14.9	19.1

Source: Jersey Electricity

Driving JEL's investment programme is its 'N-1' standard, which means it seeks to maintain supplies to customers in the event of the failure of the largest component of the system. Much of the expenditure has been related to the construction of two new undersea cables between Jersey and France (total Channel Islands import capacity of 263MW); however, investment in substations (most recently in St Helier West completed in December 2018) and reconditioned diesel engines (for backup power) have also formed part of the significant investment programme.

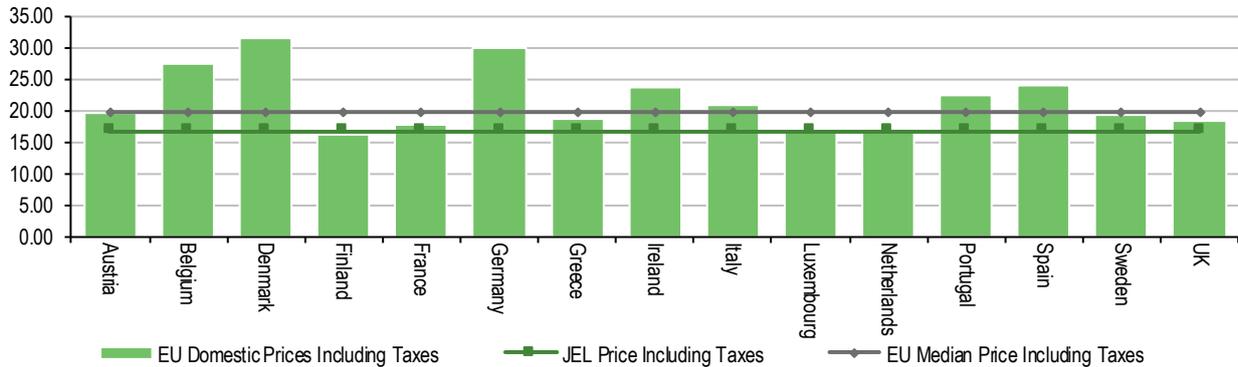
We review JEL's performance against the three service standards in the following section and outline how JEL's investment programme has helped it deliver on service standards.

Prices and price stability

JEL has established a track record of price stability helped by its ability to import over 90% of its electricity requirements, and in June 2018 announced its first price rise in over four years (2% increase). The previous increase was 1.5% in April 2014. The price stability in Jersey contrasts favourably with the rest of the UK where, according to JEL's estimates, the 'Big Six' energy suppliers have increased prices by 24% over the last two years. Figures from Ofgem suggest an average price rise of c 9% in 2018.

JEL benchmarks its tariffs against other small island operators and the average for the EU-15 and aims to keep its own tariffs within +/- 10% of the latter group (inclusive of all taxes). We calculate that JEL's general domestic tariff (14.8p/kWh) is standing at a c 15% discount to average EU-15 figures (Exhibit 5).

Exhibit 5: JEL general domestic tariff versus EU-15 for medium sized domestic customers (inclusive of taxes) H118 (c/kWh)



Source: Eurostat, Jersey Electricity

JEL contracts forward on a rolling basis to minimise volatility in electricity purchase costs but current upward pressure from wholesale prices and exchange rates is likely to lead to tariff increases in 2019. We examine these trends in more detail in a later section of this report.

Security of supply

As we have already noted, security of supply, measured by customer minutes lost, is an important component of the overall service offering for JEL’s customers. With the exception of 2012, which was affected by the failure of the old interconnectors, the result of the investment programme has been to maintain low levels of customer minutes lost. In 2018 only six minutes were lost, the best performance since 2008 and, according to Ofgem figures, substantially below the 77 minutes recorded by the ‘Big Six’ UK distributors in 2016–17.

Exhibit 6: Average annual minutes lost per customer

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
CML	59	5	9	10	45	293	13	110	7	24	8	6

Source: Jersey Electricity

Environmental performance

JEL’s investment in interconnectors has allowed it to increase the importation of low carbon electricity from France and reduce the use of on-island fossil fuelled generation in FY18 (only 0.2% c 1GWh of electricity requirements came from the on-island La Collette power station with the remaining c 5% sourced from the on-island Energy from Waste plant). In FY18 JEL imported 94.9% of electricity needs, all from low carbon sources (hydro 34% and nuclear 66%). As we have highlighted in previous reports, JEL’s ability to import electricity has allowed it to reduce oil as a generation feedstock from c 60,000 tonnes in the early 1990s, to less than 5,000 tonnes in recent years, with a beneficial effect on carbon emissions. As a result, in FY18 JEL was able to report its lowest ever level of carbon intensity, at 24g CO₂e/kWh (2017 35g CO₂e/kWh), around one 10th of the energy intensity of the UK system as a whole.

Although JEL has achieved what it has described as the ‘virtual decarbonisation of the electricity system, the company continues to explore opportunities to reduce carbon emissions and believes that ground-based solar PV, which is close to grid parity, represents the best opportunity for on-island renewable generation. Accordingly, last summer JEL announced plans to facilitate the development of ground-mounted solar farms on brown field sites with long-term Power Purchase Agreements; the first large-scale pilot plant is under construction. Largely as a result of JEL’s investment programme, the electricity sector has been successful in reducing its CO₂ emissions (the sector now accounts for >10% of island emissions). However, the transport sector, which

accounts for a third of Jersey's overall emissions of on-island carbon emissions, has been less successful and JEL sees it as offering the next big opportunity for reducing emissions. Accordingly, in the absence of any government subsidy scheme, JEL is taking steps to encourage the use of electric vehicles (EVs). We outline JEL's initiatives and consider the potential outlook for EVs in a later section of this report.

Energy efficiency and demand growth

Beyond its provisions of secure, affordable and sustainable electricity, JEL aims to manage demand (especially peak demand which is a key driver of network capex) by encouraging energy efficiency but offsetting the demand implications of this reduced per capita consumption by growing its customer base (new build and by switching households and businesses from competing on-island fuels).

Switching customers from oil-fired central heating to electric heating is, in our view, the most significant potential driver of long-term demand growth for JEL. We estimate that there are c 20,000 fossil-fuelled heating systems on the island of Jersey compared to JEL's total customer numbers of just over 50,000. In 2015 JEL established an energy solutions team and designed a range of tariffs and incentives with a view to encouraging customers to switch to electric heating. In 2017 the team achieved over 170 fuel switches in the domestic sector and signed 320 customers to electric heating tariffs (including new connections). In 2018 JEL added 160 fuel-switching customers out of a total of customer additions of 667. Applying JEL's average selling price per unit (12.9p/kWh) and average consumption per customer of 12,623kWh, this amounts to extra revenue of c £0.26m (total increase in revenue of the energy business was £1.9m). In reality, JEL's electricity heating tariffs are lower than its average selling price, so the additional revenue would be less than the £0.26m estimated above.

The switching of on-island oil-fired central heating customers to electric central heating (thereby reducing emissions), the provision of energy efficient white goods at its Powerhouse retail outlet and its ongoing Smart Switch programme all form key part of JEL's strategy to promote energy efficiency. The £11m Smart Switch programme is now 87% complete, with over 44,000 smart meters installed, and is expected to finish in mid-2019. During FY18 JEL also established a 'Smarter Living' hub in its Powerhouse store. The Energy Hub demonstrates energy efficiency and smart control technologies in a domestic setting. JEL regards the Energy Hub as an 'invaluable tool for its energy solutions team'. In August 2018, after one month of Smarter Living's operation, JEL experienced a 50% increase in the level of switching leads to the energy solutions team, which could boost customer recruitment.

Thanks to JEL's focus on energy efficiency over the last 10 years there has been an observable downward trend in consumption per customer. However, in FY18 the long-term trend was bucked as both the number of units sold (13m kWh increase in units sold +2%) and peak demand (to 178MW due to weather-related demand) rose. Of a total increase in revenue for the energy business of £1.9m, JEL ascribed £0.4m to the tariff increase, with the remaining £1.5m due to volume growth.

Exhibit 7: Selected energy trends 2008–2018

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Number of customers	46,587	47,072	47,494	47,990	48,452	48,263	48,941	49,320	49,532	49,894	50,561
Avg. no of customers	46,472	46,830	47,283	47,742	48,221	48,358	48,602	49,131	49,426	49,713	50,228
Units sold (GWh)	639	642	645	651	637	663	621	627	625	621	634
Avg consumption (kWh)	13,750	13,709	13,641	13,636	13,210	13,710	12,777	12,758	12,645	12,492	12,623

Source: Jersey Electricity, Edison Investment Research

Brexit

Jersey is not a member of the EU so, in theory, it should remain unaffected by the potential changes to the position of the UK. Given JEL's purchase of electricity under contract from EdF, it is important the status quo is preserved. It is worth pointing out that in the unlikely event of the Jersey-EDF electricity purchase contract moving to World Trade Organization terms, as part of a wider trade dispute electricity purchases would be zero rated, thereby avoiding any upward pressures on tariffs. Only in an extreme scenario of a UK-France trade dispute, requiring the introduction of import tariffs, can we envisage a scenario of increased electricity purchase costs for JEL.

Currency movements

One of the principal results of Brexit-induced uncertainty has been the reduction in the value of sterling versus the euro. In 2015, prior to the UK's referendum on EU membership, sterling was trading at approximately £/€1.40 compared to the recent level of c £/€1.10, a devaluation of c 20%. Given electricity purchase costs account for 6p/kWh (according to NERA) of JEL's average selling price of 12.9p/kWh (c 47%), a 20% devaluation in the currency would, all else being equal, require a c 9.4% increase in the average selling price ($12.9p \times 9.4\% = c 1.2p/kWh$). Due to its hedging policy, the exchange rate underpinning JEL's electricity purchases in FY18 was £/€1.27, compared to an average rate of £/€1.13 for the year. Although JEL continues to hedge its electricity purchase contracts, all else being equal, a decline in the exchange rate from the €1.27 achieved in FY18 to current rates would represent a c 12% increase in electricity purchase costs, adding approximately c 6% to overall tariffs. Of greater significance still is the underlying power price, which we discuss in the next section.

Exhibit 8: Evolution of principal exchange rates at balance sheet date

	30/09/2013	30/09/2014	30/09/2015	30/09/2016	30/09/2017	30/09/2018
£/€	1.20	1.28	1.35	1.16	1.13	1.12

Source: Refinitiv

Wholesale electricity prices

A more significant threat to JEL's electricity purchase costs is the movement in French wholesale electricity prices. Wholesale prices (year ahead) are currently c €55/MWh, significantly above the €30/MWh level prevailing for much of 2016 when a large proportion of the electricity supplied in FY17/18 was purchased. This wholesale price movement has clear implications for long-term tariff evolution. As wholesale costs amount to c 47% (6p/kWh/12.9p/kWh) of average customer costs in Jersey, the upward pressure is clear. Broadly speaking, we calculate that for each €10/MWh in French wholesale prices (at a constant exchange rate of £/€1.10) this would equate to c £9/MWh. A 50% increase in wholesale costs would require a c 24% increase in end user tariffs all else being equal ($50\% \times 47\% = 24\%$). While the current regulatory regime allows JEL to recover these extra costs via the tariff, a period of rising prices brings additional political scrutiny.

Demand drivers

We continue to keep a watching brief on potential drivers of long-term demand growth, renewables and vehicle electrification (aside from fuel switching considered earlier).

Rooftop solar

There has been little take-up of solar generation in Jersey and the lack of indigenous renewable generation acted in part as a catalyst in triggering the current ongoing regulatory debate.

As an island, Jersey's adoption of on-island renewable technology compares unfavourably with the rest of the UK, where renewable generation accounts for over 30% of total output (2018). It is nevertheless worth reiterating that Jersey does receive over a third of its electricity from certified

renewable sources in Europe via its import contract. However, as we have stressed in [previous reports](#) on JEL, the absence of renewable generation on the island can, in large part, be ascribed to the absence of financial incentives such as those offered in the rest of the UK. Renewable generation has been supported in the UK since 2002 (with the introduction of the Renewable Obligation) although the composition of the support mechanisms has undergone significant change since its inception. What remains clear, however, is the significant financial cost associated with the deployment of renewable energy. Professor Dieter Helm, in his 2017 *Cost of Energy* report, estimated that for 2018/19 the cost of renewable subsidy is likely to be £7–8bn and that by 2030 the total cost is expected to exceed £100bn. Although it is clear the cost of renewable energy has declined and much of this cost is a ‘legacy’ issue, we believe some form of incentive will be required on Jersey to stimulate greater investment in renewable energy. For our sensitivity analysis we assume the number of rooftop PV installations rises to 1,430 (currently we estimate less than 100) by 2030 (5kWp, load factor 12%). Assuming each installation consumes all electricity on site, we calculate the discounted value of revenue lost from unit sales to be worth 15p/share to JEL over the period. This analysis does not include any potential revenue from the imposition of some form of standby charges, which as we have seen, were endorsed in principle by NERA.

Vehicle electrification

As we highlighted last year, the move towards electrification of vehicle fleets is gaining momentum globally, both in terms of vehicle numbers and new players entering the market. Battery and plug-in hybrid vehicles comprised c 6% of new registrations in the UK in 2018. The UK aims to phase out new petrol and diesel vehicles by 2040 and has committed to providing £1bn of support for ultra low emissions vehicles, including helping customers with upfront purchase costs. The government has also pledged to invest a further £80m in charging infrastructure alongside £15m from Highways England, as well as providing £50m for Plug-in Taxi Programme (which provides taxi drivers with £7,500 off the purchase price of a new ultra-low emission vehicle taxi).

As we have noted previously, the geographical dimensions of Jersey (9 x 5 miles) appear favourable for the roll-out of vehicle electrification. However, as has been the case with renewable generation, the absence of government subsidies has meant that the growth of EVs on the island has been slow. In its recent FY18 results JEL stated that it believes the pace is beginning to accelerate, although EVs have yet to establish a significant presence on the island. In 2016, JEL estimated there were only c 215 EVs on the island (cars 131, other 84, all EVs 215 + 424 hybrids). At the end of 2017 the figure for pure EVs had risen to 271 and the latest figures for 2018 put the figure at c 388, an annual increase of 112.

Transport still accounts for a third of Jersey’s overall emissions of CO₂ and JEL continues to believe that vehicle fleet electrification offers the next significant opportunity for the island to reduce CO₂ emissions. As we have highlighted previously, this is supported by the original projections contained in *Pathway 2050: An Energy Plan for Jersey* (The Energy Plan). The SoJ has yet to devise a strategy for promoting vehicle electrification but in the meantime, JEL continues with its collaboration with Jersey Post on the electrification of its vehicle fleet and in 2018 Jersey Post added a further 17 Nissan ENV2000s to its fleet, bringing the total to 47 (out of a total fleet of 110). JEL is upgrading its current charging infrastructure and aims to extend the number of public charging points to around 50.

It is evident that in the absence of financial support the pace of adoption of EV technology on Jersey will remain slow. Our analysis suggests the impact of vehicle electrification on JEL’s profitability is likely to be modest.

Management

The composition of the board of directors remained unchanged during FY18. Chris Ambler continued as CEO (since 2008) and Martin Magee remained CFO (since 2002). Geoffrey Grime, chairman and board member since 2003, remained in post for FY18 but announced at the time of the publication of the FY18 results (December 2018) his intention to retire as chairman and director of the company at the AGM (held on 28 February 2019). Geoffrey Grime has been succeeded as chairman by Phil Austin, a current Non-Executive Director of the Group. Mr Austin joined JEL in 2016 as a Non-Executive Director having spent most of his career in banking with HSBC. In 2001, Mr Austin became the first CEO of Jersey Finance, a joint venture between the Government of Jersey and its finance industry, established in order to promote industry at home and abroad. With effect from 28 February 2019, Peter Simon joined JEL as a non-executive director. Mr Simon is customer product and proposition director for Centrica's UK Home business and a non-executive director of Smart Energy GB.

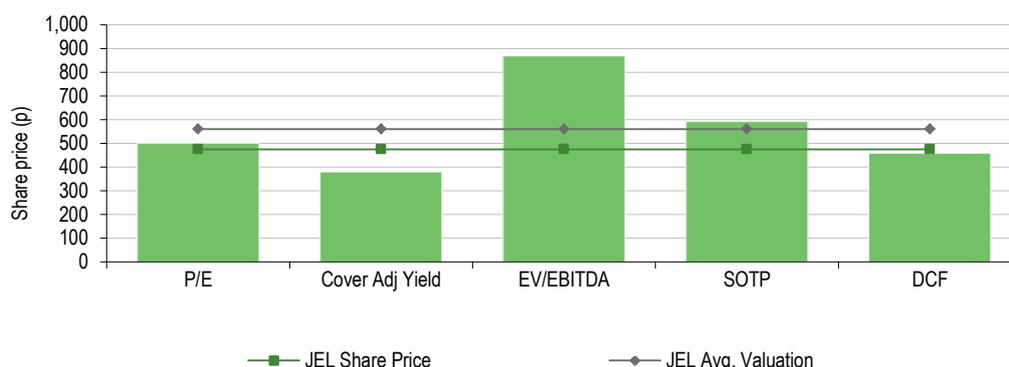
JEL's three-tier shareholding structure remained (ordinary, 'A' shares and preference shares) unchanged during the year. The SoJ continues to hold all the ordinary shares (62% of total share capital but possesses 86.4% of the total voting rights). Ordinary shares (19m in issue) entitle holders to one vote for every 20 shares held, whereas 'A' shares (11.64m in issue) entitle the holder to one vote for every 100 shares held.

Sensitivities

- Regulation. We have written in some detail on the potential for change to the current regulatory systems. Given the absence of proposals from the SoJ, however, it is difficult to quantify potential sensitivities for JEL. Modelling adjustments to the current allowed returns is more straightforward. With a regulated asset base of c £180m, we calculate that each 0.5% reduction in allowed return would reduce operating profits by c £0.9m, equivalent to 5.5% of FY18 total operating profit.
- Interconnector failure. Failure of one or more of the interconnectors could require the use of on-island generation. As we have written previously, on-island generation (fossil fuel) would increase, temporarily, greenhouse gas emissions and costs to JEL. Under the current regulatory settlement JEL would be free to recoup the additional costs but could be constrained from doing so by political sensitivities.
- FX/wholesale pricing. The impact of higher French wholesale prices and weaker sterling versus the euro, as is currently the case, increases electricity purchase costs for JEL. Once again, although additional costs for JEL can be recouped from customers by raising tariffs, this could invite additional political scrutiny. However, as we have already seen, JEL's prices remain well below EU-15 averages.
- Minority. There has been no significant change in the shareholding structure of JEL over the last year and as such the SoJ retains 86.4% of the voting rights. Other shareholders bear the risk associated with the position of a minority shareholder.

Valuation

We have updated our valuation analysis to reflect JEL's reported FY18 figures and movements in market multiples. The average of our analysis (based on the five metrics shown in Exhibit 9) indicates a valuation of c 560p (+2.5%) versus 546p last year. The reason for the uplift in the valuation reflects higher comparable peer group multiples and lower levels of net debt.

Exhibit 9: JEL valuation metrics


Source: Edison Investment Research, Refinitiv (14 March 2019)

SOTP

As a starting point for our SOTP analysis, we use the regulated asset base, which we take to be c £180m, (as revealed in JEL's FY18 Report & Accounts). We value the property business at balance sheet FY18 and the other businesses are valued at market PE of c 12x prospective earnings. The overall SOTP analysis indicates a value for JEL of 592p (+7.2%) versus 552p previously. The 40p uplift in valuation can be ascribed to a higher valuation for the energy business (+14p, due to an increased regulatory asset value), lower net debt (+25p) and other adjustments (+12p in part due to the absence of pension liabilities). The value of the other businesses has fallen by c 12p, despite a small increase to the carrying value of the property portfolio, due to a lower multiple (12x) being applied to the earnings of these businesses.

Exhibit 10: Asset based SOTP valuation

	£m	p/share	Comments
Total electricity valuation	180	587	Est. electricity business net regulatory assets
Total unregulated valuation	34	111	B/S valuations & multiple of 12x earnings
Total asset value	214	699	
Net (Debt)/Cash	(14)	(47)	
Other Adjustments	(18)	(60)	Def tax liabilities, derivatives, pref shares
Total equity value	182	592	

Source: Edison Investment Research

DCF

DCF is our least-favoured valuation approach due to its sensitivity to changes in WACC, terminal growth rate and capex assumptions. For our base case, we assume a WACC of 6.6%, a terminal growth rate of 2% and average capex of c £14m producing a valuation of 459p. Exhibit 11 highlights the sensitivity of the valuation to changes in the WACC and terminal growth rate.

Exhibit 11: DCF valuation (p/share) and sensitivities to changes in WACC and terminal growth rates

		Terminal growth				
		1.0%	1.5%	2.0%	2.5%	3.0%
	5.55%	485	535	600	686	805
WACC	6.05%	432	471	520	583	666
	6.55%	389	420	458	506	567
	7.05%	353	378	408	446	492
	7.55%	322	343	368	397	433

Source: Edison Investment Research

Comparable multiples

Exhibit 12 shows the market multiples for a group of selected peers for FY1e and FY2e. Applying the peer group multiples to our forecasts gives a wide range of values for JEL but the average figure gives an indicative valuation of 557p (this rises to 584p using a dividend cover adjusted yield) versus 528p obtained last year. The key factors behind the rise in valuation are increased forecasts for JEL's profitability and higher P/E multiples and lower yield peer group multiples. However, the yield calculation does not take in to account the additional income that may be available to Channel Island domiciled shareholders arising from the favourable tax treatment of the DPS, nor does it take account of JEL's higher level of dividend cover.

Exhibit 12: Peer group multiple analysis								
	Currency	Price	P/E FY1 (x)	P/E FY2 (x)	EV/EBITDA FY1 (x)	EV/EBITDA FY2 (x)	Yield FY1	Yield FY2
National Grid	p	874	15.4	15.0	11.4	8.7	5.4%	5.6%
Pennon	p	781	14.4	13.4	11.4	10.7	5.3%	5.7%
Severn Trent	p	2035	15.1	14.8	11.2	11.0	4.6%	4.9%
United Utilities	p	848	16.1	14.9	11.5	11.0	4.8%	4.9%
Terna	€	5.43	15.7	14.7	11.3	11.1	4.3%	4.6%
Snam Rete Gas	€	4.34	14.0	13.6	11.5	11.0	5.5%	5.7%
Enagas	€	25.60	14.2	13.2	9.1	8.8	6.3%	6.6%
Red Electrica	€	19.05	14.1	14.6	9.7	10.5	5.5%	5.6%
Average regulated utilities			14.9	14.3	10.9	10.4	5.2%	5.5%
Jersey Electricity (Edison)								
Clean EPS	p/share		32.9	35.9				
EBITDA	£m				25.8	26.8		
DPS	p/share						15.7	16.4
Implied Value of Jersey Electricity	p/share		490	513	869	870	300	301
Average of the above	p/share	557						

Source: Edison Investment Research, Refinitiv. Note: Priced at 14 March 2019.

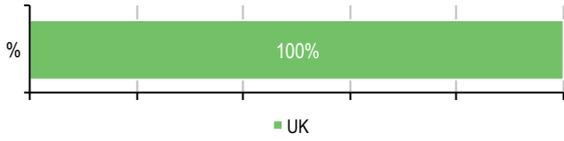
Financials

- Returns. After JEL achieved a return above its 6–7% target (operating profit/regulatory assets), we expect profitability will decline in FY19 in to its targeted range. We believe that although tight control of administrative costs will continue, higher wholesale electricity price costs will exceed retail price rises and that units sold will also decline from the record levels seen in FY18. Despite the year-on-year decline (2019 versus 2018) we still expect EPS of 32.9p for 2019.
- Capex. JEL has spent c £19m pa on average over the last 10 years or so, but with the substantial investment programme largely complete, we expect capex of c £17m in FY19 falling slightly thereafter to £13m in FY20 (FY18 £14.3m).
- Tax. We continue to assume a tax rate of 21% (FY18 21%).
- Pensions. Given the pensions surplus we continue to assume that payments remain c £1m less than the charge to the P&L for the forecast period.
- Balance sheet. We forecast indebtedness will decline from £14.3m in FY18, to £11.1m in FY19 and £4.1m in FY20. In line with company guidance, we forecast that JEL will build its corporate cash pile rather than pay down the outstanding long-term debt (£30m).

Exhibit 13: Financial summary

Accounts: IFRS, year-end: September, £000s	2016	2017*	2018	2019e	2020e
INCOME STATEMENT					
Total revenues	103,361	102,085	105,874	105,920	109,243
Cost of sales	(65,249)	(63,023)	(65,110)	(67,391)	(69,084)
Gross profit	38,112	39,062	40,764	38,529	40,159
SG&A (expenses)	(13,203)	(13,684)	(13,138)	(12,751)	(13,347)
R&D costs	0	0	0	0	0
Other income/(expense)	(350)	40	310	0	0
Exceptionals and adjustments	0	0	0	0	0
Depreciation and amortisation	(10,295)	(10,695)	(11,242)	(11,629)	(11,520)
Reported EBIT	14,264	14,723	16,694	14,149	15,292
Finance income/(expense)	(1,132)	(1,265)	(1,349)	(1,342)	(1,340)
Other income/(expense)	0	0	0	0	0
Exceptionals and adjustments	1,676	0	0	0	0
Reported PBT	14,808	13,458	15,345	12,806	13,952
Income tax expense (includes exceptionals)	(3,166)	(2,834)	(3,152)	(2,631)	(2,866)
Reported net income	11,642	10,624	12,193	10,176	11,086
Basic average number of shares, m	30.6	30.6	30.6	30.6	30.6
Basic EPS (p)	37.7	34.6	39.5	32.9	35.9
DPS	13.50	14.20	14.90	15.65	16.43
Adjusted EBITDA	24,559	25,418	27,936	25,777	26,812
Adjusted EBIT	14,264	14,723	16,694	14,149	15,292
Adjusted PBT	13,132	13,458	15,345	12,806	13,952
Adjusted EPS (p)	32.2	34.6	39.5	32.9	35.9
Adjusted diluted EPS (p)	32.2	34.6	39.5	32.9	35.9
BALANCE SHEET					
Property, plant and equipment	209,168	211,921	215,153	220,919	222,479
Goodwill	0	0	0	0	0
Intangible assets	162	1,110	938	573	523
Other non-current assets	26,755	23,537	26,399	25,014	23,618
Total non-current assets	236,085	236,568	242,490	246,507	246,620
Cash and equivalents	1,925	8,076	15,735	18,922	25,846
Inventories	5,962	6,825	7,092	7,340	7,525
Trade and other receivables	16,583	15,782	15,202	15,035	15,507
Other current assets	2,788	4,454	2,338	2,338	2,338
Total current assets	27,258	35,137	40,367	43,635	51,216
Non-current loans and borrowings	30,000	30,000	30,000	30,000	30,000
Other non-current liabilities	51,788	48,522	46,425	48,149	49,193
Total non-current liabilities	81,788	78,522	76,425	78,149	79,193
Trade and other payables	16,084	15,885	15,284	15,819	16,217
Current loans and borrowings	943	0	0	0	0
Other current liabilities	420	1,034	2,419	2,039	2,210
Total current liabilities	17,447	16,919	17,703	17,858	18,427
Equity attributable to company	164,048	176,238	188,676	194,054	200,107
Non-controlling interest	60	26	53	81	108
CASH FLOW STATEMENT					
EBIT	14,264	14,723	16,694	14,149	15,292
Depreciation and amortisation	10,295	10,695	11,242	11,629	11,520
Share based payments	56	73	52	85	90
Other adjustments	1,686	1,554	885	1,385	1,396
Movements in working capital	822	1,259	529	1,032	129
Interest paid / received	(1,522)	(1,422)	(1,377)	(1,377)	(1,377)
Income taxes paid	(396)	(421)	(1,045)	(2,000)	(2,179)
Cash from operations (CFO)	25,205	26,461	26,980	24,902	24,871
Capex	(32,395)	(15,088)	(14,873)	(17,030)	(13,030)
Acquisitions & disposals net	19	4	1	0	0
Other investing activities	0	0	0	0	0
Cash used in investing activities (CFIA)	(32,376)	(15,084)	(14,872)	(17,030)	(13,030)
Net proceeds from issue of shares	0	0	0	0	0
Movements in debt	0	(943)	0	0	0
Dividends paid	(4,295)	(4,285)	(4,467)	(4,686)	(4,916)
Cash from financing activities (CFF)	(4,295)	(5,228)	(4,467)	(4,686)	(4,916)
Currency translation differences and other	0	0	0	0	0
Increase/(decrease) in cash and equivalents	(11,466)	6,149	7,641	3,187	6,925
Currency translation differences and other	888	2	18	0	0
Cash and equivalents at end of period	1,925	8,076	15,735	18,922	25,846
Net (debt) cash	(29,018)	(21,924)	(14,265)	(11,078)	(4,154)
Movement in net (debt) cash over period	(11,521)	7,094	7,659	3,187	6,925

Source: Company data, Edison Investment Research. Note: *The figures reflect the minor restatement of FY17 figures.

Contact details The Powerhouse PO Box 45 Queen's Road St Helier Jersey JE4 8NY + 44 (0) 1534 505460 www.jec.co.uk	Revenue by geography  <p>A horizontal bar chart with a single green bar representing 100% of the revenue. The y-axis is labeled with a percentage sign (%). A legend below the chart shows a green square next to the text 'UK'.</p>
Management team	
Chairman: Phil Austin (from February 2019) Phil Austin became chairman of JEL in February 2019 having served as a non-executive director since 2016. From 1997 to 2001 Mr Austin was deputy CEO of HSBC's Offshore Island business and in 2001 became founding CEO of Jersey Finance. In 2006 Mr Austin joined Equity Trust as CEO and since 2009 he has held a number of non-executive positions and is a non-executive of 3i Infrastructure, City Merchants High Yield Trust and Blackstone/GSO Loan Financing.	Chief executive: Chris Ambler Mr Ambler has served as Chief Executive since 2008, having previously held senior positions in the utility and materials sectors. He is a chartered engineer with the Institution of Mechanical Engineers and holds an MBA from Insead. Mr Ambler is a NED of Apax Global Alpha and Foresight Solar Fund.
Finance director: Martin Magee Mr Magee is a qualified accountant and previously worked for Stakis and Scottish Power in a variety of senior financial roles. He joined JEL as finance director in 2002 and has served in this role since that date. Martin Magee is also non-executive chairman of the Aberdeen Standard Capital Offshore Strategy Fund.	
Principal shareholders – listed shares only* (Refinitiv 14/3/19)	(%)
Miton Asset Management	5.08%
<p>*Explanatory note taken from page 39 of the FY18 Report & Accounts - 62% of the ordinary share capital of the Company is owned by the States of Jersey with the remaining 38% held by around 600 shareholders via a full listing on the London Stock Exchange. Of the holders of listed shares, Huntress (CI) Nominees Limited owns 5.3m (46%) of our 'A' Ordinary shares representing 18% of our overall Ordinary shares and around 5% of voting rights. This nominee company is held within the broker firm Ravenscroft which has placed our stock with a number of private clients, and a fund, residing largely in the Channel Islands.</p>	
Companies named in this report	
EdF, National Grid, Pennon, Severn Trent, United Utilities, Terna, Snam Rete Gas, Enagas, Red Electrica	

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