



Office of Utility Regulation

Price Regulation of Electricity Services

Report on the Consultation Paper and Decision Notice

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1. Introduction

In August 2002, the Director General of the Office of Utility Regulation (“the Director General”) published Document OUR 02/29 – a consultation paper on proposals for the price control of network and retail electricity services in Guernsey.

Section 2 of this report considers the underlying need for price control in the Guernsey electricity market

Section 3 sets out various developments in the Guernsey electricity sector since the publication of the original consultation paper

Section 4 describes various policy objectives that must be balanced in arriving at a final price control

Section 5 sets out the Director General’s conclusion that an interim price control is appropriate for Guernsey Electricity’s (“GE’s”) retail electricity services, whilst further investigation of the strategic options available to Guernsey is undertaken, and

Section 6 sets out the next steps in this process.

Two organisations responded to the consultation, as listed below:

- Guernsey Electricity Limited; and
- Guernsey Gas Limited.

The Director General wishes to thank those who have responded to this consultation document for their contributions. With the exception of the responses marked as confidential, written comments are available for inspection at the OUR’s office.

2. The Need for Price Control

A central role of economic regulation is to ensure that dominant incumbents do not pass unnecessary costs through to consumers, either with respect to;

- inefficient operating practises; or
- investment decisions which have not been proven to provide demonstrable net economic benefits.

The appropriate level of costs of and investment by a company is usually considered in the context of the overall setting of a price control. The goal of any price control is to prescribe a minimum downward movement in prices or to constrain any allowable upward movement, whilst ensuring that the company will cover its costs, including costs of appropriate investment and a suitable rate of return on its assets, providing that it operates in an efficient manner.

In Guernsey this exercise must be undertaken within the wider policy framework set out by the States of Guernsey for the electricity sector. In other words, given the crucial role that electricity plays in the economic and social life of Guernsey, the States, as the policy maker for the Island, has articulated various policy objectives that must be met and balanced with the overall desire to ensure efficient operation of the electricity sector.

In document OUR 02/29 “Proposals for the Price Regulation of Network and Retail Electricity Services”, the Director General proposed that price regulation was necessary to achieve the above objective, and described in detail various types of price control that might be applied. The paper requested respondents’ views on the need for price control and the most appropriate format of that price control in the Guernsey market.

One of the respondents to the consultation paper agreed that some form of price control was required in order to prevent the use of targeted cross-subsidisation as a barrier to entry. By contrast, the remaining respondent did not consider explicit regulation of the dominant incumbent’s retail prices as appropriate unless or until similar measures were applied to similar industries in Guernsey.

Director General’s Position

Guernsey’s retail electricity market currently possesses a monopolist/dominant operator that also has a dominant position throughout the electricity supply chain. This position of economic strength is unlikely to subside in the near to medium term. In this context, it is essential that the social objective of maintaining the affordability of electricity provision, thus underpinning economic growth, is safeguarded. In the absence of competition, price control is widely accepted as the most appropriate tool to achieve this.

Therefore the Director General remains of the view that retail price control is necessary.

Decision 1

In order to ensure that consumer interests are suitably protected at this stage in the development of Guernsey’s electricity sector, the Director General will explicitly regulate GE’s retail prices.

3. Developments in Guernsey’s Electricity Sector

There have been a number of other developments in the Guernsey electricity market that are relevant to the consideration of the form, level, scope, duration and timing of any detailed price control that will be put in place. These are;

- the resolution by the States of Guernsey to issue States Directions on whether and if so how the retail market for electricity in Guernsey should be opened up to competition;
- the resolution by the States of Guernsey to endorse an explicit security of supply policy for Guernsey; and
- the submission by Guernsey Electricity Ltd of information to inform the setting of the level of any price control.

These developments are summarised below.

3.1. States Directions on Competition

At its meeting in January 2003, the States of Guernsey made a series of resolutions including a number relating to the introduction of competition in the retail electricity market in Guernsey. In particular the States resolved to:

- “1. Prepare for the potential introduction of retail competition in the future by amending the licensing regime within the Electricity (Guernsey) Law 2001 to reflect a functional split(Retail, Network, and Generation) as outlined in the Office of Utility Regulation report.*
- 2. Issue a States Direction to the Director General of Utility Regulation that an exclusive license be issued to Guernsey Electricity for supply activities subject to any exemptions granted by the Director General under Section 1(2) of the Electricity (Guernsey) Law 2001 for the period ending 31st January 2012.*
- 3. Issue a States Direction to the Director General of Utility Regulation to issue to Guernsey Electricity an exclusive license for conveyance activities, subject to any exemptions granted by the Director General under Section 1(2) of the Electricity (Guernsey) Law 2001 for the period ending 31st January 2012.*
- 4. Direct the Director General of Utility Regulation that the exclusive licenses set out in Recommendation [2] and [3] above should be replaced with exclusive licenses for retail and network activities respectively when new legislation consistent with Recommendation 1 is enacted.*
- 5. Direct the Board of Industry to monitor the development of the energy sector in the Channel Islands and bring forward a review of these arrangements by 31st January 2011 or sooner in the event of any material changes to the structure of the sector.”¹*

These resolutions further underpin the Director General’s decision that in the first instance any price control for GE should be developed at the retail level, in order to take into account the fact that a vertically integrated company will be providing electricity services in both the network and retail markets with no prospect of retail competition in the near term.

3.2. States Directions on Security of Supply

Also at its meeting in January 2003, the States of Guernsey confirmed that the Island of Guernsey should have a security of supply policy that requires the maintenance of sufficient electricity generation sources such that, in the event of two of those sources being unavailable, there would still be sufficient generation sources to meet the needs of the Island. This policy, known as “n-2”, is set out in detail in Document OUR 02/19 which is available from the OUR website.

The States endorsed this policy when it resolved to:

- “6. Endorse the diverse generation source approach to security of supply as set out in this report.*
- 7. Remove any reference to security of supply in the States guidance to the Advisory and Finance Committee in exercising on behalf of the States its role as shareholders of Guernsey Electricity Limited”².*

¹ Billet d’Etat I of 2003, Wednesday 29th January 2003, p.55

² Billet d’Etat I of 2003, Wednesday 29th January 2003, p.55

As a formal Island wide policy the costs of this level of security of supply must be taken into account when considering the level of prices for electricity in the market.

3.3. Submission of Information from Guernsey Electricity

As indicated in the consultation paper, the OUR requested GE to submit a detailed fully justified business plan and any other relevant information considered necessary to assess the level of any price control and the company has responded to information requests in this regard. The information provided by GE sets out its preferred investment strategy for Guernsey's electricity sector over a time horizon of 15 years and seeks to have prices increased to allow it to fund this strategy.

Not only is it essential that the Director General considers GE's submission from the viewpoint of efficient operation, but it is equally crucial to consider whether it is the best possible strategy to fulfil the various policy imperatives that have been set out by the States of Guernsey. The Director General, however, is not satisfied that GE has provided sufficient justification that its preferred investment scenario is the most appropriate way forward for meeting Guernsey's future electricity needs from a strategic policy perspective and this is addressed in more detail in section 4 below.

In addition, Guernsey Electricity has not provided sufficient justification that the level of costs it anticipates are those that an efficient operator would incur. This is a significant omission in that it is necessary to set price controls at a level that ensures that only the costs of an efficient operator would be recouped from prices to customers. Therefore the Director General concludes that there is a need for GE to provide full and thorough justification of its cost base to the satisfaction of OUR before a final price control can be set.

3.4. Conclusion

The decision by the States to continue the exclusive right of Guernsey Electricity Ltd to convey and supply electricity in the market in the medium term underpins the need for price control as described in section 2.

With regard to the detailed formulation of a level of price control, the costs of the formally agreed security of supply policy set out in section 3.3 will impact on any decision of the Director General and must be appropriately considered in any strategy for meeting the future needs of Guernsey.

Finally, the Director General has not received sufficient justification from GE that the scenario it plans for Guernsey's future electricity needs is the most appropriate one or that the costs it specifies as being incurred over the period of its investment strategy are efficient.

4. Electricity Policy in Guernsey

4.1. Balancing Policy Considerations

Irrespective of what form of price control might be considered the most appropriate for Guernsey's electricity sector it continues to be necessary to balance the need for efficient operation with the achievement of States policy.

It has become clear that, with respect to future investment in, and the development of, Guernsey's electricity industry the issue of cost efficiency and the interrelationship between the economic and strategic benefits of investing in high capital cost generation and interconnection equipment plays a pivotal role. Any investment strategy is complicated by the fact that there may be a degree of ambiguity between the economic considerations surrounding investment decisions and States policies associated with environmental protection and maintaining security of supply.

In other words, the "least cost" option for providing electricity generation sources for Guernsey may not be the same as the option that provides security of supply to the level that the States of Guernsey has decided is necessary in its resolution of January 2003. Another consideration is that the most economically efficient solution may not provide the most environmentally friendly solution for Guernsey. In essence therefore there are explicit trade-offs between multiple policy objectives that need to be resolved.

The main policies that the OUR considers most relevant to planning for the provision of sufficient electricity generation resources for Guernsey in the future include:

- the requirement that there be sufficient generation capacity available to meet the n-2 security of supply policy endorsed by the States in January 2003;
- any policy that the states may wish to articulate on;
 - the exportation of pollution from Guernsey by using generation sources from other jurisdictions and/or
 - the use of electricity from renewable sources; and
- the overall imperative to supply electricity to Guernsey consumers at economic prices.

One conclusion of the Director General based on the work carried out to date is that these considerations have not been adequately addressed in GE's proposed investment strategy that has been submitted to OUR in support of its application for a price control strategy that for allows price increases.

4.2. *Considering Strategic Options*

The Director General believes that these issues must be considered together and does not believe that the business plan and subsequent information GE submitted to the OUR as part of the price control process has sufficiently addressed this from the perspective of any of the policies set out above.

First, there is a degree of ambiguity regarding the relationship of GE's proposed investment strategy with the "n-2" security of supply principle endorsed by the States.

Second, the approach proposed by GE relies heavily on the assumption that environmental factors will outweigh economic ones and that any incremental rise in costs associated with this should be an allowable pass through cost to consumers. However, no comparison with the other potential investment strategies open to GE was provided. Nor is there any assessment of whether the strategy proposed is the most appropriate way to meet environmental concerns.

Finally, as explained earlier there is no justification that the base cost of the company from an operational or investment perspective are those that an efficient operator would incur and there has also been no justification that the proposed investment strategy is economically efficient.

Consequently, not only is it unclear from a regulatory perspective whether GE's proposed option is economically efficient, there is also uncertainty regarding the actual level of any potential price premium involved in such a proposal, whether the States would consider the level of any premium acceptable, what policy decisions would be made to fund such a premium if it existed and how this would relate to the OUR's price control benchmark of efficient economic operation.

Therefore the OUR does not consider it appropriate to accept GE's approach as consistent with the preferred policy of the States of Guernsey and believes that alternatives must be explored so that the States of Guernsey can articulate a clear preferred policy in the knowledge of the impact and results of those policy choices.

4.3. Conclusion

Given the vital role that secure cost efficient electricity supplies will play in the overall development of Guernsey's economy, it is critical that the economic, environmental and security of supply trade-offs across the various planting strategies available to fulfil Guernsey's future electricity requirements are fully understood and assessed prior to considering the form of any detailed price control.

A review of these options will allow for a quantification of the costs associated with various scenarios, including GE's approach which will in turn allow any price premium associated with the policy considerations that GE believes appropriate to be assessed by the policy makers (the States of Guernsey) in the context of:

- whether this is the preferred policy and
- if any premium payable is politically and socially acceptable, particularly with respect to any implications it may have for the competitiveness of Guernsey's economy.

Thereafter, if any premium is considered appropriate, it will be necessary to determine how any such premium will be funded and in particular whether consumers should pay via higher prices. The Director General believes this exercise is an essential prerequisite to the setting of price controls for the future.

5. Price Control on Guernsey Electricity Limited

In the interim period, the Director General considers that prices for electricity should remain at their current levels as no justification has been provided for any increase. Therefore, in accordance with the GE licence, the Director General will impose a price freeze on all of GE's retail electricity products until the conclusion of the above review.

Decision 2

The Director General will freeze prices for all of GE's retail products until the completion of a review of the strategic options available to Guernsey and a subsequent price control review.

In accordance with condition 20.2 of the licence granted to Guernsey Electricity Ltd under section 2(1) of the Electricity (Guernsey) Law, 2001, on 1st October 2001³, and the Director General's decision⁴ that Guernsey Electricity Ltd has a dominant position in the electricity conveyance, supply and generation markets in Guernsey, the Director General hereby determines that, until further notice, the maximum level of prices for all services provided by Guernsey Electricity Limited in the electricity generation, conveyance and supply markets in Guernsey shall be those prices that were in place on 1st March 2003.

6. Next Steps

Given the wide range of strategic policy issues that this consultation has raised, the Director General believes that it is essential that the review of strategic options for Guernsey's electricity sector involves all key policy making arms of the States including:

- The Advisory and Finance Committee as the shareholder of Guernsey Electricity Ltd,
- The Advisory and Finance Committee as the island's economic policy making committee, and
- the Board of Industry which retains residual responsibility for electricity policy.

The Director General is pleased that these committees have agreed that a strategic review is needed and are participating in establishing a mechanism to achieve the review in a timely fashion. This will enable the OUR to complete its price control review and develop a price control that has regard to wider States policy.

In addition, OUR is charged under section 4(1)(a) of the Regulation Law, with providing advice to the States on utility matters, and will be involved in and support the strategic review. Clearly it is also necessary for GE to be involved in contributing and providing information to assist in the development of the strategic options.

The Director General believes that the necessary investigation and analysis of the options can be carried out during 2003 with a view to preparing any report that is required to go to the States for policy decisions in 2004. In any case, the OUR would anticipate at the latest, being able to conclude a revised price control mechanism in time for a new price control, consistent with States policy, being implemented by 1st January 2005.

/END

³ Document OUR 02/04: Electricity Licence Conditions

⁴ Decision 1 as set out in Document OUR 02/05; Decisions under the Electricity (Guernsey) Law, 2001, Decision Notice and Report on the Consultation Paper