RESPONSE TO THE
OFFICE OF UTILITY REGULATION'S
REVIEW OF
GUERNSEY ELECTRICITY LIMITED'S
PRICE CONTROL
Consultation Paper
(Document No: OUR 06/17[A] – September 2006)

CONTENTS **PAGE**

EXECUTIVE SUMMARY

GEL has detailed its Response to the OUR's Consultation along the following lines:

- The OUR's Independent Expert Panel (IEP) has made Recommendations which represent progress on the price control and there are very significant areas of these Recommendations that we would support;
- The OUR has set out in this Consultation some subsequent implementation assumptions in the areas covered by the IEP which would adversely affect GEL's finances, profitability and ability to provide dividends to the States as shareholder - if these assumptions were to be implemented under any price control;
- The IEP made Recommendations regarding cash reserves and dividends which place such matters within the locus of decision making by the Treasury & Resources Department rather than with the OUR. These matters should be dealt with transparently and consistently by the OUR;
- The IEP's terms of reference did not cover all of the unresolved areas under the interim price control and so further issues remain to be resolved;
- The IEP's work risks introducing additional complexities to the regulation of electricity on Guernsey and we hope that the OUR will maintain the objective to reduce regulation wherever possible;
- The PPA report on generation efficiency has not been amended significantly to take account of GEL's previous comments on the draft report;
- GEL therefore believes that the OUR should not assume that the suggestions made by PPA on cost savings are achievable or appropriate for price control purposes;
- Any overall efficiency targets for GEL need to be appropriate to Guernsey circumstances from 2007 onwards, and should not be taken from UK circumstances in other sectors during the 1980s and 1990s for very much larger organisations;
- The OUR's work plan is not set out in detail but GEL believes that delay is likely due to further inputs from the OUR and the Treasury & Resources Department being required before GEL can suggest tariff levels and also due to the subsequent consultation phase required by the OUR;
- Based on the OUR's suggested interpretation of the IEP and PPA reports as they are currently presented in this Consultation, it is quite feasible for the new price control to be even harsher in effect than, the current interim price control;
- GEL therefore hopes that the OUR will give serious consideration to modifying its proposals before issuing a Consultation on the interim price determination; and
- GEL notes that several areas of the proposed price control will result in more onerous reporting and compliance requirements than have been the case to date. GEL therefore hopes that the OUR will reconsider these so as to implement the price control in a way which reduces regulatory compliance requirements. This would be consistent with resolutions passed by the States of Deliberation in May 2006 and the intention that regulation should be proportionate to Guernsey circumstances.

1. INTRODUCTION

GEL recognises that the OUR has made progress on a number of price control issues since December 2005 when the Interim Price Control was announced. Most significantly, the OUR's Independent Expert Panel (IEP) has suggested a number of approaches to be used in the regulatory price control going forward, which represent a firm foundation upon which to revisit the Interim Price Control approach.

A number of significant issues remain to be resolved and the Consultation by the OUR of September 2006 addresses some of these and therefore provides a basis to take matters forward. This Response to the Consultation by GEL is designed to give succinct feedback to the OUR for consideration in the next stages of its process. GEL has also given feedback to the OUR at an earlier stage on many of the issues through meetings during October.

GEL agrees with the OUR that *"a strong, sustainable electricity provider"* is required and that *"there is a need to provide GEL with certainty about the nature and form of regulation it will face over the price control period".* At the same time, the States Guidance under which the Treasury & Resources Department (TRD) acts on behalf of the States of Deliberation as GEL's shareholder, means that GEL is sympathetic to the OUR's requirement to set prices *"whilst also taking account of consumers' needs for affordable tariffs".*

We note the OUR's recognition that *"Given the number of material issues that need to be finalised it is not practical at this point for GEL to make an application for the tariffs it wishes to apply"*. We therefore hope that progress can be made swiftly so that both GEL and the OUR can agree a set of assumptions upon which tariffs can be set. For this to take place, serious consideration will need to be given to the views expressed by GEL in this Consultation Response. We agree with the OUR that cooperation between GEL, the OUR and the relevant States Departments has been evident to date and we hope that this will continue in order to deal effectively for all concerned with the important issues that remain to be agreed.

It will be vitally important that any price control is simple to implement and to comply with, so that more onerous on-going regulatory requirements than are the case under the Interim Price control are not subsequently required once the New Price Control is agreed.

2. STRUCTURE OF THE PAPER

2.1 Structure

The structure of the documentation proposed by the OUR is clear and helpful. GEL's Response is therefore structured identically and thereby implicitly addresses all of the specific questions raised by the OUR at the end of each section.

GEL's Response to Section 7.2 and Section 7.3 and of the Consultation – which cover Overhead costs and Generation Costs (and the report by the OUR's consultants, PPA Ltd) – are considered to be confidential. Those Response Sections are therefore submitted solely to the OUR and in the form of two Confidential Annexes to the main Response.

2.2 Comments

This Consultation Response is to be placed in the public domain by the OUR so that all interested parties can take an informed view on the key issues involved. Where confidential information needs to be referred to, the OUR has indicated this accordingly in its own public document and GEL has responded similarly, by sending two Annexes (which cover the confidential material) solely to the OUR.

GEL supports the OUR in its objective of announcing a final decision in January 2007. GEL's comments in Section 10 "Next Steps" identify where there are risks that this will not be achieved due to the intermediate steps proposed by the OUR in its document. GEL hopes to assist in overcoming these risks wherever possible.

3. DEVELOPMENTS SINCE LAST PRICE CONTROL

In December 2005 the regulatory decision document applied decisions on matters which had not been previously raised and consulted upon in the draft decision. It would be normal regulatory practice to consult on new principles before applying them to a price control decision. In the case of the decision document of 13 December 2005, the following issues and information were new and not previously consulted upon, and yet these were used to set the price control:

- The revised model used to set revenue under the price control has very recently been received by GEL. GEL hopes to examine that model and to discuss it with the OUR in the near future;
- The use of a return on turnover approach in Appendix B to determine a return for GEL's shareholder. This is inappropriate for a high asset base company such as GEL and is usually used for trading types of companies where the asset value is of relatively minor importance;
- The aggregate approach to efficiency savings as an overall percentage figure in comparison to other companies – these comparators are not relevant to current GEL circumstances (as dealt with in more detail in Section 7.1 of this Response);
- The regulatory approach at Postcomm – the IEP has confirmed that this is not a suitable precedent.
- The risk sharing mechanism for imported electricity purchase costs – this presents GEL with 25% of the risk/reward for outturn purchase cost performance. This is too high given the very limited degree of control that GEL has over European electricity price levels. The risk sharing mechanism is further distorted by the OUR's unilateral use of its own base values, rather than the assumptions presented by GEL - or some basis which is agreed between the OUR and GEL after some discussion; and
- The assessment of GEL's risk environment – given the instability of the GEL Financial Framework, the volatility of electricity and fuel markets and the continued uncertainty regarding regulatory price controls, GEL believes that the OUR's assessment significantly underestimates the overall risk experienced by GEL.

We would like to be given the opportunity to discuss these issues with the OUR before the price control is progressed to the draft decision phase, to the extent that they are each still relevant.

GEL would also like to make progress on the revision to licences proposed by the OUR in November 2005. GEL responded positively with a range of suggestions in January 2006 and since the results of the Review of Regulation and Commercialisation was approved without amendment by the States in May 2006, we would hope that this work stream can continue as planned by the OUR. We would certainly hope that this work can be completed by the end of the year, so as to bring about the reduction in the burden of regulation that the OUR originally proposed last year.

Particularly important however for the purposes of this Consultation is the need for the OUR not to devise a new form of price control which is significantly more complex than the Interim Price Control. Such complexity would mean that compliance requirements would increase over existing levels. In contrast, it is our understanding that the OUR intends to reduce the licence condition burden upon GEL – as required following the States of Deliberation debate in May 2006 and in order to be consistent with the OUR's own declarations to that effect.

3.1 Independent Expert Panel

GEL agrees with the OUR that the IEP members have contributed significantly to progressing some of the matters which were unresolved under the interim price control. GEL also believes that the IEP has reached some acceptable Recommendations in its report. These now have to be implemented successfully into the context of a price control by the OUR. The IEP's conclusions are sound in the majority of the areas they examined and implementation is the key next step. Some areas of previous disagreement between GEL and the OUR last year were not referred to the IEP by the Director General (DG) and these also remain as work in progress until a draft price control is proposed.

In Section 5.3.2 & Section 8 of this Consultation Response, GEL has identified several important aspects of the IEP's Report, its Recommendations and its specific comments regarding GEL's Financial Framework which are not dealt with consistently by the OUR in its current proposals. These need to be addressed as matters of the utmost importance if the IEP's Recommendations are to be faithfully implemented.

The IEP clearly and firmly expected GEL to be profitable and capable of paying dividends. Under the type of principles proposed by the OUR in Section 5.3.2 & Section 8 of the Consultation, GEL will not be in a position to be either of these, unless the OUR's approach is amended significantly. Failure to make such amendments is very likely to impact upon shareholder value – as set out by the IEP in Part 7 of Annex A to its report.

3.2 Efficiency Review

GEL believes that all efficiency reviews can be helpful if they are factually accurate and are specific to GEL's circumstances. Under such circumstances GEL will be pleased to implement any genuine examples found where areas for improvement can be implemented to provide net benefits to customers and the company's operations.

We are certain however, that the work by PPA is not accurate in its findings and that these should not be implemented. GEL has commented in Confidential Annex B to this Response to the OUR on the study of efficiency by Power Planning Associates.

Although GEL has been afforded the opportunity to comment upon a draft of the PPA Report, no significant degree of correction of the report for the errors identified in it by GEL has taken place when PPA prepared the Final Report. The Consultation is therefore misleading where it states: *"The PPA final report takes account of the comments provided by GEL*." Whilst PPA may have noted GEL's comments, the report has not been substantially corrected and therefore is not supported by GEL.

3.3 Financial Framework for GEL

GEL had been assuming that the Financial Framework for its business was in place and had been agreed in March 2006 by the two States Departments and the OUR, until it was examined by the IEP in July this year. Stability is required in this area for GEL - as for any business. Although the IEP's work has been helpful, continual re-examination of issues by regulation going forward must be avoided.

GEL notes the Director General's comments regarding GEL's concerns should it be forced by any price control to make financial losses. It is vitally important in this price control to recognise that if GEL is forced to continue to make losses for a period, then any profit reserves will become exhausted and GEL will not be able either to show profits or to provide dividends to the shareholder. Such a situation is not envisaged by the IEP since their Recommendations propose how shareholder dividends should be forecast for the purposes of the price control and then delivered by the business. The maintenance of profit reserves is not an academic issue or one purely of representation. It is a fundamental accounting and legal issue which determines whether or not dividends can be paid.

We are pleased that the IEP made provision for the production of dividends to the shareholder by GEL and that these should be used as an assumed output from the regulatory price control process. The existence of the island's "save-to-spend" policy was also recognised by the IEP as a conscious decision of choice by the island and is therefore also an integral part of a price control which is appropriate to Guernsey circumstances. The "save-to-spend" policy and the provision of dividends to the shareholder through profitability are in no way mutually exclusive nor are they alternative assessments of the company's state of financial health.

3.4 Price Control Model

GEL is very pleased to note that the OUR has managed to simplify the OUR model used for price control purposes. Whilst some progress has been observed, the complete picture is not transparent at this stage. The revised model should be finalised and a copy provided for GEL comment as soon as practicable.

Before submitting any tariff figures for use in the price control exercise we would hope to be allowed by the OUR to have a copy of the latest version of the model and that which will be used for price control purposes. Similarly we would expect to have a copy of the model used by the OUR both for a draft price determination and the final price determination. Such transparency is normal regulatory practice elsewhere and given the importance of the revenue calculation for all stakeholders, we hope that the OUR will agree to these requests.

3.5 Energy Policy Working Group

We agree that should there by any output from the Energy Policy Working Group that materially affects the price control assumptions then some form of adjustment of the price control should be provided for. However, in order to protect against unnecessary regulatory and company workloads, the possibility for adjustment should be triggered only if either the OUR or GEL judges that the grounds for amendment are expected to be material. This will avoid both parties having to conduct unnecessary work on the implications of policy changes when the impact on revenue and price would not be significant. Both parties could communicate briefly on an annual basis to confirm that no significant policy changes had occurred in the previous 12 months which might justify an affect upon prices being calculated – or otherwise.

Any policy change would take time to gain approval through the States and then to be implemented. Hence reflecting this in the price control could not be examined or implemented quickly. In order to ensure regulation appropriate to Guernsey circumstances (see 4.3 below), we would request that an approach which did not necessarily assume a regular review process should be proposed by the OUR.

4. LICENSING REGIME AND LEGISLATIVE FRAMEWORK

4.1 Overview

GEL notes the OUR's summary of the Licensing Regime and the Legislative Framework.

4.2 Current Licensing Regime

The framework is noted.

4.3 Legislative Background to Price Regulation

Following the letter to the States of Deliberation in May 2006 new duties were placed upon the OUR. These included that the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 should be amended to add a duty for the OUR to "regulate in a way that is proportionate to Guernsey circumstances".

The States Guidance to TRD referred to by the OUR in this section is highly relevant here since GEL and its shareholder will, as a result of the guidance, not be operating in such a way as to propose prices which would ordinarily represent full commercial returns to the shareholder. This needs to be specifically taken account of by the OUR when calculating any adjustments to the allowed revenue under the price control from that proposed by GEL and the shareholder. In GEL's view, without this recognition, there could be a significant lack of reflection of Guernsey circumstances, leading to a disproportionate regulatory response in terms of the level of allowed regulatory prices.

A further area that risks resulting in a disproportionate regulatory requirement is in the area of the complexity of the new price control and the consequentially more onerous reporting requirements which could result. At worst, GEL would hope that the New Price Control results in no new reporting and compliance requirements over and above those currently in existence. We would hope however to see reductions in reporting requirements to evolve - now that regulation has "bedded down".

The IEP Report is a document devised for use primarily by the OUR. We note that within it are a number of Recommendations which are the basis for the way forward proposed by the IEP. Outside of the Recommendations are some observations, comments and suggestions. There is considerable scope for the totality of the IEP's Report to increase the complexity of electricity regulation on Guernsey. This would be counter to the decisions made by the States of Deliberation in May this year and the OUR's own stated goal of reducing the level of regulation. We very much hope that the OUR will maintain the objective to reduce regulation wherever possible when considering the IEP's Report.

5. PRINCIPLES OF GEL'S PRICE CONTROL

5.1 Form

The discussion on the form of control does not deal with pass-through requirements, which are a key feature of GEL's cost base. The proposed RPI±X formula is only appropriate for an element of GEL's costs. For the element of GEL's cost base for which RPI is relevant, GEL agrees that an RPI-X form of control is appropriate.

However, the most significant feature of GEL's costs in total is the volatility of international fuel oil prices and the import prices which are driven by European electricity prices. A pass-through formula for these elements of costs is appropriate, rather than an RPI-X form of control. GEL would therefore propose a form of price control with simple automatic correction of prices if generation prices (oil and import) change from the level forecast by the OUR. A simple automatic correction mechanism was suggested by GEL last year and developments with the OUR since then have started to progress this important area of thinking under the existing Interim Price Control.

We hope that the OUR will agree to further this work over the next few weeks so that an unambiguous mechanism for the future can be consulted upon at the draft decision stage of the OUR's process.

In summary, GEL's price control should therefore have two elements: a pass-through element to accommodate changes to import and generation prices; and an RPI-X formula for other costs. GEL sees no reason to change the form of control from one where customer price levels are set in advance for a period and a simple adjustment to prices is then available for the future, should actual import and fuel prices not outturn at predicted price levels. GEL believes that the form of regulation should continue to be one of control of prices rather than revenues.

5.2 Scope

GEL agrees with the scope of the control and the associated proposed list of tariffs although the list set out is not quite complete. It excludes the Boiler Tariff and there are elements of the Maximum Demand Tariff missing - installed capacity and power factor data appears not to have been included. The scope proposed by the OUR remains unchanged from that included in OUR 05/31and is restated correctly overleaf for completeness:

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

- Super Economy 12:
  - Standing charge;
  - Low rate unit charge;
  - Normal rate unit charge.

- Industrial Economy Tariff – High Voltage Supplies:
  - kW charge (April-October);
  - kW charge (November-March);
  - Low rate units;
  - Normal rate units;
  - Installed capacity charge; and
  - Power factor charge.

- Industrial Economy Tariff – Low Voltage Supplies:
  - kW charge (April-October);
  - kW charge (November-March);
  - Low rate units;
  - Normal rate units;
  - Installed capacity charge; and
  - Power factor charge.

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

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

- 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.

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

The actual level of revenue under the price control will be determined by the OUR via the agreed New Price Control. When considering how this is reflected in actual tariffs GEL is very much aware of the customer perspective and the need to minimise confusion. The complexities of regulation should be "behind the scenes" as much as possible and price messages to customers should be simple.

We understand that the OUR has written to GEL's shareholder to gain input on the issue of the concept of a Customer Dividend. We would hope that the OUR will update us as soon as possible on progress in this area. We note that the IEP made no Recommendation regarding either a Customer Dividend or the Structure of Charges to customers.

Quite apart from the above issues, we do not believe that it is appropriate to consider any wider consideration of tariff rebalancing at this stage. However, GEL would expect to be able to discuss tariff rebalancing with the OUR during the period of the price control if it becomes appropriate.

To facilitate this, the price control direction should be framed so that a re-balancing of tariffs could take place during the six year period, subject to the intended total revenue being unaffected by the rebalancing and also subject to satisfactory re-assurance to the OUR by GEL that any re-balancing was justified on the grounds of improving the cost reflectivity of tariffs to customers.

5.3 Price Control Structure and Financeability

5.3.1 The structure of a price control

The structure diagram for the price control shown in this section is too high level to be meaningful to GEL and some further discussion with the OUR would be helpful. For example, capital expenditure is not included and although a regulatory depreciation schedule is correctly mentioned, its inclusion appears to be inconsistent with the statement on depreciation in Section 6.3 (see below). Further additional detail is required and GEL would then be in a position to comment accordingly before the draft direction is issued. As mentioned in Section 3.4 above, there is no substitute for a copy of the OUR's revised model – which would be invaluable in assisting discussion of precisely what is proposed in this area, which is of vital importance to the company.

5.3.2 Financeability

In this section of the OUR's document there is an over-emphasis and a dominant focus on "cash" and "save-to-spend" issues at the expense of profitability and dividends, when considering company finances under the price control. In GEL's view, both of these factors need to be given a balanced role in the regulatory perspective of GEL's finances. The proposal by the OUR to use "the level of cash in the save-to-spend reserve" as the "key variable on which to assess financial viability" is not consistent with GEL's view. Furthermore, GEL does not agree with the OUR's view to place "less weight on accounting accruals and provisions such as depreciation". This is a key issue since the focus proposed by the OUR could well result in no dividends being made to the shareholder for the foreseeable future. This would be entirely inconsistent with the IEP Report.

It was set out in the Recommendations of the IEP Report that TRD should have the major role in determining company cash levels under the save-to-spend policy and dividend levels under the price control - but this is not made clear in this part of the Consultation. We refer here to Recommendations 1 & 2 from the IEP Report in Annex A of the Consultation.

Based upon the proposals set out in this Section 5.3.2 and Section 8 of the Consultation, GEL expects modelling to show that GEL would be not be profitable for the foreseeable future and it would be unable to pay a dividend. This is not consistent with the IEP report, which clearly expected dividends to be paid. The primary cause of this adverse situation is the OUR's focus primarily upon cash reserves in this Section of its proposals. The OUR should model the price control impact with regard to profits available for distribution as well as to cash reserves – a balanced approach is required.

This Section of the Consultation makes reference to the working capital needs of the business but these needs are not referred to later in the Consultation, where it is assumed that capital expenditure is the only relevant consideration. There are a range of risk management issues which will be required to be taken account of by the shareholder when it determines the level of cash reserve that is necessary.

5.4 Monitoring and Compliance

GEL would welcome any proposal for compliance arrangements which are simple and transparent and which will result in certainty over pricing decisions. Arrangements had previously been proposed by the OUR last year but did not come into being. It would be helpful if a date were to be set for a draft set of arrangements to be made available for comment by GEL, so that the proposed deadline of having them in place prior to commencement of the price control can be achieved through achievement of progressive milestones.

Based upon discussions with the OUR on several aspects of the proposed New Price Control, GEL has increasing concerns that the new price control will be so complex as to require increased regulatory compliance requirements in the future. This is contrary to the "lighter touch" trend for regulation on Guernsey envisaged by the States of Deliberation in May 2006 (as discussed earlier in the Consultation response).

6. PRICE CONTROL FRAMEWORK

6.1 Price Control Period

GEL remains of the view that a six year price control is required - so long as appropriate pass-through arrangements for import and fuel prices can be agreed. This would produce the vital business certainty that has been lacking since Commercialisation. By April 2007 GEL will have been involved in price control discussions with the OUR for over four years and a six year price control period would reduce regulatory costs and represent implementation of regulation proportionate to Guernsey. Any price control of a much shorter length of time may not be sustainable in terms of regulatory costs and workload.

An appropriate length of price control can only be agreed if the form of price control is appropriate. The GEL price control needs to be one with a simple form of pass-through of import and fuel price variances and should not be of the RPI±X format for all costs.

6.2 Opening Regulatory Asset Value

The return on turnover used in the Interim Price Control is inappropriate for GEL's capital intensive business and GEL welcomes the OUR's support of the IEP's firm proposals to base a return upon an asset base approach.

GEL supports the OUR in implementing the IEP's Recommendations 4, 5 & 6 for a two tier approach to asset valuation, so long as the values used are supportable as reasonable estimates which are stable over a period of time. Single point values of assets and returns will not be reliable estimates to be used to implement the IEP's Recommendations since they will be spurious to the precise point in time that is chosen.

The IEP made Recommendations regarding two categories of assets according to two time periods – Commercialisation and subsequently. The IEP did not propose that the period between Commercialisation and the next price control period (April 2007) should be treated as a separate third period. The OUR's suggestions in this Section of the Consultation regarding assets for that third time period are not therefore consistent with the IEP's Recommendations.

In GEL's view there is no question of a third period for the classification of assets and therefore the post Commercialisation rate of return (RAB new) should apply to all core assets since 1 February 2002.

The question raised regarding the roll forward of GEL's proposed two asset categories can only be properly responded to within the context of the OUR's price control model (see Section 3.4). GEL would welcome clarification from the OUR on this area of the model before responding in detail on the arrangements proposed. GEL can of course maintain an appropriate split of assets pre and post Commercialisation until all pre Commercialisation assets are either fully depreciated or disposed of.

In this Section of the Consultation the OUR States that: *"Historic evidence showed the sum of funds provided by the States as shareholder were zero"*. This is not correct, as was shown in GEL's submissions to the OUR in 2005 on the price control.

In the OUR's Question 4, reference is made to capital investment to the date 31 March 2007. This value will not be available until after the price control is due to come into effect.

6.2.1 Return to shareholder on RAB (historic)

Although GEL can accept the IEP's Recommendations in this area, GEL does not agree with the reasoning and the approach that the OUR proposes for implementation. The OUR uses a financial return figure which is too specific to be a reasonable approximation of GEL's returns in the period leading up to Commercialisation.

The OUR's proposal to allow only a 0.245% return on pre-commercialisation assets should be replaced by a return figure calculated over a longer time period than that proposed by the OUR. In any case, the OUR's figure relates to a 10 month period, rather than to a 12 month period. To set the return for all future years on just one figure risks an extremely spurious basis for future returns to the company on its main asset base. Furthermore, when inflation is taken into account, should the value of 0.245% proposed by the OUR be considered nominal then it is a significant negative value when expressed in real terms. The IEP regarded the value of 2% real being too low for post-Commercialisation investment and a significant negative return for pre-Commercialisation assets would be in very stark contrast. It is extremely difficult to envisage any possible justification for a return on assets which is less than zero in real terms – particularly when that value is to be used for all future years on the main asset base of the company.

GEL calculates relevant values for a return as follows for the 12 month periods to the dates shown overleaf:

March 1998 = 7.096%
March 1999 = 11.009%
March 2000 = 6.132%
March 2001 = 2.128%
March 2002 = 0.549%

AVERAGE = 4.807%

GEL suggests that rather than GEL and the OUR suggest alternative figures, that an average value of 4.807% should be adopted. GEL believes that assuming the use of an average over a time period is a robust implementation of the IEP's recommendations in this area. If adopted, the OUR's suggestion would have a major impact upon future shareholder returns and this would be based upon largely spurious data at one precise point in time. The unique and extraordinary items influencing GEL's accounts and returns in that one period would then unduly be deemed by the OUR to be appropriate circumstances to apply for all future years.

GEL notes the evidence of a similar approach to the one suggested by GEL being taken in the precedent case quoted by the IEP. This indicates evidence that implementation in the water sector quoted by the IEP supports GEL's position of not using a single return value derived from one period.

GEL considers it appropriate to exclude the exceptional income from the BCCI liquidator in determining the return. This would adjust the above average figure downwards to 4.3%, which would be acceptable to GEL.

6.2.2 Return to shareholder on RAB (new)

GEL welcomes both the IEP's and the OUR's recognition that a real pre-tax WACC should be applied to new investments. GEL's views on this matter are supported by work by G Horton, which has been sent separately to the OUR. This would support figures within the range of 5.97% to 7.81% (both real values), which is being considered by the OUR.

GEL believes that a low value within the range suggested by the OUR in its Consultation should tend to be considered for the return on new investment. This is so that the impact on prices for future customers is not too marked as new assets replace old assets. This is particularly the case if the OUR chooses to apply a very low return for existing assets, since customers would then face an artificially steep trend in price increases in the future.

GEL has considerable concerns that the OUR is proposing to apply too low a value to pre-Commercialisation returns and possibly too high a value to returns on new assets – leading to instability for customer price trends. There is no evidence that the IEP expected very large differential return levels to result, in practice, from its theoretical proposals to use two asset bases.

The interim period from Commercialisation to March 2007 was not invoked by the IEP's Recommendations and therefore need not be referred to. If it is to be referred to by the OUR, then the return on assets provided within the period should be the same as is used for assets going forward. However, any extending of the post-Commercialisation period to March 2007 is neither factually correct nor consistent with the IEP's Recommendations.

GEL believes that the OUR's considerations regarding per kWh and fixed charge issues risk unnecessary complexity when trying to explain a New Price Control to customers. We understand that the concept of a Customer Dividend has been referred by the OUR to GEL's shareholder and hope to be kept informed by the OUR of its progress in this area.

6.3 Depreciation schedule

GEL would like to review carefully the OUR's proposals in this area once the OUR's modelling approach has been clarified. At present it appears that the OUR's approach would result in regulation which is disproportionate to Guernsey circumstances since the OUR is not proposing to allow depreciation based upon historic cost accounting.

GEL had requested that this topic of depreciation be included in the IEP's Terms of Reference since it was a key area of the price control discussions in 2005. However depreciation was not included in their Terms of Reference and therefore the IEP did not make recommendations in this area. Although the IEP did not specify an approach to depreciation in its Recommendations the report appears to assume that a standard approach is to be adopted.

The standard "building block" approach to electricity price control regulation should indeed be used by the OUR for GEL's price control. Existing assets have useful lives and depreciation charges to the profit and loss account are providing for a reasonable charge for the usage of the asset in the financial years. With all other income and expense unchanged, the net cash arising over the full useful life of all existing assets would ultimately, under the historic cost convention, allow cash to be banked until a new asset of the same type is acquired to replace the old one. Depreciation that has not already been charged to the profit and loss account in respect of existing assets should be allowed both for statutory and regulatory purposes.

Under standard accounting approaches, depreciation charges to the profit and loss account are used to provide for a reasonable charge for the usage of those assets in the relevant financial years. GEL suggests that the OUR adopts an approach to price control modelling that includes a depreciation charge in its regulatory analysis.

Under the OUR's proposals to suggest a new period between Commercialisation and the new price control (which was not envisaged by the IEP) there appears to be the proposal that there would be no depreciation allowance for assets purchased between Commercialisation and 1 April 2007. This is an unreasonable position to adopt, for the reasons outlined above.

Depreciation is a fundamental accounting principle which should be recognised and allowed. As the OUR has recognised, capital expenditure can fluctuate significantly in any year. GEL does not consider that fluctuating values in this respect are at all desirable. The matter of the lower return on assets that existed at the point of commercialisation is already dealt with in the treatment of the RAB (historic). As far as depreciation is concerned, historic and new assets should be treated in the same way.

7. OPERATING COSTS

GEL believes that all efficiency reviews can be helpful if they are factually accurate and are specific to GEL's circumstances. Under such circumstances GEL will be pleased to implement any genuine examples found where areas for improvement can be implemented to provide net benefits to customers and the company's operations.

In the last price control review, the evidence was never forthcoming from ESBI to support the operating cost savings outlined in their report for the generation area. The historical savings in overhead costs as part of existing business cost performance was not picked up by their methodology and their work did not recognise the additional activities required in this business area as a result of Commercialisation.

Regardless of the method used to derive current and future efficiency suggestions – whether top down or bottom up – the predicted savings needs to be realistic and achievable as a result of being based upon relevant and sound analysis.

Although GEL has been afforded the opportunity to comment upon the Draft PPA Report, no significant degree of correction of the report for the errors identified in it by GEL has taken place when PPA prepared the Final Report set out in Annex B of the Consultation.

GEL expects the OUR to recognise that the establishment of unrealistic efficiency targets which cannot be achieved without serious prejudice to the company's core service will be a serious disincentive to the company in continuing its drive for greater efficiency.

7.1 Introduction

The cost headings and definitions set out by the OUR in Table 7.1 are understood by GEL and can form a sound high level basis for distinguishing between different levels of management control and different types of activity.

Taking account of the specific observations made below by the OUR upon efficiency, the suggested top down approach to overall cost levels does not take account of GEL's circumstances and the bottom up analysis of generation costs contains uncorrected errors that GEL has commented upon separately. In both cases the predicted cost savings from efficiency will not be achievable by GEL and so should not be assumed for price control purposes.

GEL agrees with the content of Table 7.2 as a high level representation of examples of the approaches that can be taken for different cost categories and the associated rationales.

The work by PPA has been complex, data intensive and costly in terms of GEL staff time. In spite of this, significant errors have been made by PPA. This causes the need to question very seriously whether this work has been an example *of "regulation in a manner proportionate to the circumstances in Guernsey"*.

Tables 7.3 and 7.4 contain data for very different organisations to GEL, in different jurisdictions to Guernsey and in different sectors to that of the integrated provision of electricity. In addition they relate to organisations which did not go through the changes experienced by GEL pre-Commercialisation in which substantial change and cost savings were achieved. They are therefore not appropriate benchmarks. Use of such benchmarks would result in operating costs which were unsustainably low. As a result, the price control would be too harsh and price regulation would not be proportionate to the circumstances in Guernsey.

In contrast to this view, the OUR states, when referring to the suggested benchmarks, *"those industries that in many important respects share common features with GEL"*. The Consultation does not however identify these respects. The list is very long however of the very different features for all of the suggested companies, each of which is very much larger than GEL – some by a factor of several thousand times. GEL is a very small company with consequentially very high levels of efficiency and cost savings achieved elsewhere in other sectors in very much larger companies cannot be achieved under the specific circumstances of Guernsey Electricity.

For GEL the price control must be appropriate to the circumstances of a small, highly efficient company which operates the full range of electricity supply business processes, after a period of substantial cost reductions in the lead up to Commercialisation. This would bear little resemblance to the circumstances of other sectors in the UK during the full period of the 1990s after a privatisation which was wholly different in terms of both circumstances and objectives.

7.2 Overhead costs

GEL has already covered these issues in 2005 in its Response to the OUR's previous Consultation. These are summarised again in the Confidential Annex A to this Consultation Response. Activities and costs in the year ended 31 March 2006 and to date confirm GEL's view – as presented to the OUR last year.

The proportions in 2001/2 are inappropriate bases for the setting of future efficiency targets. This is because the period relates to a pre-Commercialisation situation when the scope of activities in that area of the business was very different to what has been required since Commercialisation. There are a number of business activities and operational functions which are now required which would not be included in the benchmark cost proportions if the year 2001/02 is used. This would then have the effect of setting future allowances below efficient cost levels.

7.3 Generation costs

GEL's Response to this Section is contained in a Confidential Annex B to the main Response.

7.4 Pass-through of fuel and imported electricity costs

Further detail of the OUR's pass-through proposals is provided in this section of the Consultation and any such clarification is welcomed by GEL.

GEL believes that understanding of the OUR's proposals can only be obtained through the calculation of a provisional estimate of all pass-through correction amounts. Full calculation of pass-through amounts is a key issue for GEL and for customers due to the large amounts of cost involved. The price control needs to provide for pass-through correction via an agreed formula.

GEL has very recently received information on this topic with respect to the Interim Price Control and is examining the detail of the OUR's work. GEL notes that the OUR proposes in this Section of its Consultation that *"an alternative approach might be appropriate given a potentially longer price control period".*

GEL's comments on that alternative approach are provided directly below and under the response to Section 9.3 of the Consultation.

7.4.1 Fuel costs

GEL looks for a simple form of regulation which is proportionate to the circumstances of Guernsey. GEL believes that the implementation of the type of annual correction mechanism being considered by the OUR could result in very onerous compliance arrangements in the future. This would represent a marked increase in regulatory activity over and above what is required at present.

GEL believes that a much simpler mechanism is required, which calculates solely the difference in fuel cost that would have been allowed by the OUR if the actual fuel price levels had been known in advance, when setting the price control.

7.4.2 Imported electricity costs

GEL looks here also for a simple form of regulation which is proportionate to the circumstances of Guernsey. GEL believes that the implementation of the type of annual correction mechanism being considered by the OUR could result in very onerous compliance arrangements in the future. This would represent a marked increase in regulatory activity over and above what is required at present.

GEL believes that a much simpler mechanism is required, which calculates solely the difference in import prices that would have been allowed by the OUR if the actual import price levels had been known in advance, when setting the price control.

8. CASH RESERVES

This section of the Consultation does not refer to the IEP's Recommendation 1, which deals with cash reserves. Recommendation 1 from the IEP Report states that TRD should specify the required level of cash reserves. This therefore needs to be set out by TRD in order for matters to progress in this area. In Section 8.4, future contact between the OUR and T&R is referred to and this needs to be progressed as quickly as possible. GEL would like to assist in the process of reaching a conclusion on how the IEP's Recommendation 1 can be implemented.

There are no Sections in the Consultation on profitability and dividends which are equivalent to the Section on cash reserves. GEL would suggest that these matters are consulted upon as a matter of urgency since they are key financial indicators which deserve equal consideration to the issue of cash reserve levels. The IEP covered dividend levels in their Recommendations 1 & 2 and the current Consultation appears to be omitting those areas as a result of a focus mainly upon the issue of cash reserves.

Paragraph 20 of the IEP's report makes it clear that several issues within GEL's Financial Framework should not to be determined by the OUR, but rather are to be determined by the Departments of the States.

"..we accept that it is for T&R (as shareholder) and C&E (with responsibility for energy policy and regulation) to determine certain aspects of the Financial Framework. These include:

- *the appropriate valuation of GEL at the time of commercialisation;*
- *the basis of GEL financing (ie Spend to save);*
- *the shareholder returns to be expected;*
- *the use of cash surplus; and*
- *the incentivisation of GEL management."*

Hence the OUR's questions 14, 15, 16, 17 & 21 – which relate to the above areas – are not legitimate matters for regulatory decision and consultation, if the IEP's recommended approach is to be adopted - although on the last of the above matters, the IEP suggests that T&R does consult with the OUR.

It is also clear from the IEP's comments on Sections 1 & 2 of GEL's Financial Framework (see Annex A of their report), that the OUR's role was envisaged as one of implementation in the areas covered by those parts of the Financial Framework.

In the IEP's comments upon Sections 6 & 7 on GEL's Financial Framework, it is very clear that the IEP expects GEL to be profitable. The IEP states:

"If GEL earns positive returns on its RAB(s), as it should if it achieves its predicted level of efficiency, and if all new investment is financed out of the CAPEX cash reserves, then GEL should make profits in every year"

The IEP then goes on to state:

"Shareholder value will only be maintained if GEL adopts the investment, valuation and dividend policies as set out in comments above."

Based upon the proposals set out in Section 5.3.2 and Section 8 of the OUR's Consultation, which are open to interpretation, GEL would not necessarily be profitable nor would there be a dividend flow as expected by the shareholder. Furthermore, the OUR is proposing in Section 8 of the Consultation that cash reserve levels should be the prime indicator of the financial position of the company. Such approaches, if adopted, would be completely counter to the views of the IEP, as expressed in the excerpts above from their report regarding GEL's Financial Framework.

8.1 Adjustment to opening cash reserve

GEL does not consider the adoption of a "save-to-spend" policy as involving any form of *"premium to customer tariffs".* Indeed the opposite can be shown to be the case, since the interest on cash reserves provides income to the company which is used to off-set costs of providing services to customers under the tariff.

Consideration of cash reserves for the price control should be restricted to the funding needs of the core business, and confirming that there is no cross subsidy between core and non-core. GEL are mindful of this and properly account for any funds that may be due to or from each part of its business. This applies to both forecast values and actual values.

The OUR has stated that its Direction in 2005 was based on achieving £17 million nominal by 31 March 2017 (£10 million real). Any movement in cash from today's position should therefore be considered in conjunction with 8.2 and 8.3 below.

8.2 Level of 'Save to Spend' reserve

This Section appears to suggest that the OUR will consider setting tariffs solely with regard to the cash levels required for capital expenditure each year. The relevance of profitability and dividends has already been referred to above.

As recommended by the IEP, the level of the cash reserve is a matter for the GEL shareholder – TRD. Once TRD has considered the matter and made its decision known then GEL would expect to target delivery of that level of reserve. Monitoring will of course be necessary and GEL would propose a "service standard" approach for a band range, with exception reporting to the shareholder – this being copied to the OUR for further regulatory consideration, if necessary.

GEL supports the OUR's proposal in this section not to involve itself with the significant resources that would be required to estimate and predict risks of cash levels falling below those required for planned capital expenditure. We agree with the IEP that cash levels are a matter for the shareholder. The proper governance of risk management of cash levels lies between the company and the shareholder. Regulatory involvement in this area is unnecessary and would be inconsistent with a "light handed" form of regulation which is appropriate for Guernsey.

8.3 Targeted level of 'Save to Spend' reserve for end of time horizon

As explained above, we believe that the target level of the "save-to-spend" reserve is a matter for the shareholder – as recommended by the IEP.

The time horizon suggested by the OUR of the period to 2016/17 is appropriate for overall modelling purposes within the price control process but is actually quite arbitrary. Hence the suggestion to aim for zero cash at that point in time is also very arbitrary. More importantly, it is a premature and inappropriate regulatory suggestion, if the matter is to be one for TRD to determine, as was recommended by the IEP.

8.4 Distribution of cash reserves

This Section of the Consultation quotes paragraph 45 of the IEP Report *as "the Panel's key recommendation here"* but this is an observation of the IEP, not one of its seven Recommendations. In any case, the use of cash reserves is a matter for the shareholder – as are any decisions regarding dividends – this is explicitly recognised in the Recommendations made by the IEP.

We cannot stress too strongly the need for the OUR's price control to take notice of profitability, which constrains the level of dividends if profit reserves are depleted through the setting of regulatory price controls at too low a level. These are legal requirements which are based around statutory accounting rules.

Similarly to the point made above, the OUR is incorrect in saying *"a situation where the shareholder makes no decision and leaves funds within the cash reserve is not an alternative provided for in the Panels' recommendations, which the DG endorses."* The IEP made seven Recommendations, none of which covers this point. The IEP made clear in its Recommendations 1 & 2 that dividends are a matter for the shareholder. This is not therefore a regulatory issue for consultation via the OUR but rather is a matter upon which TRD is entitled to make a decision.

The final paragraph of this Section is quite a speculative interpretation of the IEP's work. We would suggest that the Panel's very clear set of 7 Recommendations should be the focus of price control preparations and assumptions.

If GEL's shareholder were to accept the IEP's Recommendations of a two-tier asset base with a lower than commercial rate of return on the historic base, then this is ample evidence that the shareholder is abiding by the States Direction to protect customers from high prices. Under such circumstances, the company can reasonably expect to be profitable, at least to a modest degree and to produce dividends, leaving T&R to take a view on how to deal with the Cash Reserves – as recommended by the IEP.

GEL's view on the use of a relatively low rate of return on post-commercialisation assets is consistent both with TRD's requirement to show restraint in pricing and with the behaviour expected of a publicly owned utility.

8.5 Time Horizon

The time horizon of 10 years was envisaged by GEL as preferable to the OUR's 25 year time horizon in its price control model. This remains GEL's view as an appropriate time scale to model revenues but this does not mean that any target level of cash reserves set by the shareholder should necessarily occur at that point in time - just because it is the new agreed date for the regulatory price control model. The time horizon for cash levels should be driven by the "save-to-spend" policy, not the regulatory price control model. That time horizon should be specified by the shareholder, in accordance with its role to implement the "save-to-spend" policy, and consistent with the IEP's Recommendation 1.

9. OTHER ISSUES

9.1 Fixed and variable charges

It is crucially important that customers are not disturbed and confused by complexities of regulation. The outcome of the price control should be presented by all parties in as simple terms to customers as possible. Whist there might be a number of countervailing factors from which the effective end price is derived, this should not be presented in all its complexity to customers.

The actual level of revenue under the price control will be determined by the OUR via the agreed New Price Control. When considering how this is reflected in actual tariffs GEL is very much aware of the customer perspective and the need to minimise confusion.

We understand that the OUR has written to GEL's shareholder to gain input on the issue of the concept of a Customer Dividend. We would hope that the OUR will update us as soon as possible on progress in this area. GEL would commit to seeing through that new control in the simplest possible form to customers. We note that the IEP made no Recommendation regarding either a Customer Dividend or the Structure of Charges to customers.

9.2 Security of supply costs

GEL believes that the supply security position of the island and the contributions towards the cost of these by different customer groups is not an urgent matter for consultation under the price control. Given the extremely tight timescales to which the OUR is working, this matter need not be addressed at the current time.

9.3 Incentives and Annual adjustment

Incentives are a matter for TRD to consider. TRD are best able to judge the circumstances of appropriate and best practice relevant to Guernsey Electricity within the totality of the matters required to be considered by the shareholder. This is best practice of Corporate Governance.

To date GEL has always agreed to a pass through approach to deal with the prices of imports and fuel which were not known when setting the price control. GEL would support the OUR in the future in applying a suitable mechanism which is simple and automatic, in that it will operate according to an agreed calculation.

Since the OUR's Consultation was published, GEL has received some preliminary notes from the OUR on a new specific Annual Adjustment Mechanism. GEL will be responding separately to this but so far is very concerned that any mechanism which is more complex than the Current Interim Price Control will increase the burden of regulation. This would be contrary to the "lighter touch" regulation expected following the States of Deliberation debate in May 2006. In addition the new mechanism might have the effect of fundamentally altering the Form of Price Control. Some clarification by the OUR is required, since there is however no indication in Section 5.1 of the OUR's Consultation document (on the Form of Price Control) that a fundamental change to the nature of the price control is envisaged by the OUR.

GEL sees no reason to change the form of control from one where customer price level are set in advance for a period and a simple adjustment to prices is then available for the future, should actual import and fuel prices not outturn at predicted price levels. GEL believes that the form of regulation should continue to be one of control of prices rather than revenues.

10. NEXT STEPS

It would be helpful if the next steps in the price control could be set out by the OUR in some detail. At present GEL believes that the absence of such milestones risks under-estimation of the timescale involved, which could result in a delay to GEL's price control coming into effect. If this is the case, then GEL would like to request an undertaking from the OUR that GEL will not be disadvantaged by any such delay and the resultant lower revenue, if a delayed implementation of tariff increases were to take place without a compensating adjustment.

GEL believes that financial modelling of the new information on the OUR's current proposals is likely to show financial loss performance for the company into the future. It would be helpful if the OUR's model for the price control could be updated and finalised so that such modelling can be shared with GEL.

GEL understands that the OUR has written formally to GEL's shareholder on relevant issues. It is envisaged that the DG will then form preliminary views - which it is intended will be a pre-requisite for GEL to submit tariff proposals. The OUR would then need to analyse these proposals and consult upon them. Respondents would then require a further consultation period. After this, further analysis by the OUR would result in the composition of a Final Decision document

GEL believes therefore that perhaps the OUR envisages something such as the following process:

Generic Consultation Responses Received	End Oct.
TRD approached by OUR	Oct?
TRD Decisions confirmed	End Nov?
OUR model update complete	End Nov?
Basis for tariff application given to GEL	End Nov?
GEL submits tariff application	December?
OUR completes analysis of tariff application	End January?
OUR issues Draft Direction Consultation	End January?
Deadline for Consultation Responses	End February?
OUR issues Final Direction	March 2007?
New tariffs come into effect	1 April 2007?

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If this, or something similar is the plan that the OUR envisages, then the risk that the OUR's proposed implementation date of 1 April 2007 for new tariffs will not be achieved is very high. This is because several of the timescales above appear to GEL to be necessary and close to the minimum required. The longer that tariffs remain at their current unsustainably low level, then the higher will be the increases in tariffs necessary when they are changed. Such instability and large changes to tariffs are not welcomed by customers, who tend to prefer predictable and smoothed changes to price levels rather than large step changes.

Regardless of the fundamental financial issues to be dealt with in order to set a new price control, the OUR has already agreed in principle to allow GEL to pass through the prices of import and generation under the existing price control. In the event that the New Price Control is delayed, this pass-through agreement could be used as a fair means to agree an interim increase in price which will be both in customers' interests in terms of reducing step changes in tariffs in the future.

Hence the concept of an interim price increase by the OUR before April 2007 is raised by GEL. For example, a modest increase could take place based upon agreed estimated pass-through prices only. This would help to smooth price increases to customers and is therefore in all parties' interests. However we understand that the OUR does consider that this interim contingency measure will not be required as it believes that the 1 April 2007 date will be met with a full New Price Control.

In writing to the shareholder on relevant matters the OUR should ensure that this is via a transparent process and one in which GEL would wish to have full involvement. To proceed on this basis would be consistent with the cooperative and productive approach adopted by the IEP. The shareholder has already consistently indicated the following views which are relevant to the GEL Financial Framework, the price control and some of the areas covered by the IEP's Recommendations:

"Save–to Spend" cash levels to remain in the range £10m -15m;
GEL to maintain its efficient operations;
Lower than full commercial profit levels;
Profit reserves to be used to smooth price increases to customers;
Price smoothing to be adopted; and
Current dividend formula to be maintained on new profit levels

This highly attractive approach by the shareholder from the customer perspective should be recognised by the OUR so that price levels consistent with this approach are not reduced further by regulation. GEL would hope for an inclusive and transparent process if further information from the shareholder is to be used as part of the current price control process.