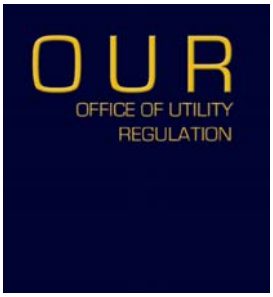

Office of Utility Regulation

Review of Guernsey Electricity Limited's Price Control

Draft Decision

Document No: OUR 05/23 **September 2005**

Office of Utility Regulation
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1. Introduction

This document sets out a proposed price control for Guernsey Electricity Limited ("GEL"). A feature of the Island's electricity market is the presence of only one provider of a resource that is essential to support the social and economic life of the Island. As a result the Guernsey customer, home or business, is in a position where they have no choice in either service provider or the price at which they take their electricity supply. Many countries have in place legislative frameworks to balance such a position. When the States decided in 2001 to commercialise the various utility companies, it also opted to provide for independent oversight of the utility companies by a regulatory body. The OUR is charged with this role through enforcement of licence conditions and the price control process which requires GEL to justify the price it charges for electricity.

Through this price control the Director General ("DG") seeks to ensure that Guernsey consumers are asked to contribute towards the costs of the provision of electricity by an efficient operator. In practical terms this means the proposed decision seeks to ensure that customers are only asked to bear, through the price paid for their electricity, those costs (both operational and capital expenditure) that are justified and that GEL can demonstrate have been efficiently incurred and benefit its customers. The sustainability of GEL to meet the longer term needs of the Island is also an important consideration.

A consequence of the weak negotiating position of the Guernsey customer is that without controls on how GEL chooses to spend money on capital projects or other investments, customers will be expected to pay for investments even where these don't realize any benefits to them. In a normal commercial environment, companies that make investments that do not benefit their customers, generally have to charge higher prices than their competitors to recoup their investment, and tend to lose customers as a result. As the only electricity provider on the Island, GEL is not in this position and is therefore less exposed to the disciplines that exist for providers in more competitive markets. The OUR's role is to compensate for this by providing an additional level of scrutiny of proposals for capital investment to ensure the rationale for customer benefits is adequate.

A further outcome the OUR is seeking to achieve in this price control is to ensure customers only pay for the costs incurred in running an efficient business. As technology and people skills develop so does the scope for improving the running of a business. This is one of the goals of the move from a States Trading Board environment to a commercialised company. The OUR is tasked with ensuring the Guernsey customer is not paying too much for their electricity because their electricity provider is not taking full advantage of the potential to reduce its operating costs. Again in a competitive market, companies are encouraged to make such improvements in order to maintain or win customers. The pressure on GEL to be as proactive in making such improvements is less than in normal competitive markets for similar reasons to those discussed already, namely, a company that has captive customers has less incentive to seek to improve than one that can lose its customers to competitors who are better at running their business, leading to unnecessarily high prices. This is borne out in the Guernsey context where GEL remained profitable and

increased its cash reserves over the past three years despite a decision by the OUR to freeze electricity prices since 2003, suggesting the level of GEL's prices were historically too high and scope for efficiency did exist. The OUR's role is therefore also to compensate for the lower level of incentive by providing an additional level of scrutiny of proposals for operating costs to ensure the rationale for customer benefits is adequate.

A final area worth highlighting is the role of the OUR in ensuring GEL adopts a proportionate approach when acquiring funds from customers for future investment. GEL has a policy of maintaining its cash reserves at relatively high levels to pay for capital investments as they arise. These cash reserves are maintained by charging customers a premium in their electricity bills. This is effectively a form of lending by customers to the electricity provider on the Island. It is estimated that GEL has currently collected on average around £700 of savings per customer in its cash reserves for future expenditure.

In the OUR's view GEL has strong incentives to acquire cash from customers earlier than necessary since these cash reserves provide a significant source of revenue through the interest gained while the company bears no costs in adopting this approach. The importance of this revenue source is evident in the fact that the interest on these savings contributed almost 60% of GEL's pre-tax profits in 2004/05. Furthermore, the use of this cash reserve is not subject to the level of scrutiny the company would be subject to if it borrowed these funds from a financial institution. Given this the OUR has assessed GEL's proposed approach to building up its cash reserves to ensure it has adopted a proportionate approach to fund its future capital expenditure.

This draft decision is based on a rigorous assessment of GEL's costs and proposed expenditure (both capital and operational). It has identified a number of areas where the DG believes further savings can be made that will benefit consumers whilst at the same time ensuring GEL continues to be a strong, sustainable electricity company to meet the Island's needs now and in the future. It shall ensure that GEL is able to meet its commitments and build the cash reserves it will require in the future whilst providing value for money to the consumer.

2. Structure of the Paper

2.1. Structure

The rest of this paper is structured as follows:

Section 3: sets out the background to the price control and the role of the States in setting the policy framework;
Section 4: summarises the legal framework of this price control;
Section 5: provides an update of developments since the last price control;
Section 6: sets out the DG's position key technical elements of the price control;
Section 7: assesses the revenue required by GEL to meet its commitments over the price control period;
Section 8: sets out the main proposals on GEL's capital expenditure for the period of the price control;
Section 9: sets out the main proposals on GEL's operational expenditure for the period of the price control;
Section 10: addresses GEL's accumulation of cash reserves for future capital expenditure;
Section 11: Summarises the main proposals of the draft decision; and
Section 12: addresses the price control compliance requirements and the next steps in the process.

2.2. Comments

Interested parties are invited to submit comments in writing on the matters set out in this paper to the following address:

Office of Utility Regulation
Suites B1& B2
Hirzel Court
St Peter Port
Guernsey
GY1 2NH

Email: info@regutil.gg

All comments should be clearly marked "*Comments on the Review of Guernsey Electricity Limited's Price Control*" and should arrive before 5pm on **28th October 2005**.

In line with the policy set out in Document OUR 04/01 – "Regulation in Guernsey; Revised Consultation Procedures", the DG intends to make any comments received available on the OUR website. Any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However the DG regrets that he is not in a position to respond individually to the responses to this consultation.

Any comments received will be taken into account by the DG in informing his final decision regarding GEL's price control which will come into effect on 1st January 2006.

3. Background

In March 2003 the DG, following consideration of proposed tariff increases from GEL, decided there were a number of strategic issues where clarification of the wider States policy would be required before any decision could be made on any future price control on GEL. In that decision (OUR 03/07[1]) the DG highlighted that, given the vital role that secure, cost efficient electricity supplies play in the overall development of Guernsey's economy, it was important that the economic, environmental and security of supply trade-offs across the various planting strategies realistically available to fulfil Guernsey's future electricity requirements be fully understood and assessed prior to considering the form of any detailed price control.

The DG's view was that a review of these areas would allow for a quantification of the costs associated with various scenarios, including GEL's approach which would in turn allow any price premium associated with the policy considerations to be assessed by the States in the context of:

- a preferred policy;
- if any premium payable was politically and socially acceptable (particularly with respect to any implications it may have for the competitiveness of Guernsey's economy); and
- how such a premium might be funded.

Since that decision the Department of Commerce & Employment, aided by consultants Mott McDonald, has carried out a major study on the options for meeting the future generation needs of the Island. The study has critically assessed a range of generation options realistically available to Guernsey to enable the States to meet its electricity needs over the foreseeable future. This report assessed each option against other policy considerations, including security of supply, independence, environmental issues and overall cost.

The report was presented to the Department of Commerce & Employment in December 2004. Since then the Department has consulted widely with other States Departments and agencies and will in the near future present a policy letter to the States requesting support for the broad approach proposed in that policy letter.

The OUR has liaised closely with the Department of Commerce & Employment given the importance of its work to the framing of any price control decision. This draft decision is therefore based upon the OUR's understanding of the proposed policy and is subject to adoption of that policy by the States. In the event that the States adopts a decision that differs from that upon which this draft decision is based it may be necessary to revisit the price control currently being proposed.

[1] Price Regulation of Electricity : Report on the Consultation Paper and Decision Notice.

4. Licensing Regime and Legislative Framework

4.1. Overview

The legislative framework underpinning the regulatory regime for the electricity sector is governed by:

- The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 (the "Regulation Law");
- The Electricity (Guernsey) Law, 2001 (the "Electricity Law");
- The Electricity (Guernsey) Law 2001 (Commencement and Amendment) Ordinance 2001; and
- States Directions to the DG adopted by the States of Guernsey[2].

The Electricity Law defines the three activities that constitute the electricity supply chain under the current legislative framework, these are;

- the generation of electricity;
- the conveyance of electricity across the electricity network; and
- the supply of electricity directly to homes and businesses.

These terms, are defined in the Electricity Law and govern the current licensing framework which is outlined below.

4.2. Current Licensing Regime

The States of Guernsey has issued a number of States Directions to the DG in relation to the licensing of electricity activities in Guernsey. In accordance with those Directions the DG issued the first licences for electricity generation, conveyance and supply to the incumbent electricity company – GEL - on 1st February 2002.

The market for generating electricity is, in principal, open to competition. In terms of conveyance, under the current regime no other operator can lay electricity cables and anyone generating electricity must therefore use the existing electricity network of GEL to convey that electricity from their generation plant to customers. In terms of supply, only GEL may sell electricity to end customers.

4.3. Legislative Background to Price Regulation

Section 5(1) of the Electricity (Guernsey) Law, 2001, provides that the DG may include in licences such conditions as he considers necessary to carry out his functions. The Law specifically provides that such conditions can include (but are not limited to) conditions regulating the price premiums and discounts that may be

[2] Billet d'Etat No.XVIII 2001, pages 1263-1264 and Billet d'Etat I of 2003, p.55

charged or (as the case may be) allowed by a licensee which has a dominant position[3] in a relevant market[4].

In accordance with these provisions, the "Electricity Licence Conditions" include the following condition 20.2:

"The DG may determine the maximum level of charges the Licensee may apply within a relevant market in which the Licensee has been found to be dominant. A determination may;

(a) provide for the overall limit to apply to such charges;
(b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; and
(c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies."

This condition allows the DG to regulate the prices that a licensee charges for its electricity services in a way and for a period that he deems appropriate, provided the licensee has a dominant position in the relevant market.

As set out in a previous OUR document (OUR03/07), 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 change 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.

[3] Condition 5(1)(f) of the Electricity (Guernsey) Law, 2001.
[4] Section 22 of "The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 states that:
"A dominant position in relation to a relevant market shall be construed as it would be in the United Kingdom under the Competition Act 1998, but with the substitution, where appropriate, of references to the Bailiwick for references to the United Kingdom."
The Competition Act 1998 utilises the definition of dominance that has developed under European Community Competition Law.

5. Developments in Guernsey's Electricity Sector

There have been a number of other developments in the GEL 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 consideration by the States of Guernsey of the strategic generation options for the Island and the proposals arising from those considerations; and
- the submission by GEL of information to inform the setting of the level of any price control.

These developments are summarised below.

5.1. States review of the Strategic Generation options for the Island

Following the decision by the OUR to freeze electricity prices in 2003, the Department of Commerce & Employment commissioned a study to investigate and cost the generation options available to GEL to meet the Island's electricity needs. This study sought to consider each of the possible generation options against a range of criteria which included:

- Security of supply;
- Environmental;
- Independence of supply;
- Diversity of supply; and
- Cost.

This report was presented to the Department of Commerce & Employment in December 2004. Since then the Department has consulted with other State bodies and has identified what it believes to be a sustainable and pragmatic approach to the further consideration of these policy issues at this time. The States will shortly be asked to consider this approach.

In view of the timing issues created by the new contract signed by GEL for the importation of electricity from France (which takes effect from 1st December 2005) there is a need to have a new price control in place to take account of the changes to GEL's cost base. It is therefore necessary to proceed with a draft decision at this time in advance of the proposed policy being debated by the States. Therefore, this draft decision is based on the DG's current understanding of that which the States will be asked to endorse. Should, following that debate, there be a requirement to further consider the impact of the agreed States policy on the final price control decision this will be undertaken at the most appropriate time.

However for the present this price control is based on an understanding that the States will, in broad terms, wish to:

- allow GEL, for the period of this price control, to build sufficient reserves to fund such capital expenditure as the States may determine at a future date best meets Guernsey's needs;
- ensure that these reserves are sufficient to fund capital expenditure in:
    - generation on the Island that satisfies the n-2 security of supply policy
    - maintenance, improvement and extension of the existing link
- ensure that the price control decision encourages measures aimed at improving the environment in Guernsey in an efficient, sustainable and cost efficient manner.

It is against this background that the DG has considered the application for tariff increases requested by GEL as outlined in section 5.2 below.

5.2. Submission of Information by GEL

On the 7th of July 2005 GEL proposed tariff increases effective as follows:

1 December 2005	–	9.8%
1 April 2006	-	8.4%
1 April 2007	-	6.0%
1 April 2008	-	6.0%

The proposal to increase tariffs in two stages in December 2005[5] and April 2006 equates to a proposed increase of 19% in April 2006. In total the application seeks to increase electricity tariffs by 34% by the end of the price control period.

GEL has stated that the principal drivers for the company's request for price increases stemmed from changes to a number of factors impacting on its cost base. These included:

- changes in the price of key inputs driven by developments in international energy markets;
- identification of capital projects to meet the increasing demands for electricity by the Island; and
- the need to increase GEL's contributions to the company pension fund.

Not only is it essential that the DG considers GEL'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 remainder of this paper assesses these issues in detail.

[5] GEL's new contract with EdF runs from 1st December 2005 and GEL's application sought to introduce the first tariff change on that date.

6. Principles of GEL's Price Control

6.1. Form

In document OUR 02/29[6] the DG proposed to impose an incentive regulation form of price control (i.e. RPI-X or RPI+Y) on GEL. Document OUR 03/07 concluded that in order to ensure that customer interests were suitably protected given the stage of competitive development of Guernsey's electricity sector, the DG would explicitly regulate GEL's retail prices.

Proposed Decision

The DG proposes an incentive regulation form of the price control (i.e. RPI-X or RPI+Y) to regulate GEL's retail prices.

6.2. Scope

Responses to the OUR's previous consultation (OUR 02/29) on the scope of the price control were split between a preference for the price control to be placed on a basket of tariffs and a view that price controls on an individual tariff basis would provide greater detail with regard to the probable range of future prices as well as provide safeguards to competition. As GEL has not proposed different price increases across its different tariffs and given the advantages of transparency, it is proposed that any price change is applied consistently to all tariffs and that the scope of the price control will include the following services:

- Standard Tariff:
  - Standing charge; and
  - Unit charge;

- Super Economy 12:
  - Standing charge;
  - Low rate unit charge;
  - High rate unit charge

- Industrial Economy Tariff – High Voltage Supplies:
  - kW charge (April-October);
  - kW charge (November-March);
  - Low rate units; and
  - High rate units

- Industrial Economy Tariff – Low Voltage Supplies:
  - kW charge (April-October);
  - kW charge (November-March);
  - Low rate units; and
  - High rate units

[6] Proposals for the Price Regulation of Network and Retail Electricity Services – Consultation Paper

- Maximum Demand Tariff – High Voltage Supplies:
  - kW charge (April–October);
  - kW charge (November-March); and
  - All units

- Maximum Demand Tariff – Low Voltage Supplies:
  - kW charge (April-October);
  - kW charge (November-March); and
  - All units

- Heat Pump Tariff:
  - All units;

- Non-Peak Tariff:
  - Standing charge; and
  - All units;

- Superheat Tariff:
  - Standing charge; and
  - All units;

- Public lighting Tariff:
  - Standing charge; and
  - All units;

The DG intends to cover these services within the scope of the proposed price control.

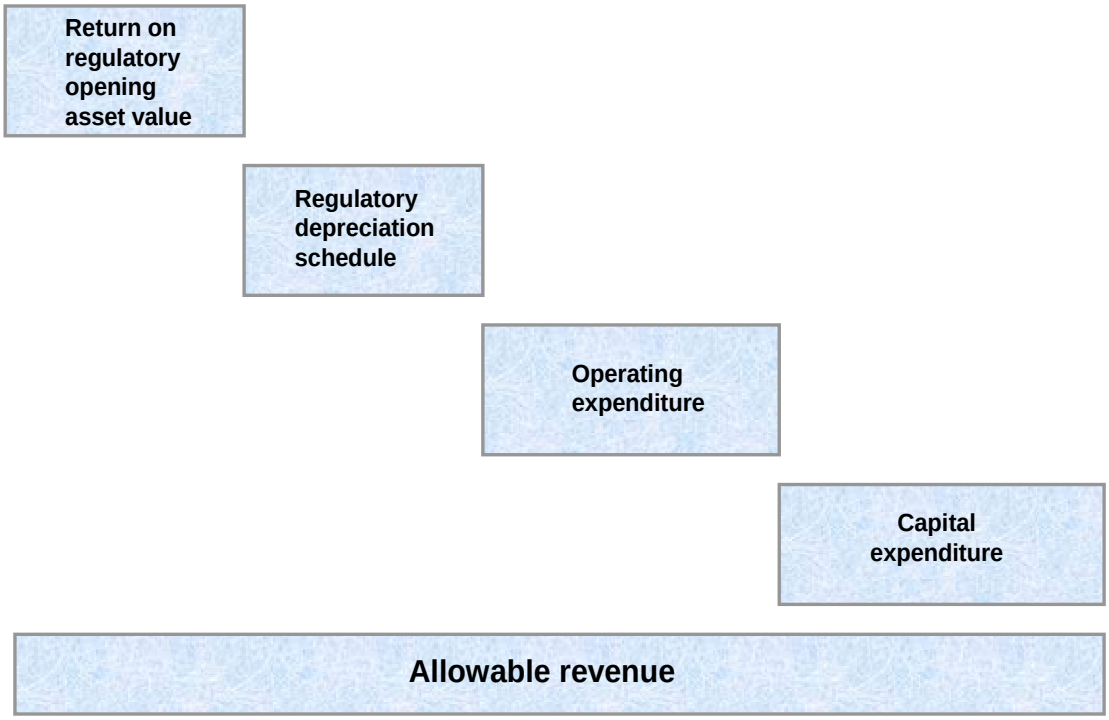
Proposed Decision

The DG proposes to apply the same percentage price changes to all services listed in section 6.2 of this paper within the scope of the price control that will be applied to Guernsey Electricity Limited.

6.3. General structure and process for price control

6.3.1. The structure of a price control

A price control takes the following general structure, where allowable revenue is the sum of the amounts under each of the categories below that GEL is permitted to recover from customers through their electricity bills:



6.4. Relevant price control period

The OUR's document 03/07 assessed the factors that inform an appropriate period of price control for GEL. There is no evidence to suggest to the DG that this assessment would lead to a materially different conclusion for the forthcoming price control period. The DG is therefore of the view that GEL's price control measures should be set for a period commencing 1 January 2006[7] and ending on 31 March 2009[8]. Where GEL experiences material changes to its future cost not taken into account within the price control it is free to approach the OUR to request that such issues be consider on their merits.

[7] As the States meeting to consider the policy being proposed by C&E will not take place until 30th November, a final determination on the price control will await that decision. It is therefore proposed that the initial tariff change take place on 1st January 2006.

[8] While the DG understands that the contract with EdF expires in November 2008, for the purposes of compliance and to minimise uncertainty in the price control process, he is proposing that the price control be linked to GEL's financial year end.

Proposed Decision

The DG proposes to set a price control for GEL Limited for the period 1st January 2006 through to 31st March 2009.

6.5. Monitoring and Compliance

The aim of the compliance procedures will be to ensure that GEL meets its obligations under the price control. This overall aim has the following objectives:

- to minimise the resources required for compliance and monitoring, both from GEL and the OUR; and
- to ensure maximum transparency and certainty for GEL to make its pricing decisions.

The DG intends to ensure that the requirements to demonstrate compliance with the price control will be as simple as possible and intends to publish guidelines to assist GEL in this regard. These guidelines will be available prior to the commencement of the price control period on 1st January 2006.

7. Allowable Revenue

In considering the appropriate level of tariffs for GEL, a key factor to be considered is the level of cash required by the company to meet its commitments over the period of the price control. This is termed its 'allowable revenue' and is determined based on the costs that an efficient operator would incur. The policy of "Save to Spend" has additional implications in that the allowable revenue over the price control must also take account of the need for investment necessary beyond the period of the price control.

Derivation of GEL's allowable revenue for the period of the price control, and therefore the extent of any price change, requires consideration of a number of factors, namely:

- Regulatory opening asset value;
- Regulatory depreciation schedule;
- Capital expenditure;
- Operating costs; and
- Cost of capital.

Each of these issues is discussed further in this section.

7.1. The Regulatory opening asset value

GEL's opening asset value will have a bearing on the level of prices since the return allowed on these assets will be recovered through electricity prices. This is a standard approach when assets have been financed through borrowing of some form since the company needs to earn a return to cover such costs.

However GEL has acquired its existing assets by paying for them from cash reserves rather than borrowing. These cash reserves were built up over time through the company's policy of 'Save to Spend', where contributions made by electricity customers through a premium paid in their electricity bills over previous years were set aside in the company's cash reserves with the State.

GEL's assets used to support licensed activity have therefore already been funded by customers through their electricity bills paid over previous years. Allowing GEL a return on assets already purchased through these reserves built up from the 'Save to Spend' policy would mean that customers would be effectively paying for the same assets twice.

In order to ensure that customers are not placed in such a position, the DG has concluded that no return on GEL's regulatory opening asset value should be included within its allowable revenue. This should not be interpreted in any way as an assessment of the value of GEL's assets, as this is a materially different appraisal process. The above analysis is only an assessment of whether electricity customers should be charged a return by GEL on assets for which they have already paid.

Proposed Decision

The DG proposes that no return on GEL's regulatory asset value should be included within its allowable revenue.

7.2. The Regulatory Depreciation Schedule

While GEL's approach to funding capital projects in the past is relevant to the OUR's view on the return from its regulatory asset value, the OUR's consideration of the regulatory depreciation schedule is informed by the continuation of the 'Save to Spend' policy by GEL over the period of the forthcoming price control.

Depreciation is part of a company's cost of doing business as there is a loss or decrease in value of assets as a result of usage, age or market conditions. Firms will generally include an allowance for depreciation as an expense in their financial statements to take account of this and firms can adopt a variety of conventions to calculate this cost.

The regulatory depreciation schedule is intended to allow for the fact that a business needs to put aside a sufficient amount of funds to maintain or replace the assets of the business in the future. Since this is a reasonable cost of running a business, allowable revenue of a price-controlled business will generally include an allowance to raise the revenue needed to meet this cost.

However, GEL's ongoing policy of 'Save to Spend' has already provided it with cash reserves of around £20m, while further contributions to these reserves will occur over the period of this price control. These reserves are intended to fund future replacement, improvement and acquisition of assets.

Therefore the DG concludes that a depreciation schedule is already provided for in GEL's 'Save to Spend' policy over the period of the forthcoming price control. It would therefore not be appropriate to allow GEL to include in its allowable revenue an additional regulatory depreciation schedule.

Proposed Decision

The DG proposes not to include an additional regulatory depreciation schedule in GEL's allowable revenue.

7.3. Capital expenditure

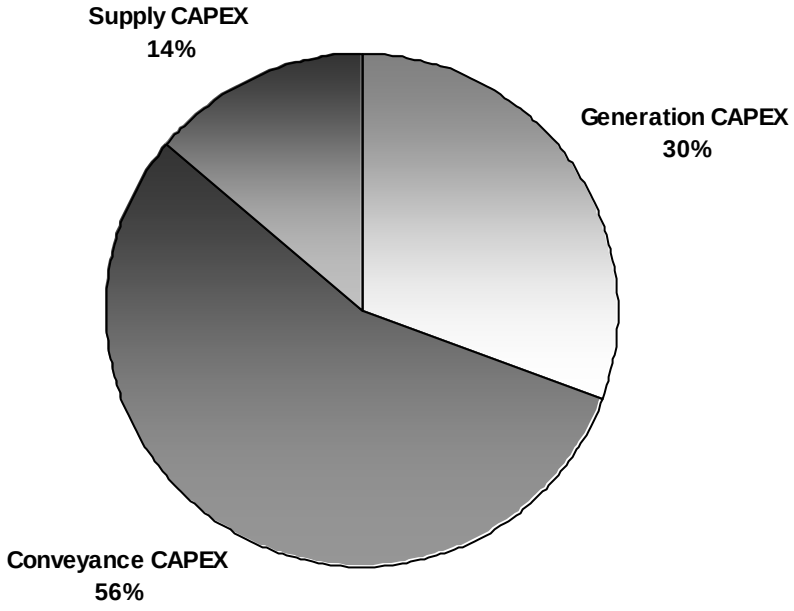
Market developments present significant challenges to a business such as GEL as technologies develop, customer demand increases and input costs change. In particular, the nature of electricity generation as well as conveyance of electricity from generation source to the customer require long term investment decisions involving substantial capital costs.

GEL must also reconcile a number of competing priorities in the area of States policy. The States require that a range of priorities are taken into account through licence conditions imposed on the generation, conveyance and supply activities of GEL on the island. For example, Licence condition 35.1 requires GEL to contract for electricity and ancillary services at the best effective price reasonably obtainable.

Licence condition 35.3 also requires GEL to have regard to any considerations liable to affect its ability to discharge its obligations under the licence in the future, including the future security, reliability and diversity of sources of electricity available for purchase.

GEL proposes to spend approximately £15.2m on capital expenditure over the period of this price control. Figure 1 below illustrates the proportion of expenditure in each of the three main categories of capital expenditure.

Figure 1: GEL Proposed CAPEX over the price control period



The OUR has considered these proposals to assess whether there is capital investment that should be excluded from GEL's allowable revenue on the basis that the benefit to customers are not adequately justified.

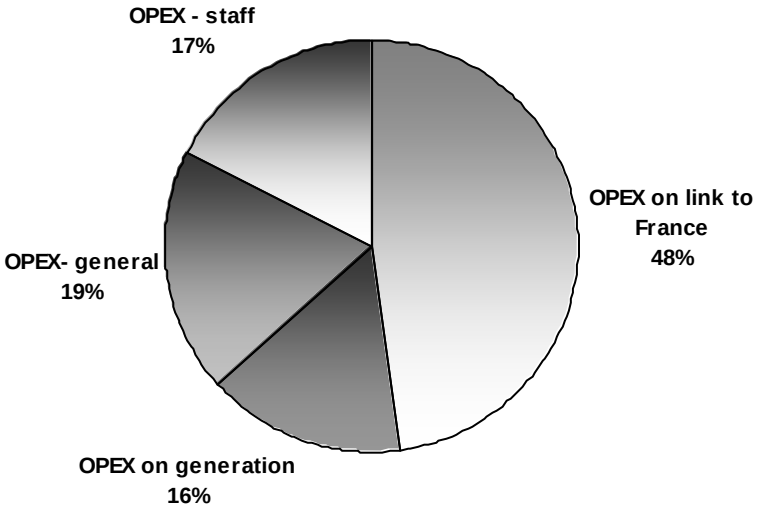
In undertaking this element of the price control, the OUR's position is one of assessing the benefits to the consumer of certain investments. The reasons for this are straightforward; without an assessment from the consumer's perspective, it is possible for a company to justify any investment. However, a particular investment may be made for reasons that are not directly related to the provision of electricity nor needed to support that core activity. This provides a fundamentally different level of review than that which the company or its Board may undertake.

The proposals by GEL for the period of the price control where the DG has concerns that the intended capital expenditure is not consistent with that of an efficient operator are discussed in further detail in Section 8. The areas that will be covered are: automated meter reading (AMR), future generation and investment in reducing greenhouse gases.

7.4. Operating costs

GEL proposes to spend approximately £91.9m on operating its business over the period of this price control. Figure 2 below illustrates the proportion of expenditure in each of the main categories of operating expenditure.

Figure 2: GEL Proposed OPEX over the price control period



The proposals by GEL for the period of the price control where the OUR has concerns that the proposed operating expenditure is not consistent with that of an efficient operator are discussed in further detail in Section 9. These cover the areas of: import costs, pensions, costs of generation and overhead costs.

7.5. Cost of capital

Capital is a resource companies must generally compete for either from shareholders (in the form of equity or retained profit) or other lenders (in the form of debt). For regulatory purposes, the cost of capital is in effect an "opportunity" cost in that it is the value that is foregone by the best alternative option for the provider of funds to the company. In practice, the best alternative option depends on the range of sources of capital from which a particular firm opts to choose.

If a business consciously restricts its choice set for various reasons then the opportunity cost can be interpreted as relating to this narrower set of alternatives. Companies may, for example, choose to restrict their choice set for particular company specific reasons. For instance, rather than become involved in complex forms of financing, a company can place their retained profits in deposit accounts or provide them as loans rather than investing them in the business. In these circumstances the decision choice for that company has been deliberately simplified, with the cost of capital effectively being the interest received on a deposit or that received on the loan provided.

Given that companies undertake a range of capital projects with different levels of risk and borrowing, and that projects can vary in terms of levels of funding required, a means of arriving at a single cost of capital for a company is needed. This is done by taking a weighted average of the cost of capital ("WACC") from each of these projects to produce a single cost of capital. To arrive at a WACC for GEL requires a number of issues to be considered in detail.

GEL has been asked to submit details of its proposed WACC and its justification for that rate. GEL has submitted as its preferred WACC for this price control a return on capital of 1%.

While the DG has noted this proposal, he is concerned that insufficient consideration may have been given to the assessment of this figure and the purpose to which the WACC is used for regulatory purposes. The DG, notwithstanding GEL's proposal, has a duty under the law to ensure that GEL is sustainable and that as part of his assessment he is minded to form an alternative view on GEL's WACC.

One manner open to the DG is to consider the return GEL receives on the balance of the cash reserves it keeps with States Treasury. The DG understands that GEL receives 4.8% on its cash reserves. The DG believes, coupled with information available from other energy regulators, that this figure represents a more appropriate rate of return than that which GEL has proposed and DG proposes to allow this cost of capital in deriving the firm's price control.

Proposed Decision

The DG proposes a cost of capital for GEL of 4.8%

8. Capital expenditure over the price control period

Electricity generation and the related activities is a capital intensive business. Ensuring that such costs are tightly controlled is important in determining the impact upon electricity customers, where such costs are to be recovered through electricity charges. GEL has outlined a number of capital projects that it intends to undertake during the course of the price control period. Certain of these relate to the on-going maintenance of the generation, conveyance and supply chain while others relate to ancillary activities or new projects.

The OUR's role, as mentioned earlier, is not to judge the merits of any particular project or investment. Its role is to assess, from the consumer's perspective, whether a proposed investment is likely to result in benefits to the consumer as a result of a particular investment. It is recognised that regulated companies make investments for various reasons. However the regulator's role is to ensure that such investments are those that an efficient operator would make and that they deliver value to the consumer. The DG has reviewed GEL's proposed plans and has set out below his observations on certain areas of capital expenditure proposed by GEL.

8.1. Cash Reserves

The cash reserves held by GEL amounted to £18.062m as at 31 March 2005. This reserve will have been reduced by the amount spent on non-core activity and other capital projects that are the subject of this draft price control decision. Where the OUR considers that an investment is non-core or there is insufficient justification in terms of benefit to electricity customers of such investments the cost of these investments are added back to cash reserves and the price control is set with reference to this revised level of cash reserves.

This is not to say that the investments are not allowed, but that such investments should not be funded by way of recovery of the costs from electricity customers. The implication of this approach is that GEL management and its shareholder will bear the risks of such investments rather than the electricity customer. Where such investments do yield benefits that exceed their costs then GEL will earn a higher return than provided for under the price control. The converse is also true.

8.2. Automated Meter Reading (AMR)

The established metering technology used on the Island is located at the customer's premises. In order to measure consumption between periods of time a meter reader will generally need to visit the premises of the customer to record the change in consumption since the last reading. Currently, GEL's quality of service targets require it to obtain an actual meter reading once a year for 99.5% of customers. The internet or post provides an alternative means for customers to supply their own meter readings to GEL.

GEL has announced that it intends to install an automated meter reading (AMR) system throughout its customer base and submitted a business case to its Board in July 2003 proposing the future installation of an AMR system to replace the established metering technology. This investment involves the installation of these new meters

together with the supporting systems. The rationale for the AMR project as stated by GEL in its business plan is to reduce meter reading costs and provide two-way communications to a customer's meter in a secure manner, allowing GEL to build up accurate load profiling information for its customers through the accurate daily read of energy meters.

For the purposes of this price control GEL has indicated it is seeking an amount of approximately £0.892m over the price control period as part of the allowable revenue recoverable from electricity customers. During the period prior to the price control GEL has effectively drawn approximately £1.2m from its cash reserves to fund investment in this technology. In support of its case for this investment GEL has submitted to the OUR the Board business case of July 2003 as well as its post-implementation review document of January 2005, in which a cost/benefit assessment is made for the project.

The basis for a Board decision is often very different to that required to support an argument that the costs of an investment should be met by the electricity customer for purposes of a price control. The OUR has concerns about the adequacy of the cost/benefit assessment for price control purposes given the lack of evidence on the extent of cost savings that would benefit the electricity customer. A robust cost benefit analysis would be expected to compare the cost of installing the new meters with the cost savings of doing so. While the OUR's efficiency review suggests the standard of GEL's engineering expertise is high the evidence seen by the OUR to date does not translate the technical merits of the technology into identifiable savings in operating costs nor does it quantify the benefits to customers. These are essential features of such an investment programme for purposes of an assessment for price control purposes.

The DG is also concerned about the degree to which any cost savings identified by GEL could be realised The high fixed costs of the technology suggest electricity providers with larger customer bases should find this technology more economical to implement than GEL. However the uptake of AMR technology by larger commercialised electricity providers is low, which is at odds with the full adoption of the technology by a provider operating at the scale of GEL.

It is the DG's view, based on an assessment of the justification provided by GEL, that the decision by GEL to invest in AMR does not offer sufficient benefit to customers to merit the adoption of this proposed investment and the costs placed on electricity customers proposed are not those that an efficient operator would incur.

As noted already, to date the OUR estimates that GEL has spent around £1.2m on AMR. Given this, as discussed above, an adjustment is made to GEL's cash reserves to reflect the fact that electricity customer prices will not be used to fund this investment. However, since GEL would have needed to incur some level of cost to replace and maintain the existing meter stock there is an argument that some allowance should be made for this, both for historic investment in metering as well as for future investment.

For this reason the OUR is allowing GEL to recover 50% of historic and future investment in AMR in recognition that a level of investment is required in metering.

This should not be interpreted as approval of AMR but in the absence of evidence on the level of spending GEL would have incurred on metering if it had not invested in AMR or a sufficiently robust argument on the benefit of AMR technology to electricity customers this approach provides some recognition of the need for some form of investment in metering.

Proposed Decision

The DG therefore proposes to exclude 50% of the proposed £0.892 investment in AMR over the period of the price control.

8.3. Future Generation

While a number of elements contribute to the price of customer's electricity, generation costs account for a significant proportion (70%) of the final price. The future generation options chosen by GEL will therefore have a direct bearing on future electricity prices. The economics of investment in this area is therefore a critical part of the long term planning for electricity provision for the Island. There is also a need to consider pricing issues within the general policy direction for electricity generation, in particular the context of overarching economic, social and environmental aims of Guernsey. The assessment of this element of GEL's proposed costs will have a large bearing on any future tariffs consumers are asked to bear.

As mentioned earlier in this report, during 2003 and 2004, the Department of Commerce & Employment conducted a review of strategic options for Guernsey's electricity sector. As a key input to this review of strategic options the Department of Commerce & Employment contracted with consultants, Mott McDonald, who delivered a final report in December 2004. This report identified the trade-offs between certain policies and provided a broad indication of the likely cost differences between the alternatives over a reasonable time period.

Following this and further work by the Department of Commerce & Employment, the DG understands that the States will shortly be asked to consider certain policy decisions. The OUR, following discussions with the Department of Commerce & Employment, has reflected its understanding of the proposed policy in framing this price control. In the event that the policy ultimately determined by the States varies from this current understanding the DG will consider whether any amendments are required to the price control. Based on the DG's current understanding of the proposed approach, the OUR has included this as a key reference for OUR's assessment of GEL's preference out of the generation alternatives identified.

As mentioned at section 5.1 of this report, the DG understands that the States will consider adopting a policy which proposes:

- for the period of this price control allow GEL to build sufficient reserves to fund such capital expenditure as the States may determine at a future date best meets Guernsey's needs
- that these reserves should be sufficient to fund capital expenditure in:
    - generation on the Island that satisfies the n-2 security of supply policy
    - maintenance, improvement and extension of the existing link

- that the price control decision encourages measures aimed at improving the environment in Guernsey in an efficient, sustainable and cost efficient manner.

Currently, Guernsey has sufficient capacity to meet a maximum demand of 174MW when it has access to the full 60MW available through the Jersey/France interconnector. As it is only contractually entitled to 16MW (increasing to 17MW) of capacity through the interconnector, 130MW is taken as the guaranteed capacity available to the Island. However, projections of the Island's demand for electricity suggest future investment is needed to increase the capacity available to the Island.

A number of alternatives are available to GEL to meet these future requirements. GEL's preference is for an additional guaranteed capacity of 20MW to be made available to Guernsey through the construction of a third 85MW cable connection between Jersey and France. The total capital investment required for this proposed project is estimated at £59.9m at 2005 prices and it is expected that this capacity would be available in 2012/13. GEL's licence requires it to contract for electricity and ancillary services at the best effective price reasonably obtainable (Licence Condition 35.1) while also taking into account States policy.

In order to comply with the proposed States policy, which requires cash reserves to be accumulated to fund future generation (the exact form of which will not be determined for some time) in undertaking this price control review, the DG is mindful that in order to meet this requirement an approach which provides for the likely more expensive option must be adopted. Therefore in calculating the level of cash reserves required by GEL, he has adopted GEL's preferred option (i.e additional link between Jersey and France) as the basis upon which to plan for the cash reserves required to meet any future requirements. It should be noted though that, pending a more detailed examination by the States of the exact generation option it prefers in the longer term, GEL's preferred option may not in fact be the means by which Guernsey's electricity needs are met in future.

Should one of the cheaper options identified in the Mott McDonald report be preferred then the level of cash required will be lower than that being allowed by the DG at this time.

Proposed Decision

The DG proposes to allow a level of "Save to Spend" contribution to fund £59.9m of investment in future generation capacity over the period of the price control.

8.4. Reducing greenhouse gas emissions

Guernsey has ratified the Kyoto Protocol at the request of the Lord Chancellor. The Island is however not separately measured or identified in the Kyoto agreement as its emissions form part of those of the UK. The basic commitment of the Kyoto Protocol is to reduce emissions of a basket of six greenhouse gases[9] to below 1990 levels between 2008 and 2012. The UK has of its own volition, targeted a reduction of 20%

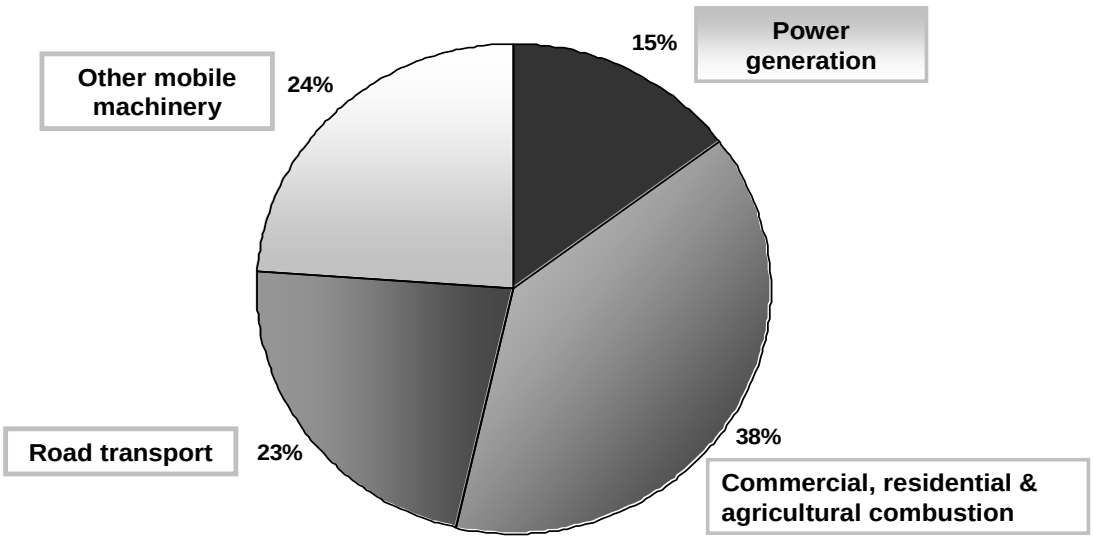
[9] Carbon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride.

in carbon emission by 2010/2015 and has set a target that 10% of the electricity generated in the UK will be from renewable generation by 2010.

Guernsey's contribution to UK's greenhouse gas emissions is low. The Environment Department estimates the maximum average carbon dioxide and sulphur dioxide emissions of the Island are between 0.04% - 0.05% of the UK's 2000 level while NOx emissions average 0.3% of the UK's 2000 level. A reduction in Guernsey's emissions is therefore unlikely to have any substantial impact in relation to the objectives of EU and UK environmental legislation or the Kyoto agreement.

In terms of emissions associated with power generation on the Island, as illustrated in Figure 3 below, this accounted for only 14.5% of 85,032 tonnes of carbon emissions in 2002 with the balance accounted for by commercial, residential and agricultural combustion (38.9%), road transport (22.6%) and other mobile machinery (23.8%).

Figure 3: Guernsey Greenhouse gas emission estimates (2002)



Source: National Environmental Technology Centre-AEA Technology

In terms of the Bailiwick's N_2O emission, power generation accounts for only 0.3% of emissions and does not contribute to any of the other four greenhouse gases within the Bailiwick. While more recent figures are unavailable, the current level of emission due to electricity generation on the Island are likely to be even less than that in 2002 when these figures were compiled given that On-Island generation has fallen by 80% over the period 2000 to 2004.

It is however acknowledged that since GEL does to some extent burn fossil fuels to provide electricity to the Island, the electricity provider could contribute to a reduction in greenhouse gas emissions. In the context of the wider States policy, consideration is given in this price control as to how this can best be achieved to ensure customers

benefit and what level of customer costs are proportionate to meet these objectives. The OUR therefore intends to make an amount available within GEL's capital expenditure allowance to fund investment to reduce greenhouse gas emissions.

The range of alternatives to achieve reduction in emissions is wide. The DG is required to assess whether the approach taken to-date by GEL is likely to provide an efficient means to support the environmental agenda. The associated costs, the likelihood of success and length of time before the Island is likely to realise the benefits of such investment are important considerations that inform such an assessment.

At one end of the spectrum of measures available to reduce the Island's emissions from generation, is investment in 'energy efficiency'. Electricity is often wasted because, for example, lighting is poorly controlled or buildings are poorly insulated. Products are also less energy efficient than they could be - for example, the average upright freezer on the market today uses almost three times as much energy as the most efficient freezers. Energy saving light bulbs use less than a quarter of the energy of ordinary light bulbs, and also last ten times longer.

Businesses and householders may not know how to cut energy use, which is just one of many demands on their time and capital. Investment in 'energy efficiency' can therefore take many forms including consumer education or subsidisation of energy saving measures (for example, supplying energy saving light bulbs to help offset tariff changes). Such measures can provide a low risk investment with benefits realised in a relatively short time period. The value of drawing on energy efficiency initiatives to achieve reductions in emissions was recognised in the UK's Energy White Paper, which stated that, "*The cheapest, cleanest and safest way of addressing our energy policy objectives is to use less energy"* [10,11]. Ofgem, the UK gas and electricity regulator, estimates that even at relatively low levels of support, energy efficiency has achieved savings of about £35 per household per annum and 0.6Million tonnes of carbon per household over the lifetime of the energy efficiency measures.

At the other end of the spectrum of measures to address greenhouse gas emissions is investment in renewable generation technology. GEL's proposed approach to reduce greenhouse gas emissions on the Island is to invest in marine current renewable generation. It has already invested £250,000 for an equity stake in Marine Current Turbines, a UK-based industrial consortium behind research into new current technology. There is also the likelihood that further funding will be sought as this venture progresses as it is capital intensive. Further the OUR understands that GEL's preferred means of financing such future investment is through a levy on its customers and that the company is considering a further investment of £800,000 in this technology. Additional investment of this scale would increase the current cost of the investment to the average customer from almost £9 to over £37.

[10] UK White Paper – "*Our energy future – creating a low carbon economy*"

[11] The level of investment by the UK in the 'Energy Efficiency Commitment' programme is approximately £3.60 per domestic household per annum and a reduction in consumption of approximately [10%] per annum is targeted.

According to recent reports[12] prepared for the UK's Department of Industry which assessed a range of renewable technologies, these technologies are likely to have a role in achieving long-term energy policy objectives. However a key conclusion of these assessments is that, *"…there appears to be limited potential for any renewable technologies to reach commercial viability within the next decade"*[8].

With regards to technologies utilising sea currents and tides, these reports conclude that tidal generation has even longer term prospects than most of the alternative renewable technologies. This is possibly due to the obvious risk of failure given the hostile environment of the ocean and that competing, less location dependent technologies, may attract more capital investment due to their portability. These reports also indicate that even if renewable technologies such as tidal generation ultimately prove successful there are constraints on the rate at which their capacity can be expanded to meet more than a fraction of demand over the foreseeable future. In terms of unit costs, tidal technology is in a class of renewable technology with one of the highest risks and the greatest cost. Estimates indicate that even by the year 2016/2017, should the technology be sufficiently developed, tidal generation will be more than 150% more expensive than the current price of electricity paid to supply the Guernsey customer[13].

GEL is an electricity provider with a customer base that is a fraction of a percentage of the customer base of the larger European providers. It therefore has substantially fewer customers over which it can spread the fixed costs of investment in renewable generation technology and particularly one as high risk as marine current generation technology. In the DG's view there are reservations about GEL's proposed approach to reduce greenhouse gas emissions given the uncertainty, high cost and significant amount of time before investment in tidal renewable technology may deliver any benefit for its customers, in particular when compared to investment in 'energy efficiency' initiatives, for example.

It is the DG's view that an efficient electricity provider the size of GEL would not usually be associated with investment in a renewable technology such as tidal generation, even allowing for the fact that it does have access to a tidal resource such as that found in the waters around Guernsey. It is also apparent that the company in which GEL has invested (Marine Current Turbines Limited) has chosen to develop and trial the technology next to the UK market to exploit tides in that region, rather than around Guernsey. This suggests Guernsey customers are unlikely to be early recipients of renewable electricity from this source even if this particular venture is successful. However, even if such trials were carried out locally, it is unclear what additional benefits might be gained from this investment that might not otherwise be gained from a 'wait and see' approach.

In the DG's view it would seem more efficient for an electricity provider such as GEL to initially invest in reducing greenhouse gas emissions through one of the least costly alternatives and which offers a more immediate prospect of having a positive impact on that goal and for its customers. The DG does not therefore intend to allow GEL to

[12] '**What is the potential for commercially viable renewable generation technologies**', *Interim report prepared for the Department of Trade and Industry*, January 2005 (paragraph 6.2).
[13] To the limited extent to which electricity generated by tidal technology is available it costs more than 300% the current price paid to supply Guernsey's customers.

recoup from customers the equity investment in Marine Current Turbines. However the DG does believe it appropriate that the company be allowed seek a contribution to its capital expenditure on emissions reduction to an amount that an efficient operator might incur and that is proportionate to the scale of the Island's population.

The UK's Energy Efficiency Commitment scheme has over the past two years aimed at supporting the UK's Climate Change Programme of cutting greenhouse gas emissions and also providing particular help to low-income customers. In the context of this policy, an amount of £3.60 per domestic customer is the estimated expenditure of UK suppliers to meet their obligation under this scheme. The results of this initiative lend support to the view that energy efficiency measures are likely to be a more immediate and cost-effective way for GEL customers to contribute to reductions in greenhouse gas emissions on the Island than the approach taken by GEL.

The OUR therefore proposes to allow for an amount of £3.60 per customer on standard tariff or economy 12 tariff to be included within GEL's allowable revenue for purposes of supporting the Climate Change agenda. This amounts to a total of approximately £101,000 per annum. The requirement to demonstrate the use to which these funds are put are discussed later in this document.

Proposed Decision

The DG proposes to allow for an amount of £3.60 per customer on standard tariff or economy 12 tariff to be included within GEL's allowable revenue to allow for investment to reduce greenhouse gas emissions.

9. Operating expenditure over the price control period

9.1. Imported electricity

This section of the report contains commercially sensitive information and is not publicly available. It addresses the import of electricity from France through the CIEG cable. GEL is facing increased import costs from December 2005 and an allowance is being made in the price control to reflect this.

9.2. Pensions

The employees of GEL are members of the States of Guernsey Public Servants Pension Scheme (PSPS). This is a defined benefits pension scheme funded by contributions from both employer and employees to the pension scheme at rates. These rates are determined on the basis of independent actuarial advice, which are calculated to spread the expected cost of benefits payable to employees over the period of those employees' expected service lives. The most recent valuation of the GEL pension fund has now identified a deficit at the end of the March 2005 of £4,940,000.

Many organizations in Guernsey and other countries are facing challenges to address shortfalls in their pension funds, much of this driven by increased life expectancy and falls in equity markets over recent years. The approach proposed by GEL to ensure this deficit does not grow further is to increase the level of its contributions from the current level of 8.35% to 16%. Also, in order to address the existing shortfall the payment of lump sums by the company into the credit of GEL's account in the pension fund is proposed by GEL. The Board of GEL has already approved a sum not exceeding £500,000 to be paid into this fund for the year ended 31 March 2005. It is further proposed that the same amount is paid into the fund for the next nine years.

The need to address the shortfall and prevent it from growing is an accepted cost for which allowance must be made in GEL's allowable revenue. The proposal by GEL to increase the current level of employee contributions to 16% is accepted by the OUR.

In terms of the proposal to address the shortfall over a period of nine years, there is a need to consider whether alternatives are available to GEL that have less impact on customers. In line with the approach in other jurisdiction, a more proportionate response would appear to be one where recovery of the pension deficit is phased over a period comparable to the average remaining service period of its employees. Periods of between 15 to 20 years are more typical in price control decisions of which the OUR is aware than a recovery period of 9 years. Given this, the OUR proposes that the costs of addressing the current pension deficit should be recovered over a 15 year period rather than the proposed 9 years. The effect of this would be to allow GEL only £330,000 per annum rather than the £500,000 proposed to address the current shortfall.

9.3. Generation

This section of the report contains commercially sensitive information and is not publicly available. It addresses the operating costs GEL face in generating electricity . The OUR has taken a view on what it believes is an efficient level of costs for GEL for this part of its business and has reflected this in revenue GEL is allowed recoup from its customers.

9.4. Overheads

This section of the report contains commercially sensitive information and is not publicly available. It addresses the level of GEL's overhead costs associated with running its business. The OUR has taken a view on what it believes is an efficient level of costs for GEL for this cost category, particularly given the change over the past number of years in GEL's business (the move from on-island generation to importation). The OUR has proposed certain adjustments to the costs sought by GEL and this is reflected in the revenue GEL is allowed recoup from its customers.

10. Cash reserves for capital expenditure from 2009/10 to 2016/17

An assessment is made in this section of some of the proposals where OUR takes a different view to GEL on levels of capital expenditure required beyond the forthcoming price control. Proposals are then made on the appropriate level of reserves allowed to GEL over the price control period and in the period 2009/10 to 2016/17.

10.1. Save to Spend allowance

The OUR notes that GEL operates a policy of building up cash reserves through a premium on electricity prices in order to fund future capital projects. This policy, referred to as 'Save to Spend' contrasts with the manner in which companies engaged in equivalent commercial activity are funded. There are a number of advantages of operating on the basis of a level of debt, including greater flexibility of investment planning.

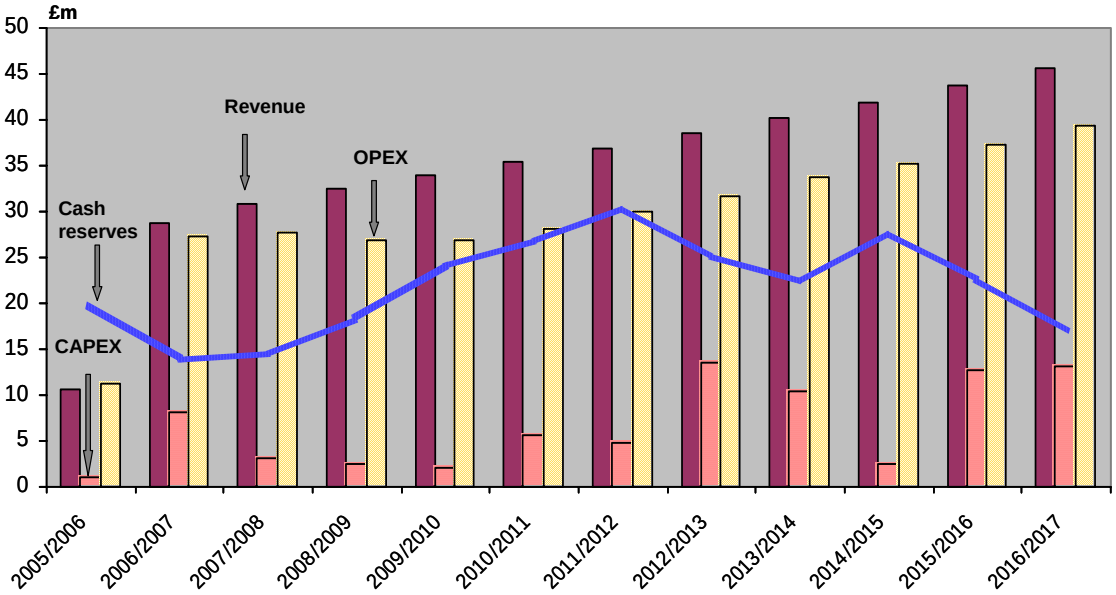
From a regulatory perspective, further advantages are found in the discipline placed on a company that does not have the buffer of significant cash reserves effectively borrowed from customers over long periods of time. For example, in the case of GEL interest on these cash reserves contributed the majority of the company's profit in 2004/05. These reserves were also drawn upon to fund non-core activity that offered no benefit to electricity customers.

As noted in both the Mott MacDonald report and in the OUR's own efficiency review, there are benefits to a utility such as Guernsey Electricity carrying a certain level of debt. The DG notes that the 'Save to Spend' approach insulates GEL to some degree from the disciplines of commercialisation, reduces the benefits of commercialisation to electricity customers and impacts upon the cost of regulation. However in setting this price control the DG has based this draft decision on the basis that 'Save to Spend' is the preferred financing approach. The assessment below considers the need for capital investment by GEL for the future.

Price controls for industries such as the electricity sector in Guernsey need to consider projections several years into the future given the timeframe required for planning such investment. The characteristics of large peaks and troughs in capital expenditure patterns and GEL's 'Save to Spend' policy require an assessment of investment plans for a further time horizon than is typical.

As already discussed, GEL operates a policy of 'Save to Spend' where cash reserves are built up by collecting additional revenue from customers to finance future capital expenditure. The amount needed to ensure cash reserves are at a level adequate for future investment is therefore needed to assess GEL's best estimates of expenditure at this time.

Figure 4: Income, Expenditure and cash reserve forecasts



As illustrated in Figure 4 above, a period of major investment programmes is planned by GEL which should be completed by the end of 2016/17. The DG intends to base his proposal for the level of cash reserves necessary for GEL to fund future capital expenditure by assessing the levels of contribution required to fund future capital expenditure up to the end of 2016/17.

A further relevant factor on which the OUR must take a view is the appropriate level of cash reserves available to GEL at the end of the period 2016/17. This is necessary to ensure customers are not faced with potentially large increases driven by a new cycle of capital investment that will commence at the end of 2016/17. The total capital expenditure identified by GEL to cover projections from 2009/10 to 2016/17 is estimated at £65.2m. It is estimated that at the end of the forthcoming price control period (i.e. March 2009) GEL will have cash reserves with States Treasury of £18.4m. Given the information available to the OUR from GEL, and taking account of the recommendations from C&E with regarding to future generation options, the level which the OUR considers adequate is for a remaining balance of around £10m in real terms to be available from GEL's balances at the end of the financial year 2016/17.

As at March 2005 GEL's balances with States Treasury was approximately £18.1m. However, funds spent on AMR prior to the price control period have been added back to cash reserves given this expenditure has not been approved under the price control. Investment in Marine Current Turbines have also been added back to cash reserves on the same basis. The assumed cash reserve is therefore taken as £21.2m given these adjustments.

This proposal is based on the DG's current understanding of the means by which future capex investments will be funded. In the event that a different means of funding such projects is determined – such as a mixture of debt and cash reserves – then the DG's position on this issue may be reviewed at that time.

11. Conclusion

The conclusions of the OUR's assessment in this draft decision paper are set out below.

11.1. Capex

Capex is an important input into the calculation of GEL's allowable revenue under the price control and has been assessed by the DG. The net effect of the adjustments to GEL's capex is to reduce the total amount forecast to be spent between 1 January 2006 and 31 March 2009 by £0.45m to £14.8m.

Proposed Decision

The DG proposes to reduce GEL's capex proposals by £0.45m over the period of the price control and intends to use these revised capex forecasts for determining allowable revenue.

11.2. Opex

The DG's decision on the appropriate opex to be included with GEL's allowable revenue has been based on a detailed review of the company's business plan and forecasts. This has included a detailed assessment of both the potential for future efficiency gains by GEL and an assessment of its demand forecast.

As a result of all the detailed analysis and review of GEL's forecast opex costs, (Annex A of the confidential version of this document sets out the details of the draft price control decision), the DG is minded to adjust the allowable opex costs proposed by GEL by £1.34m over the price control period to £93.2m.

Proposed Decision

The DG proposes to adjust GEL's proposals for opex upwards by £1.34m and intends to use these revised opex forecasts for determining allowable revenue.

11.3. Cost of Capital

The DG understands that GEL receives 4.8% on its cash reserves. The DG believes, coupled with information available from other energy regulators, that this figure represents a more appropriate rate of return than that which GEL has requested and the DG proposes to allow this cost of capital in deriving the firm's price control.

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Proposed Decision

The DG proposes to use as the cost of capital in setting a price control for GEL Guernsey Limited a pre tax nominal WACC of 4.8% in the OUR economic model for the price control.

11.4. Level of Price Control

11.4.1. Level of X Factor

The final level of the control has been set so that if GEL operates in an efficient manner, will be able to recover its costs associated with the price controlled business from the revenue attributable to that business. The DG, in setting the maximum that GEL may increase tariffs by over the period of the price control, has had regard to the long term requirements of the company as well as the immediate changes that the company will face in its operating cost base as a result of the revised import contract with EdF.

The DG therefore proposes to set the price control at a level of RPI-0.9%.

Proposed Decision

The DG proposes to set a price control for GEL over the period of the price control as follows such that it may increase its tariffs for each of its services by a maximum of RPI - 0.9% during the following periods:

1st January 2006 – 31st March 2006:	RPI – 0.9%
1st April 2006 – 31st March 2007:	RPI – 0.9%
1st April 2007 – 31st March 2008:	RPI – 0.9%
1st April 2008 – 31st March 2009:	RPI – 0.9%

12. Price Control Compliance and Next Steps

GEL will be required to comply with the final price control decision once it is formally adopted later this year. It will then be important that consumers and the regulator have confidence that the requirements under the price control are being met.

Demonstrating compliance to the OUR for GEL should be relatively straight forward given the manner in which its prices are being controlled. However because of the nature of its 'Save to Spend' policy it is important that customers have confidence in the manner in which its cash is being treated. As customers are paying a premium for their electricity to fund future investments by GEL, it is important that it be demonstrated that this cash is being used for the purpose for which it is being collected. Ideally the cash should be ring-fenced for future investment with very clear criteria laid down to establish how and when cash can be called upon. However the DG notes that this is a matter for the Board and the Shareholder and does not propose to comment further on this issue.

However, demonstrating compliance to the OUR and customers is a matter which does concern the DG. With this in mind the DG proposes to require that GEL provides its customers with an annual statement setting out the state of the 'Save to Spend' fund. This should set out the total value of the fund, any expenditure from the fund during that year and the purpose to which it was put. It is intended that this may simply be an insert with customer's bills at the end of each financial year setting out the state of the fund at a particular point. However, before making any final determination on how this might best be achieve, GEL is invited to submit any proposals that it may have on this issue.

For the formal compliance report to the DG during the price control period, the DG will discuss with GEL how best this might be undertaken so as to minimise the reporting requirement on the company whilst ensuring that the DG has sufficient robust information upon which to verify compliance. The DG will address this issue directly with GEL prior to the publication of the formal price control decision.

The DG will, following this consultation, and the consideration by the States of the policy letter being brought to it by C&E in November 2005, look to publish the formal price control decision as early as possible in December 2005 to allow for GEL to introduce tariff changes from 1st January 2006.

Ends/