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Mr John Curran
Director General
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Suites B1 & B2
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28 October 2005

Dear Mr Curran,

Comments on the Review of Guernsey Electricity Limited's Price Control

We would like to thank you for your invitation to comment on your document OUR 05/23 dated September 2005 on the review of Guernsey Electricity Limited's price control. Taking this opportunity, we set out in this note our views on the proposed price control and hope that you will find our comments constructive and useful to your decision making process.

The comments we make are general in nature as we do not know the specific details of GEL's cost base. We apologise if this leads us to comment inaccurately in the specific context of the Guernsey electricity industry.

We believe that some general concepts of economic regulation are widely accepted as being the most appropriate to (1) incentivise the efficiency of electricity companies' investment programs and operations, and (2)promote improved quality of supply. We highlight in this note the areas where we believe that the OUR proposal may depart from these generally accepted concepts. Two of the key economic principles underlying the regulation of the electricity industry are:

- to balance in a fair way the respective interests of consumers and shareholders, and
- to allow a reasonable return on investments where electricity companies have invested efficiently.

It is our view that a number of modifications could be made to the proposed price control that would allow the regulatory framework to be closer aligned with these two principles and provide stronger incentives to GEL to perform efficiently. We also believe that our proposed modifications would by and large be simple to implement before the Final

Decision is made, considering that the OUR seems to have most of the necessary information readily available. Our comments on a number of specific sections of your document follow.

Section 6.1 We note that you are proposing to apply a fixed 3-year RPI-X price control on the retail price. In other power systems, we have seen the RPI-X price control being applied to activities where companies can control cost (typically network operations) and a pass-through of costs being allowed for cost items that are out of the control of companies (typically energy procurement costs). Disallowing the pass-through on uncontrollable costs in our view has the potential to significantly endanger GEL's shareholders (in an environment where uncontrollable costs are rising) and, conversely, disincentivises GEL from decreasing its tariffs in an environment where uncontrollable costs turn out to be lower than anticipated.

Sections 6.3 and 7.1 to 7.3 We believe that an arms-length regulatory regime, based on a rate of return on the Regulatory Asset Value (RAV), a depreciation allowance and an OPEX allowance such as for the Distribution Network Operators (DNOs) in the UK, would be likely to (1) provide a more stable regulatory environment where precise and enduring rules are set, (2) require a lesser degree of intervention from the regulator and (3) create stronger incentives for GEL to be efficient in managing its CAPEX and OPEX.

The OUR has a different policy. In particular, OUR "proposes that no return on GEL's RAV should be included within its allowable revenue" (section 7.1) and "proposes not to include an additional regulatory depreciation schedule in GEL's allowable revenue" (section 7.2).

Sections 7.5 The WACC is the rate of return usually allowed on the value of assets owned by network owners, or RAV. For example, for the 4th Distribution Price Control Review, OFGEM based the calculation of allowed revenues on a WACC of 6.9% pre-tax or 4.8% post-tax. This calculation assumes a cost of equity of 7.5%, a cost of debt of 4.1% and a gearing of 57.5%.

Choosing between a "Save to spend" policy and allowing GEL to raise debt finance requires to take a view on what GEL's optimal financial structure is. In the UK, DNOs are allowed a rate of return on the RAV of 4.8% post-tax, based on an assumed gearing of 57.5%. This does not mean that DNOs are in practice constrained to a gearing of 57.5%. It is our view that a "Save to spend" policy, corresponding to a 0% gearing, is not incompatible with a regulatory framework based on a rate of return on the RAV and an allowance for depreciation and for OPEX.

Thank you again for giving us the opportunity to comment on your draft price control decision. The issues identified above are not intended to be exhaustive. We hope that, in spite of our limited understanding of the specificities of Guernsey's electricity system, our comments will bring you a fresh and helpful perspective on regulation principles and that these comments may influence your final Price Control decision for the period running from 1 January 2006 to 31 March 2009.

Please do not hesitate to contact me by telephone on +44 20 7583 5000 (switchboard) or by email at mark.v.hughes@uk.pwc.com for any clarification on the issues mentioned above.

Yours faithfully,

Mark Hughes
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