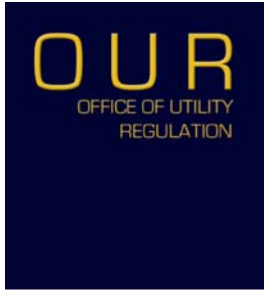


Office of Utility Regulation

Guernsey Electricity Limited's Price Control

Final Decision

Document No: OUR 07/04

February 2007

Office of Utility Regulation
Suites B1 & B2, Hirzel Court, St Peter Port, Guernsey, GY1 2NH
Tel: (0)1481 711120, Fax: (0)1481 711140, Web: www.regutil.gg

CONTENTS

1. Introduction 2

2. Structure of the Paper 3
2.1. Structure 3
2.2. Responses to the Draft Decision Paper 3

3. Licensing Regime and Legislative Framework 4
3.1. Overview 4
3.2. Current Licensing Regime 4
3.3. Legislative Background to Price Regulation 4
3.4. Shareholder instruction to GEL 5

4. Principles of GEL's Price Control 7
4.1. Form 7
4.2. Scope 7
4.3. Relevant price control period 9
4.4. Monitoring and Compliance 9
4.5. Allowable Revenue 9
4.5.1. The Regulatory opening asset value -RAB (historic) 10
4.5.2. Cost of capital – RAB (historic) 10
4.5.3. The Regulatory opening asset value – RAB (new) 11
4.5.4. Cost of capital – RAB (new) 11
4.5.5. Regulatory Depreciation Schedules 12
4.6. Capital expenditure 12
4.7. Automated meter reading rollout 13
4.8. Operating costs 14
4.8.1. On-island and Import costs 14
4.8.2. **Generation** ***[Confidential]*** **........ 14**
4.8.3. OPEX – Other ***[Confidential]*** **........ 14**
4.8.4. OPEX Staff ***[Confidential]*** **........ 14**
4.8.5. **Pass-through of fuel and imported electricity costs** ***[Confidential]*** **15**

5. Save-to-Spend cash reserves 16

6. Conclusion & Next Steps 18

Annex A – Summary of Key Elements of Price Control 19

Annex B – Pass-through formulae ***[Confidential]*** **........ 20**

 © Office of Utility Regulation, February 2007

1. Introduction

This document sets out the price control decision for Guernsey Electricity Limited ("GEL"). The price control period is for four years, commencing 1st April 2007 and ending 31st March 2011. The price control will be of an RPI+Y form, with a pass-through of allowed fuel costs and imported electricity costs provided. An adjustment mechanism will facilitate the pass-through calculation. The price control is based on a maximum price increase of 14.82% (i.e. RPI+10.42%) on current tariff levels over the price control period. GEL is free to commence increasing tariffs with effect from 1st April 2007. The maximum price is based on forecasts made and subject to pass-through and inflation changes. The timing of any resulting changes, if they pass a threshold for materiality, will be communicated to GEL on an annual basis beginning at December 2008. Since these are maximum tariff prices GEL will have flexibility in respect of the timing and extent of any price changes introduced provided they do not exceed the maximum tariffs set in this decision.

Since publication of the price control in 2005, the OUR has worked closely with all stakeholders including GEL, Treasury and Resources Department ("T&R") and Commerce & Employment ("C&E"). The Director General ("DG") has also sought the input of an Independent Expert Panel ("IEP") who has advised the DG on an optimal framework given States policy. The T&R Department ("T&R"), as GEL's shareholder, in response to the IEP's recommendations has also provided a significant contribution to the setting of this price control through clarification of expectations of GEL. The efficiency targets are based on the recommendations by PPA, a power consulting firm, who has advised the DG following a review of GEL's generation business. The DG would like to thank all parties, and in particular GEL's management, for its assistance in finalising this price control.

This final decision follows the consultation document OUR 06/17 and draft decision document (OUR 06/20) relating to this price control decision. The maximum tariffs allowed in this decision are based on implementation at 1st April 2007. GEL will now be required to demonstrate that prices do not increase by more than RPI+10.42%, which represents a 14.82% increase based on the latest available RPI figure of 4.4% as published by the Treasury & Resources Department.

 © Office of Utility Regulation, February 2007

2. Structure of the Paper

2.1. Structure

The structure of the paper is as follows:

Section 3:	summarises the legal framework of this price control;
Section 4:	sets out the principles proposed for GEL's price control and presents aggregates of the components of allowable revenue proposed under the price control;
Section 5:	assesses the key element of GEL's financeability, namely the level of GEL's future 'Save-to-Spend' cash reserves;
Section 6:	sets out the conclusions and next steps in the process;
Annex A:	summarises the key elements of the price control; and
Annex B:	sets out the detail of pass-through arrangements.

2.2. Responses to the Draft Decision Paper

The DG received responses to the draft decision paper from:

- Guernsey Electricity Limited ("GEL") and
- Guernsey Gas Ltd ("GGL")

The DG wishes to thank those who have responded to the consultation paper and draft decision paper for their contributions. In accordance with the OUR's policy on consultations set out in Document OUR 05/28 – "*Regulation in Guernsey; the OUR Approach and Consultation Procedures*", non-confidential responses to the draft decision are available on the OUR's website (www.regutil.gg) and for inspection at the OUR's offices during normal working hours.

 © Office of Utility Regulation, February 2007

3. Licensing Regime and Legislative Framework

3.1. 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 by the States of Guernsey[1].

The Electricity Law defines the three activities that constitute the electricity value 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.

3.2. 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 principle, 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.

3.3. 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 charged or (as the case may be) allowed by a licensee which has a dominant position[2] in a relevant market[3].

---

[1] Billet d'Etat No.XVIII 2001, pages 1263-1264 and Billet d'Etat I of 2003, p.55
[2] Condition 5(1)(f) of the Electricity (Guernsey) Law, 2001.
[3] Section 22 of "The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 states that:

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.

The DG includes for completeness the States guidance to T&R at the time of commercialisation of GEL. This guidance stated, inter alia, that:

4. Financial performance targets for Guernsey Electricity Limited shall be set so as to:

1. *deliver improved efficiency in fulfilling the requirements of the Public Supply Obligation imposed under the regulatory regime whilst drawing a balance between seeking a commercial return on the resources employed and the effect on the community of any increase in charges which may result; and*
2. *achieve as soon as is practicable an appropriate commercial return on the resources employed in the provision of other services.*

3.4. Shareholder instruction to GEL

On 5 December 2006, T&R issued instructions to GEL that the Company should:

"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.

 © Office of Utility Regulation, February 2007

- Maintain a Save-to-Spend policy such that sufficient cash reserves are held to fund future capital expenditure.

- Any surplus cash may only be used for purposes authorised by the Department. One such use may be to use some of the surplus cash to phase in price increases for the benefit of the company's customers.

- The Statutory accounts of the company, including the carrying value of assets, continue to be prepared in accordance with best accounting practice.

- A return on capital is adopted such that an annual dividend of £0.5m to £1.0m is produced in the medium term although it is accepted that in the short term there may not be a dividend.

- The dividend policy is set at 33% of post tax profits.

 © Office of Utility Regulation, February 2007

4. Principles of GEL's Price Control

In OUR 06/17 and OUR 06/20 the DG set out in detail the background to certain matters contained in this section. Interested parties may wish to review those documents for background on the matters discussed below. For the purpose of this paper, the section below details the key issues arising and the DG's position.

4.1. Form

Both respondents (GEL & GGL) agreed with the DG's proposal for an RPI+Y form of price control and agreed this should be combined with arrangements for the pass-through of fuel and electricity import costs.

Decision

The DG will provide for an incentive regulation form of the price control (i.e. RPI+Y) to regulate GEL's retail prices with provision for an adjustment mechanism to achieve pass-through of fuel and imported electricity costs[4].

4.2. Scope

GEL agreed with the tariff list set out in the draft decision and the specific arrangements for particular tariffs proposed by the OUR.

GGL does not accept that the same percentage price change should be applied to each tariff and believes tariff re-balancing needs to be performed as a matter of urgency. GGL has also requested the removal of the GEL Standby Tariff from the scope of the price control arguing this tariff is unfair and without precedent.

The DG considers that GGL's concerns are more appropriately considered in a more structured format than may be possible through this price control review. A consideration of whether individual tariffs are cost-reflective and consequently any rebalancing exercise that may arise from that process would have to take account of a number of issues, requiring a more complete set of evidence than that available to the DG to date.

GGL has raised issues about the inclusion of the Standby-Tariff. If the tariff were removed from the scope of the price control this would imply there was no restriction placed on the tariff level by the price control itself. In these circumstances GEL would have a wider degree of discretion to increase this tariff. The DG believes that on balance the inclusion of the tariff in the price control is therefore more appropriate.

Decision

The DG will include the tariffs by Guernsey Electricity Limited listed below within the scope of the price control and bases the price control on the same percentage price change to each. GEL may re-balance its tariffs during the control period subject to the DG's approval.

[4] The adjustment mechanism is detailed in Annex B

 © Office of Utility Regulation, February 2007

- Standard Tariff:
    - Primary Standing charge;
    - Secondary Standing Charge; and
    - Unit charge;

- Super Economy 12:
    - Primary Standing charge;
    - Secondary Standing charge;
    - Low rate unit charge; and
    - Normal rate unit charge

- Industrial Economy Tariff – High Voltage Supplies:
    - kW charge (April-October);
    - kW charge (November-March);
    - Low rate unit charge;
    - Normal rate unit charge;
    - Standby Charge; and
    - Power Factor adjustment

- Industrial Economy Tariff – Low Voltage Supplies:
    - kW charge (April-October);
    - kW charge (November-March);
    - Low rate unit charge;
    - Normal rate unit charge;
    - Standby Charge; and
    - Power Factor adjustment

- Maximum Demand Tariff – High Voltage Supplies:
    - kW charge (April–October);
    - kW charge (November-March);
    - Unit charge
    - Standby Charge; and
    - Power Factor adjustment

- Maximum Demand Tariff – Low Voltage Supplies:
    - kW charge (April-October);
    - kW charge (November-March);
    - Unit charge;
    - Standby Charge; and
    - Power Factor adjustment

- Heat Pump Tariff:
    - Unit charge;

- Non-Peak Tariff:
    - Standing charge; and
    - Unit charge;

 © Office of Utility Regulation, February 2007

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

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

- Public lighting Tariff:
    - Standing charge; and
    - Unit charge;

4.3. Relevant price control period

In the draft decision, the DG proposed a four year price control. GEL agreed with the proposal for a four year price control while GGL advocate a shorter period of three years. The DG has noted GGL's comments, but remains of the view that a four year control is appropriate as it reconciles the need to maintain a robust price control framework with the need to provide GEL with business certainty.

Decision

The DG sets a price control for GEL for the period 1st April 2007 to 31st March 2011.

4.4. 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 adequate compliance and monitoring, both from GEL and the OUR; and
- to ensure transparency and certainty for GEL to make its pricing decisions.

Compliance with the maximum level of tariffs set by this price control will therefore involve GEL ensuring its tariffs do not exceed the levels set by the DG.

A pass-through mechanism is provided for. As shortfalls or surpluses arising from a pass-through arrangement are recovered in future revenues, this has the potential to alter the level of allowable revenue for future years of the price control period should outturn differ materially from that assumed in the final decision. The information required by the DG for these purposes is detailed in Annex B. Prior to the end of each calendar year the DG will inform GEL of any revision to the maximum tariff level announced in this decision, where this de minimis includes any penalty arising from AMR roll-out target not met.

4.5. Allowable Revenue

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

- Regulatory opening asset value;

 © Office of Utility Regulation, February 2007

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

The principles used by the DG in each of the above issues are discussed in detail in OUR 06/17 as well as OUR 06/20. This section presents the views of respondents on these aspects of the price control and the DG's final decision.

4.5.1. The Regulatory opening asset value -RAB (historic)

GEL agreed with the allocation of all core investment prior to February 2002 to RAB (historic) resulting in an estimate of £72.5m for this asset base. GGL support the decision to value RAB (historic) based on the book value in 2002 and to index it each year to RPI.

Decision

The value of RAB (historic) is set at £72.5m as at 1 April 2007 which will be rolled forward on an annual basis indexed by the latest available RPI figure published by T&R.

The change in RAB (historic) over the period of the price control is shown below

[Confidential: Table redacted]

4.5.2. Cost of capital – RAB (historic)

GEL does not agree with the approach proposed by the DG, arguing that an approach adhering strictly to the wording of the recommendation of the IEP, rather than adopting an approach recognizing a more stable period of time results in a return value that is over-dependent upon a single historical figure. GGL disagreed with the proposed cost of capital on RAB (historic), and maintain such a low return will ensure that GEL's tariffs do not approach that of a true commercial operator in the short to medium term. GGL also does not believe that the period chosen represents a pre-commercialisation operation.

In the DG's view, no respondent has been able to provide objective evidence to support arguments for a time-period over which surpluses earned by the States Electricity Board prior to commercialization could provide a more appropriate basis for the return on RAB (historic) than that proposed by the IEP. The DG has considered the arguments for a return value on RAB (historic) based on annual surpluses earned by the States Electricity Board (SEB) over an extended time-period prior to commercialization, but is of the view there is considerable subjectivity in moving away from the IEP's recommendations in this area. The IEP proposed a specific reporting period in full knowledge of the existence of other options for deriving a return on RAB (historic), including some average of surpluses by the SEB prior to commercialization. As stated in the draft decision, the purpose of setting a return on investment expenditure prior to commercialization was not to provide a commercial return to GEL's shareholder for these assets. The IEP advised a particular

basis for deriving a cost of capital for RAB (historic) and provided a sound reason for this recommendation, namely, that commercialization of itself should not be a reason for prices increases. Consistent with the IEP's recommendation, the DG will use the figure derived from the accounts covering the period 2001/02.

Decision

The cost of capital on RAB (historic) is set at 0.549%

4.5.3. The Regulatory opening asset value – RAB (new)

GEL agreed with the allocation of all investment from February 2002 to March 2007 within RAB (new) resulting in an estimate of £17m for this asset base. GGL support the draft decision in respect of RAB (new) but would like to see the detailed calculation of RAB (new) from 2002 to 2007.

Decision

The value of RAB (new) is set at £17m as at 1 April 2007. This asset base will be rolled forward on an annual basis indexed by the latest available RPI figure published by T&R.

The change in RAB (new) over the period of the price control is shown below

[Confidential: Table redacted]

4.5.4. Cost of capital – RAB (new)

GEL has responded to OUR 06/20 with the view that the DG has underestimated the level of risk faced by GEL and maintains a higher return than that proposed by the DG is very likely to be required by private capital. However, GEL states that while the DG's proposal of 5.97% real is low it is acceptable. GGL do not consider 5.97% to be a commercial return and believe the DG has underestimated the risks of operating GEL, arguing that in the very small, low growth and isolated environment of Guernsey higher risk is entailed, and a small growth premium of 1% should be added to the rate of return. GGL is also of the view that GEL's cost of capital should take account of the three increases in the Bank of England rate that have occurred since August 2006.

The DG considered the balance of risk faced by GEL and set this out in the draft decision. He does not agree he has underestimated the risks faced by GEL as there are a number of material factors relevant to GEL that offset to some extent those factors contributing to its risk. Also, given the price control will cover a period of four years, a medium term rather than a short term outlook is appropriate in setting cost of capital. The DG therefore does not consider it appropriate that cost of capital levels set for four years should be raised due to short term monetary policy decisions in the UK. The DG remains of the view that the cost of capital of 5.97% on RAB (new) is appropriate given the specific circumstances that exist for GEL.

 © Office of Utility Regulation, February 2007

Decision

The cost of capital on RAB (new) is set at 5.97%

The IEP have advised that provision should be made for a customer dividend in the event the shareholder requires less than a full commercial return but the shareholder has not made such a provision for this price control. The materiality of the issue for this price control is low however given the relatively low level of RAB (new) at the commencement of this control.

Growth in RAB (new) over the future will however increase the materiality of this issue as the return on this asset base will lead to increasing levels of profit. The DG considers that for future price controls should this become a material issue he would have to address any undermining of hard-budget constraints, by either allowing a less than commercial return on RAB (new) or provide for a customer dividend allowance in some form.

The table below shows the forecast profit levels after tax and interest, as well as the assumed cash contributions to reserves, and shareholder dividend allowed for over the four years of the price control

[Confidential: Table redacted]

4.5.5. Regulatory Depreciation Schedules

GEL supports the use of historical depreciation and agrees to the basis of a depreciation allowance in the draft decision as reflecting the depreciation on the actual capital assets to date. GGL support the inclusion of depreciation as a cost.

Decision
The combined regulatory depreciation schedule for RAB (historic) and RAB (new) over the period of the price control is shown below.

[Confidential: Table redacted]

4.6. Capital expenditure

In the current price control, the DG provided for an amount of £8.4m in 2006/07 for capital expenditure while GEL's capital expenditure for that period appears to be closer to £5.9m. Respondents have not commented on this issue raised by the DG in the draft decision. As proposed by the DG in OUR 06/20 he will reduce GEL's allowable revenue for the price control commencing 1 April 2007 by the amount of interest earned on the funds in cash reserves not employed for the capital expenditure allowed in the price control covering the financial year 2006/07.

GEL consider a highly unproductive workload will be created if GEL is to be required to explain large elements of its capital expenditure programme to the OUR and do not believe there is need for specific provision to be made in the price control for any

information the DG seeks in this regard. GGL did not consider it was in a position to comment on capital costs as the actual figures were not published.

The DG has accepted GEL's capital expenditure as submitted for purposes of setting this four-year price control. Over the price control period he will however seek confirmation from GEL that it is meeting its targets for these capital expenditure allowances.

GEL's capital expenditure forecasts for the period after the price control are used by the DG to inform a prudent level of 'Save-to-Spend' reserves to undertake such investment. The period after 2010/2011 will cover the peak cyclical investment period for GEL and the components of that investment will be reviewed in greater detail in the period leading up to the price control that will commence in April 2011.

Decision

The DG has provided for capital expenditure by GEL over the period of the price control as follows:

[Confidential: Table redacted]

4.7. Automated meter reading rollout

GEL strongly suggest that the OUR should not introduce penalties which they regard as a retrospective process from the perspective of hindsight. GEL submitted a revised rollout albeit within the same overall period agreed between OUR and GEL. GEL consider the proposed penalty of £40 per meter as arbitrary and suggest this is reduced to £25 to ensure regulatory consistency with other agreed guarantee standards in metering and that consideration of inability to access premises should also be allowed for.

While GEL has developed plans up to the rollout stage, the DG remains concerned at the lack of any detailed plan for the full rollout of AMR system. The rollout schedule and expenditure also appear inconsistent with GEL's submitted capital expenditure. It is in the interests of all customers that the rollout is completed within the rollout period, to ensure that all customers benefit, and that tariff options enabled by the AMR system can be introduced at such a point. The DG has considered the timetable submitted in January that showed further delays to the plans submitted by GEL in December but sees no reason to depart from the rollout as submitted in December 2006

However the DG has decided that any delays to the full delivery of the project should incur a financial penalty. The following rollout plan as provided by GEL in December will be the basis for the targets, with all years referring to year end targets:

 © Office of Utility Regulation, February 2007

Financial Year	No of Meters Installed Single Phase	No of Meters Installed Poly Phase	No of Local Controllers Installed
2006/07	6,500		68
2007/08	6,000		50
2008/09	6,000		50
2009/10	4,500	1,500	50
2010/11		3,500	32
	23,000	**5,000**	**250**

For the period of this price control the DG will apply a penalty of £30 per meter for each meter not installed when compared to the rollout schedule above. This compares to the approximately £100 that each customer is paying through tariffs for these meters. The penalty will only apply if the total number of installed meters is less than 95% of the target. However if the penalty is incurred it will be applied to the full shortfall number.

4.8. Operating costs

4.8.1. On-island and Import costs

Based on the DG's forecast demand growth rates, oil prices and import prices, the DG has allowed on-island and import costs as shown in the table below.

The pass-through adjustment mechanism as described in Annex B will take account of the deviances from these forecast costs.

[Confidential: Table redacted]

4.8.2. Generation *[Confidential]*

4.8.3. OPEX – Other *[Confidential]*

4.8.4. OPEX Staff *[Confidential]*

Decision - Total Operating costs

The DG will allow the following operating costs over the period of the price control:

[Confidential: Table redacted]

[Confidential: Table redacted]

[Confidential: Table redacted]

[Confidential: Table redacted]

4.8.5. Pass-through of fuel and imported electricity costs

[Confidential]

 © Office of Utility Regulation, February 2007

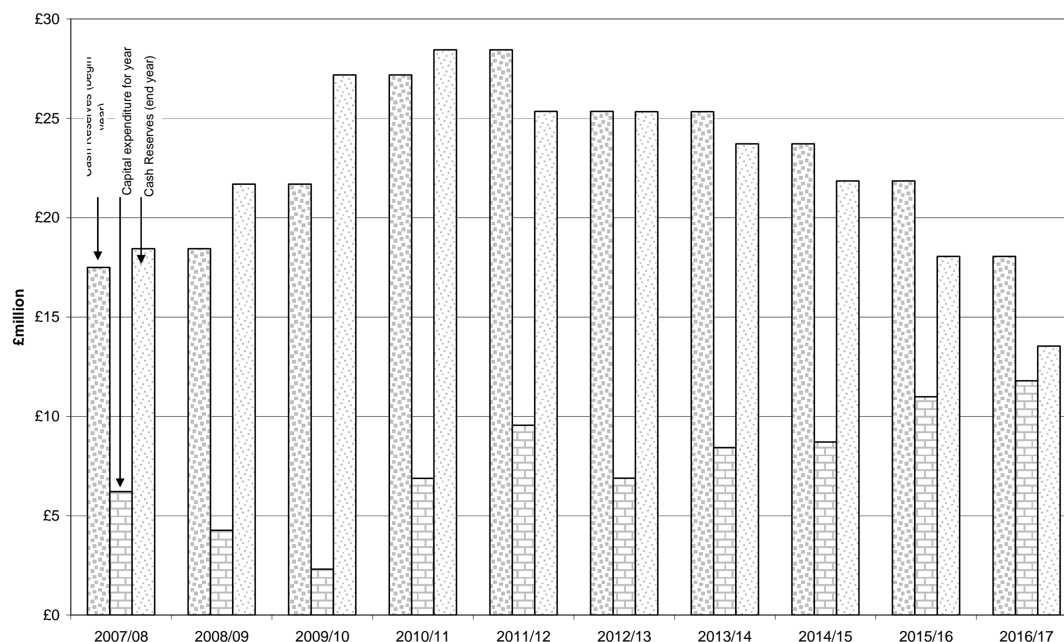
5. Save-to-Spend cash reserves

GEL estimate that the level of the 'Save-to-Spend' reserve will be £17.5m by 1st April 2007. The price control commencing 1st April 2007 is therefore based on this estimate[5].

The IEP has recommended that T&R as the shareholder should set out a rule establishing the appropriate level of cash reserve required under the 'Save-to-Spend' policy. The shareholder has issued an instruction to GEL to maintain a 'Save-to-Spend' policy such that sufficient cash reserves are held to fund future capital expenditure (see Section 3.4). The DG has therefore set the level of 'Save-to-Spend' reserve by ensuring these satisfy this rule over a 10-year time horizon from 1st April 2007 subject to the assumption that GEL operates at efficient levels as required under this price control. The DG has also made allowance for 67% of GEL's post tax profits to be added to the 'Save-to-Spend' reserve, with the remaining 33% paid to the shareholder as a dividend.

Figure 5.1 below illustrates the relationship between GEL's capital expenditure requirements and the level of the 'Save-to-Spend' reserve over this period. This shows GEL will have sufficient cash in its 'Save-to-Spend' reserve to fund future capital expenditure, satisfying both the rule established by T&R and the DG's key criterion for financeability of GEL's operations. The level of reserve is also more than sufficient to provide a level of working capital for the business.

Figure 5.1: Save-to-Spend reserves and Capital Expenditure (2007/08 to 2016/17)



[5] Should the level of cash reserves on 1st April 2007 be materially different to the starting level of £17.5m assumed, the level for the price control commencing 1st April 2011 will be adjusted to take account of this difference.

 © Office of Utility Regulation, February 2007

GEL's profits may be greater than that projected, and in these circumstances the full excess profit could be paid to the shareholder, i.e. the dividend may be greater than 33% of the profit, while still ensuring that the full addition to the 'Save-to-Spend' reserves is made.

In the event that GEL's profits turn out lower than expected due to missed regulatory efficiency targets, GEL's capital expenditure needs must still be met. Lower profit levels will however have implications for the 'Save-to-Spend' reserve levels. The need for tight control on this element of the price control by the Shareholder is therefore emphasised here. A regulated business that misses efficiency targets is expected to meet the resulting shortfalls through accessing funding from sources other than the customer since customers are not expected to compensate for management inefficiencies. Additional funding can take the form of a capital injection, a reduced dividend or some combination of both.

If cash reserves are not at the projected level at the end of the price control, in the absence of an extraordinary event over which GEL management have no control, this may mean that 'Save-to-Spend' reserves are being used to fund inefficiencies and represents a lack of financial constraint. Under law, the DG has a duty of protection to customers and the promotion of economic well-being of Guernsey. While the cash reserves are projected to be at very high levels by the end of the price control (some £28million) any deviance from this level will represent a loss to Guernsey. For this reason, the DG will assume opening 'Save-to-Spend' reserve levels at the start of the price control commencing 1st April 2011 no lower than the level assumed in this price control.

The Shareholder therefore may wish to consider appropriate reporting arrangements to satisfy itself of the degree to which this indicator of regulatory compliance is on target.

The figure below illustrates the level of forecast 'Save-to-Spend' reserves over the period of the price control, showing that over the period of the price control £✂m needs to be added to the cash reserves.

[Confidential: Table redacted]

 © Office of Utility Regulation, February 2007

6. Conclusion & Next Steps

The conclusions of the DG's assessment in this decision paper are based on the most recently published RPI figure by the States which is 4.4%. This may differ from the latest available RPI figure when GEL announces its next price change. On this basis the DG proposes to set the price control for 1 April 2007 at a level of RPI+10.42%, which equates to a change in tariffs of 14.82%. Forecasts for inflation have been assumed for subsequent years of 3.6% (2008/09), 3.5% (2009/10) and 3.4% (2010/11).

Decision

The tariff change for each year of the price control is as follows:

1st April 2007 – 31st March 2008:	RPI + 10.42% (14.82%)
1st April 2008 – 31st March 2009:	RPI – 3.6% (0%)
1st April 2009 – 31st March 2010:	RPI – 3.5% (0%)
1st April 2010 – 31st March 2011:	RPI – 3.4% (0%)

Monitoring and compliance obligations on GEL are as set out in section 4.4.

Ends/

 © Office of Utility Regulation, February 2007

Annex A – Summary of Key Elements of Price Control

[Confidential: Table redacted]

Annex B – Pass-through formulae *[Confidential]*

 © Office of Utility Regulation, February 2007