Guernsey Electricity Limited

Formal Response to the

OUR's Draft Decision:

<u>Guernsey Electricity Limited Price Review 2010</u>

Document No: OUR 11/04 February 2011

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Executive Summary

Guernsey Electricity Limited (GEL) has experienced a number of regulatory price controls since 2002 and the latest of these has set tariffs for the period April 2007 to March 2011. The most significant issue has been the volatility of global wholesale energy markets, which significantly affects GEL's costs for oil and imported power. The regulatory approach to tariffs has forced GEL into reduced profitability and a loss making position, while at the same time not allowing the smoothing of changes in tariffs to customers. The current Office of Utility Regulation (OUR) consultation on its Draft Decision fails to learn lessons from the past in this area and at the same time presents a range of new regulatory proposals which GEL cannot accept. The States has commissioned a review of the regulatory arrangements on Guernsey that has recommended significant and radical reform – "the States Review". It is against this background - while formal proposals are yet to be taken back to the States - that this electricity price review is being conducted.

The salient points of the Draft Decision are;

- GEL has requested a 7% increase on 1 April 2011 for one year and GEL would accept the 6.3% proposal in the OUR's Draft Decision;
- The OUR's Draft Decision however contains a great deal of new regulatory material – much more than is necessary or appropriate – and which GEL cannot accept;
- The statement in the OUR's Draft Decision that: *"The DG notes….. that the shareholder's interest and customer interests are not the same thing."* could be read as exaggerating the tension between the shareholder's and customer's interest in a publicly owned utility;
- The OUR is also incorrect in proposing that an RPI-X form of price control is appropriate for GEL; and
- Given fundamental problems such as these, all regulatory proposals and calculations other than the headline tariff increase should await the outcome of the States' debate on Regulatory Reform. Unfortunately, the Draft Decision sets out an approach to the regulation of GEL which shows no evidence of having taken account of the fundamental problems with the existing regulatory framework which independent experts have recommended for substantial reform. The Draft Decision also involves proposals based on lack of evidence, inconsistent

methodologies and a form of regulation cited as inappropriate by the Regulatory Policy Institute report.

The following are the key specific areas of concern for GEL;

- The OUR's Draft Decision continues a form of price regulation whereby GEL and its shareholder cannot smooth energy cost volatility through to customer prices. The ability to smooth tariff changes is a key benefit to Guernsey of having an electricity business owned by islanders. Energy markets will stay volatile and GEL and its shareholder would prefer to be allowed to adopt a policy of smooth tariff changes for customers;
- The Draft Decision incorporates inconsistency and ambiguity surrounding both past and future methods by which non controllable import and generation costs are recovered after they are incurred. The position is now such that the biggest financial risk that GEL faces is inappropriate regulatory treatment of import and generation costs;
- Following a price control reopening, GEL would expect to see a consistent and fair treatment of its costs for all years in the previous price control period. This is not the case in the Draft Decision;
- GEL is a highly capital intensive business, investing for the long term with a critical emphasis on security of supply. The OUR's proposals on regulatory revenue will result in an unpredictable and uncertain revenue basis upon which to base the company's imminent future investment plans;
- The OUR over-reaches the regulatory role by proposing a regulatory involvement in capital expenditure control within and throughout the period of a price control which micro-manages GEL and undermines the roles of the Board and Shareholder. Proper corporate governance arrangements are already in place;
- In addition an "incentive" arrangement is proposed for capital expenditure which is perverse and effectively holds GEL responsible for amongst other things, the weather, via a penalty mechanism; and
- GEL fully accepts the need for proportionate scrutiny and pricing oversight - generally by exception – and a drive to becoming more efficient based on knowledgeable assessment. The Draft Decision however assumes future levels of operating costs which potentially could be far too low given the changing electricity business of GEL and the very large capital investment programme upon which the

company has already embarked to meet the increasing demand for electricity in the island, and in accordance with States Energy Policy.

Bearing in mind all of the above features, GEL cannot accept the Draft Decision as it currently stands. GEL hopes that the Final Decision will be substantially different from the Draft. No party on the island will wish to see any further waste of island resources that would result from the Final Decision being unacceptable. GEL would need to consider its approach if the current level of unacceptability appeared in the Final Decision.

In summary:

- GEL believes that no elements of the Final Decision should relate to matters beyond the tariff change for the GEL financial year 2011/12. Elements which serve as a guide to what is likely to happen are not appropriate for the Final Decision and should be dealt with outside the formal conclusion of this one year price control; and
- GEL would therefore suggest that the proposals should be limited to the headline tariff increase only for one year. All other issues should then be revisited after the States' debate on Regulatory Reform. There is no need for the OUR to go beyond this in its Final Decision next month. The scope for agreement between GEL and the OUR on the level of a 1 April 2011 price rise ought therefore to be very promising.

1. Introduction

The States has commissioned a review of the regulatory arrangements on Guernsey that has recommended significant and radical reform - “the States Review”. It is against this background - while formal proposals are yet to be taken back to the States - that this electricity price review is being conducted.

In recent years energy markets around the world have demonstrated unprecedented price volatility and we can expect them to continue to do so. GEL cannot exert control over international fuel oil costs and European electricity market prices. Faced with periods of rising international prices, GEL and its shareholder would prefer to adopt a policy of smooth tariff changes for customers – to limit the degree to which cost shocks are actually experienced by our customers and the island economy. The previous price controls by the OUR and the current Draft Decision do not contain any commitment to tariff smoothing – either in specifically dealing with GEL’s costs for the current year of 2010/11 or with reference to the principle of smoothing more generally.

Given the backlog of energy costs incurred by GEL which have not yet been allowed to be passed through (Cost Pass Through - CPT), a tariff increase is necessary to reflect better the true costs of supplying electricity and to provide for the company’s future investment plans. It is not sustainable if tariffs fail to reflect more properly the costs of imported electricity and the price of fuel oil for generation. GEL has suggested a 7% increase. In the Draft Decision the OUR has suggested 6.3% (that being expressed as RPI+2.8%, which requires further clarification in terms of the value of RPI which is proposed to be used). Potentially these 2 approaches each provide a very similar level of tariff increase for customers – the scope for agreement between GEL and the OUR on the level of a 1 April 2011 price rise is therefore very promising.

However the Draft Decision does not simply propose a tariff increase but also:

(i) makes no substantial reference to, or provision for, the concerns and conclusions raised by the Regulatory Policy Institute in their Report to the Commerce and Employment Department, and yet these relate directly to many of the most important proposals contained in the Draft Decision. GEL believes that the major findings in the Regulatory Policy Institute’s Report have significant implications for both the conduct of electricity regulation and the overall regulatory framework for electricity. The degree of change proposed by the Regulatory Policy Institute is such that the matters need to be resolved first by the States;

(ii) contains new proposals on a wide range of topics[1] which will have an impact upon GEL well beyond April 2012 despite the Price Control only being for one year. However during discussions the OUR have stated that this is not their intention and that years two to four are indicative only. In contrast, the document states that the figures *"serve as a guide to what is likely to happen to future prices"*. GEL believes that no elements of the Final Decision should relate to matters beyond the interim 2011/12 decision. Elements which serve as a guide to what is likely to happen are not appropriate for the Final Decision and should be dealt with outside the formal conclusion of this one year price control; and

(iii) contains a number of specific proposals[2] which GEL could not agree with if they were to remain within the Final Decision.

Consequently, GEL cannot accept the Draft Decision as it currently stands. GEL would need to consider its approach if the Final Decision has a similar level of unacceptable features. Specifically, GEL disagrees with the approach in the Draft Decision which:

- Continues inappropriately to apply price cap regulation to GEL as a publicly owned utility, when such a form of regulation has been deemed to be inappropriate in the Regulatory Policy Institute Report;
- Exaggerates the ways in which the role of GEL's shareholder and its priorities might not naturally coincide with the interests of GEL's customers;
- Over-reaches the regulatory role by proposing a regulatory involvement in capital expenditure control within and throughout the period of a price control which micro-manages GEL and undermines the roles of the Board and Shareholder, since proper corporate governance is already in place;
- Assumes future levels of operating costs which could be far too low given the changing electricity business of GEL and the very large capital investment programme upon which the company has already embarked (see Figure 1 in section 4.8);

[1] For example future operating cost savings levels, the capex incentive scheme and financial ring-fencing proposals.
[2] For example inconsistency in pass-through cost treatment and the future treatment of 2010/11 costs.

- Incorporates the setting of a new efficiency target of 5.5% per annum on non pass through costs which has no justification and is entirely inappropriate. These operating cost assumptions take no account of GEL's circumstances and would inevitably mean a reduction in essential service standards;
- Prevents the timely recovery of substantial costs which were legitimately and efficiently incurred for imported electricity and generation on behalf of customers in the period 2007-2011; as defined under the CPT established for that price control period;
- Creates a change to the OUR's basis of the calculation of allowed CPT used by the OUR for 2009/10 from that previously used. This change has the effect of reducing the regulatory allowance to GEL from £6.3m to £1.6m – an extremely significant reduction of £4.7m;
- Incorporates a lack of clarity surrounding both past and future CPT calculations – including the proposed closing value of the current price control. GEL and the OUR have discussed the matter in a number of recent meetings. We understand that the OUR intends to allow pass through of all energy-related uncontrollable costs but has not clarified how these costs will be calculated or the timing of their recovery. This position has the effect of leaving GEL's Board with no ability to control or understand with confidence its future income stream. Such a lack of clarity is unacceptable and was condemned by the Regulatory Policy Institute;
- Adds considerable and unnecessary uncertainty to GEL's future financial position through inconsistent, unpredictable and potentially ambiguous methodologies;
- Proposes an "incentive" arrangement for capital expenditure which is perverse and effectively holds GEL responsible for amongst other things, the weather, via a penalty mechanism;
- Discloses confidential information to third party competitors in the public consultation document; and
- Sets out an approach to the regulation of GEL going forward which shows no evidence of having taken account of the fundamental problems with the existing regulatory framework which independent experts have recommended for substantial reform.

In highlighting the above severe concerns GEL confirms its commitment to:

- Proportionate scrutiny, which should generally be by exception, and;

- A continuing drive to becoming more efficient in a pragmatic way which will not adversely affect the security and reliability of the island's electricity supply.

GEL calls therefore for the operation of a one year price control limiting itself to the 1 April 2011 increase. This would be a pragmatic approach pending the outcome of the review of regulation, with the only clarification required of the OUR being the tariff levels to be announced for 1 April 2011. There is no need for the OUR to go beyond this scope in the Final Decision. All other matters should be dealt with only following the States' consideration of Regulatory Reform which is planned to go to the States later in 2011. The OUR could produce a new Price Control to take effect April 2012 – according to the outcome of the States Review.

It is in customers' interests that a clear set of tariffs is announced for 1 April 2011 as soon as possible. The statutory notice period of one month for tariff changes will not be possible since the OUR's deadline for comments on their Draft Decision is 4 March. In order to give as much notice to customers as possible, the Final Decision should be kept as simple as possible and should be limited to just the headline tariff increase for 1 April 2011. This would be consistent with the Final Decision not containing new regulatory proposals ahead of the States' Review.

GEL believes that a price increase of 6.3% as proposed by the OUR is in all stakeholders' interests as a pragmatic solution pending the States' Review. Such a price increase would allow electricity prices to move towards the appropriate economic level, would allow GEL to fulfil its licensed functions and would allow GEL's future investment plans to be maintained - all without pre-empting the proper consideration by the States of the problems identified with the existing regulatory framework which have been identified by the Regulatory Policy Institute. All other regulatory proposals and analysis should await the outcome of the States' Review.

2. Structure of the Response to the Draft Decision Paper

This process of a Draft Decision followed by a Final Decision is welcomed since it reduces the risk of inappropriate proposals being made in final form by the OUR. For ease of reference, this Response document is structured identically to the Draft Decision document.

3. Legislative and Licensing Background

3.1 Overview

The OUR's summary of the legislative framework does not make reference to the report by the Regulatory Policy Institute which identifies the unsuitability of RPI-X form of regulation since GEL is publicly owned and suggests moving to a less activist approach to price regulation. GEL is therefore astonished that the OUR has not made reference to the findings of the Regulatory Policy Institute and the process by which those issues will be duly examined in the States' Review. In view of the uncertainty regarding the appropriateness or otherwise of the existing regulatory regime, GEL believes that the OUR should go no further than proposing the level of a price increase to be adopted on 1 April 2011.

3.2 Current Licensing Regime

GEL's position with respect to being the sole party responsible for installing and operating the electricity distribution network and supplying electricity to customers has been agreed until 2012 - a situation which is currently being reviewed by CED. GEL's plans have been set out on the basis that this position will continue beyond 2012 but the period of any continuation has not yet been confirmed. This remains as work in progress by the CED. If the OUR later proposes to set a price control for beyond 31 March 2012, this will need to take account of the future licensing regime that has been agreed at that time.

3.3 Legislative Background to Price Regulation

The OUR makes reference to the existing legislation and then takes the view that *"in the absence of competition, price control is widely accepted as the most appropriate tool"*. However the Regulatory Policy Institute's investigation has identified that price cap regulation is inappropriate for GEL since it is a States-owned monopoly. This observation from the Regulatory Policy Institute and their associated recommendations for a more adjudicative style of regulation are of fundamental importance and have not been taken into account by the OUR in its proposals. This omission is highly significant. GEL reiterates its call for no price control principles or arrangements to be set out for agreement until after the States' Review.

4. Summary of responses to the OUR's previous consultation

GEL notes that the OUR has received a response to its Consultation from only one private individual. Two of the remaining three responses other than GEL's response are from private sector companies. These organisations will no doubt have framed their responses with their shareholders' and their commercial advantage primarily in mind. GEL requests the OUR to take proper account of this when assessing consultation responses in future.

In particular, GEL is extremely concerned that the OUR is releasing commercially confidential information to Guernsey Gas – a competitor to GEL which is completely unregulated and which is obliged neither to provide information to the OUR or to have such information published openly. Based upon the Draft Decision, the OUR is using its consultation process to open up the risk of unfair disadvantage to GEL, which operates to the disadvantage of stakeholders in the electricity sector.

4.1 Structure of Price Control

Form

The DG proposes that there was support for an RPI-X form of price control and that the DG proposes to use the RPI-X approach to price setting. This support was only from one respondent and importantly does not reflect the Regulatory Policy Institute's conclusion that the RPI-X approach is inappropriate for GEL.

Period

Justification for a one year price control is given on the basis of the need to ensure that the new CPT mechanism is appropriate and also on the basis of *"the generally uncertain economic climate".* Whilst GEL accepts the need for a one year arrangement, we do not agree with the reasons given. The OUR's approach to CPT has already resulted in GEL under-recovering efficiently incurred costs and facing very great uncertainty over its future revenue allowances. The OUR has been reviewing GEL's price control since 2002 and has not yet identified an appropriate and stable pass through mechanism. As a consequence, the uncertainties faced by GEL and its customers through regulation far exceed the significant uncertainties of the economic climate.

Scope

GEL notes that the DG proposes to set out separately the terms of reference for a review of tariffs. GEL has no objection in principle to a review of the relativity of its tariffs and welcomes a process of reassurance that GEL's tariff set is not discriminatory or anticompetitive. The terms of reference for such a review and a plan would need to be issued by the OUR and considered very carefully, so that GEL and the OUR can participate appropriately and schedule resources accordingly. GEL and the OUR need to assess the impacts upon all customer groups in a fair and equitable manner, whereas those most vociferous in the OUR's consultation process will most likely be serving their own self interest perspective about one tariff - to support their own needs without taking due consideration of what would best suit the island's interests.

GEL is therefore concerned that the OUR's process and approach should not give undue leverage to particular interest groups and thereby distort competition. In particular, Guernsey Gas have an extremely strong commercial self-interest in forcing GEL - via the powers invested in the OUR – to price uncompetitively. Contractually commercial confidential information might need to be supplied to the OUR as part of the OUR's process and GEL is extremely concerned that such information might not be properly protected by the OUR in their process.

GEL is in the process of phasing out one tariff by not allowing new customers onto that tariff and yet respecting existing legacy customers' wishes for the tariff not to be withdrawn from them. We do not think that publishing all of the details of such arrangements will be helpful and could lead to confusion. We are happy to go into detail on this area with the OUR and discuss with the OUR the criteria that we use. However, we would suggest that we should only be required to publish such information if the OUR believes that to be necessary, after discussion with GEL.

We would suggest that charges for standby generation are dealt with as part of the OUR's tariff review process. The publication of buy back tariffs will require very frequent updates since it is based upon GEL's avoided cost. The cost of such regular publication will probably be disproportionate to its value, since just seven customers are currently interested in the arrangements and already have access to the information that they need. However our website could be used as a method of communicating relevant values for customers to view.

The Draft Decision notes that *"GEL believes that it would be more efficient for the business to set its own tariffs"*. Whilst this is true, it is highly relevant to note that the Regulatory Policy Institute are of this very same opinion in their Report to CED. GEL is astonished that the OUR dismisses GEL's view with no justification, when independent experts on regulatory arrangements have specifically and very recently reviewed the Guernsey approach to electricity regulation at the behest of the States. These experts have made proposals contrary to what the OUR is suggesting should happen and yet no account of them is made in setting out any justification for the OUR's approach.

We fully support the Regulatory Policy Institute's perspective on this matter and believe that considerable costs can be saved and benefits derived from the adoption of the Regulatory Policy Institute's recommended alternative approach. This would involve GEL setting tariffs and the OUR being involved in an overseeing role on an exception basis, via a regime of limited regulation and an adjudicative approach.

4.2 Financeability & Save to Spend

Those who read the OUR's Draft Decision and this Response document should be made aware of the following two requirements placed upon the Board of Directors by its shareholder, the States of Guernsey, and set out formally in writing:

- GEL is required to meet a "Save to Spend policy", which therefore means prudent saving before the need to spend; and
- GEL is formally required by its shareholder to place all monies to be held for greater than one day to be invested with the States' Treasury.

These two requirements are fully in force at GEL, and will remain so until formal instruction from the shareholder to the contrary.

We are concerned that the DG proposes to continue his work to ring fence GEL's reserves.

The shareholder representative, the Treasury & Resources Department (TRD), is updated regularly on GEL's performance and a forward strategic plan - including the profit and cash forecasts - is shared in a formal document annually, with updates given to the shareholder quarterly.

GEL is a long term capital intensive business and cash requirements for capex are very substantial. However cash is also required for working capital which is needed to pay regular invoices for revenue as well as capital items. Therefore when considering cash one cannot consider only capital expenditure in isolation.

GEL also supplies cash and capex forecasts to the OUR for the purposes of the price controls. These are submitted by GEL to the OUR, and any significant variances are explained.

GEL notes the OUR's intention to work with GEL on the regulatory starting point for a "reserve" and its allocation for the core business going forward. The OUR states that this price review is using assumptions so as *"to ensure that even in a worst case scenario the investment programme can be delivered".* GEL needs to discuss the detail of the OUR's cash modelling in order to understand the "worst case scenario" as the term is ambiguous.

GEL has no expectation for investments which relate to non-core business activities to be allowed in the regulatory asset base or to be included in future regulatory depreciation allowances. However there might be legitimate reasons for investments which are not an agreed part of the investment plan to be funded through a reduction in the balance of the monies placed, as required, with the States' Treasury. For example, necessary but unforeseen capital expenditure does occur from time to time, given the inherent uncertainty in the condition of existing assets and changing circumstances. We would expect such expenditure to be judged periodically upon its merits in business and customers' terms, rather than being pre-judged as unallowable purely as a result of it not been included in a prior plan.

The interest which is assumed to accrue to the assumed save to spend "reserve" should not include interest gained in connection with non-core business activities. Interest can be credited to core or non-core activities as it is currently done, dependant on the cash balance position during any one year. The GEL monies all placed with States' Treasury are for the company's full activities, not just for the core business.

There is very little detail in the Draft Decision regarding how the OUR proposes to have an involvement in the save to spend reserve. GEL are of the view that scrutiny by exception is the only requirement as the fully qualified Board of Directors and TRD provide all the necessary corporate governance in the use and disclosure of cash and its use. GEL believes that the OUR should make modelling assumptions explicit at the point of a price review but should not be involved between price reviews.

If it were to be the OUR's intention to be involved during the price control period, then the nature of this involvement would need to be set out in full so that GEL can assess its impact. The Regulatory Policy Institute concluded that the lack of full detail of regulatory proposals in previous price controls caused ambiguity and disagreement in the past. The lesson learned from this is that GEL should not agree to aspects of a price control if the details are not unambiguously set out in full at the time of the Final Decision.

If the OUR is considering involving itself in the establishment and management of GEL's capital programme, then such an involvement would go well beyond any reasonable regulatory process and to a large extent would duplicate the role of GEL's Board and executive management. Such intrusion would result in further wasted time and money for islanders and is wholly inappropriate. It could be considered that the OUR would be taking the role of a shadow director.

4.3 Rate of Return

GEL sees no reason to re-examine the rate of return for either pre- or post-commercialisation assets at this time. In fact, GEL seeks as much stability to the financial fundamentals of the price control as possible.

4.4 Capital Expenditure & Incentives

GEL is pleased that the OUR has agreed to GEL's capex programme following the work by their consultants during 2010. This study by the OUR's consultants has not led the OUR to decide to defer or reduce the need for capital expenditure.

The proposed publication of plans is an unnecessary step since any required information can be provided to the OUR by GEL. GEL's plans will undoubtedly and necessarily change over time in order to adapt to changing circumstances. The formal publication of timetables, milestones and benefits within the price review period would result in time and resources being expended on public explanations of necessary changes rather than adding any value to the investment processes. It would also result in increased costs and could prejudice GEL's negotiating position with suppliers. The OUR has more than sufficient powers to deal fully at the time of a price control review with any investment concerns that arise. GEL is concerned that a disproportional amount of time could be spent on this new regulatory reporting requirement.

The incentive scheme proposed for GEL's capex activity is perverse and effectively holds GEL responsible, amongst other things, for variations in the weather. The problems associated with this proposal are dealt with later in this response under the relevant section.

GEL notes the comment made by the OUR as follows:

"It was noted that customer's own investment in backup generation helps to reduce peak demand".

This comment is fundamentally flawed – customers' backup generation does not in any way reduce peak demand.

Customers install backup generation in order to protect themselves against the risks associated with local distribution power system failures which occasionally happen. Whilst it is GEL's purpose to ensure that overall power system reliability is acceptable to the vast majority of customers, some customers have a particularly high risk associated with the failure of their electricity supply and, therefore, quite rightly seek to mitigate this risk by installing backup standby generation. This backup generation is not called upon to run unless the main power system fails, so it makes no contribution at all to any reduction in demand.

Whilst it might be possible to contemplate such equipment being used instead of the normal power supply at times of high demand, this is unlikely to be acceptable to customers who fit such equipment because its primary purpose is to protect against power system failures. If the equipment becomes part of the normal power generation fleet of the island then its purpose as backup will be fatally compromised.

4.5 Tariffs

GEL agrees that it is not appropriate for the OUR to attempt to address all of the tariff issues in this one year price review. GEL accepts in principle a process of a tariff review and seeks more detail on the OUR's proposals. GEL would seek confirmation from the OUR as to precisely how any rebalancing exercise would operate at the same time as the new CPT mechanism is being examined. The exercise should be a rebalancing exercise such that any identified reductions in revenue from certain tariff offerings would be exactly matched in revenue terms by increases in revenue from other tariff offerings. GEL seeks the OUR's recognition of the inevitable scope for there to be those who pay more for their electricity after a tariff rebalancing exercise. This feature of any process needs to be accepted and taken into account before the process commences.

4.6 CO_2 Emissions

In December 2007 the OUR was asked to progress a specific task area on Energy Policy in conjunction with GEL – the issue of favouring the cable link interconnector as a low carbon emission source (see 4.7 below). We welcomed that work stream but we do not believe however that it is necessary or appropriate for the island's regulatory arrangements and the OUR's process of a price control to be used as means to provide or standardise data on CO_2 emissions and other environmental information. We look forward to being invited to work with the OUR on the actions originally requested by the States. This section of the OUR's Draft Decision did not put forward any specific proposals in this area and we await further action from the States of Guernsey.

4.7 Favouring the cable link as a low carbon emission source

There were no proposals in the Draft Decision on this topic. As with CO_2 emissions, this issue is a matter of policy for which the States of Guernsey has competency rather than the OUR.

4.8 Operating costs

The OUR has conducted several efficiency studies of GEL in the past. Despite its poor quality, the previous work by consultants PPA that is referred to was indeed used by the OUR at the time of the DG's Final Decision in February 2007 for the current price control running from 1 April 2007 to 31 March 2011. The balance of planned efficiency improvements that this refers to continues into a new price control period. GEL notes the inclusion of the balance of this efficiency saving reflected in the OUR's new financial model for 2011/12 as presented to GEL with the Draft Decision Document OUR 11/04.

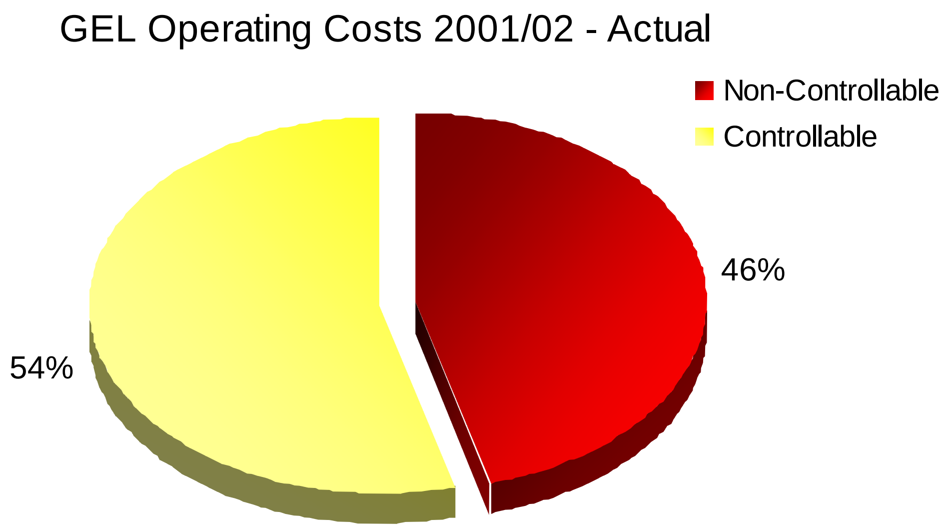
GEL's comments on the comparator information presented by the OUR on operating cost efficiency are dealt with in section 5.1 of this document. These comments show that such information is not relevant to GEL's circumstances. However, the Draft Decision uses the information to propose that GEL save a further 5.5% per annum each and every year of the forthcoming four years (the time frame covered by the supporting OUR model). It is not made at all clear in the text of the document that this actually represents a reduction in controllable costs in excess of 20% over the next four years in a business that is growing. Subsequent conversations with the OUR have stated that these levels of cost reduction – which appear explicitly in the Financial Table in Annex B - are only indicative and are not proposals. However GEL can only assume that the figures in the document are a part of the draft of the DG's decision.

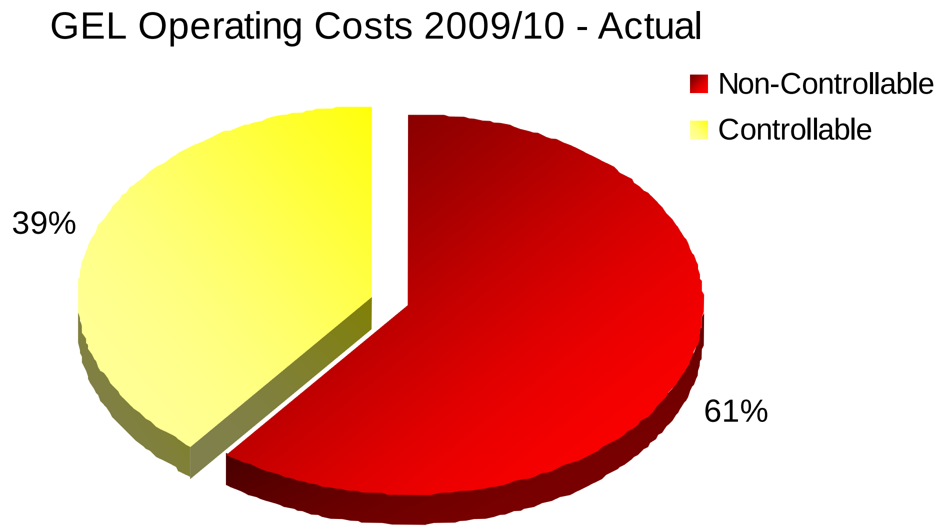
The OUR seeks to justify this assumed cost improvement by reference to historic UK performance and by comparison to Guernsey Post. Such comparisons are not valid – either in terms of a different time period and scale or in terms of an unrelated sector which is in decline. GEL has already made major efficiency improvements - both before and after commercialisation and is committed to a further review (see Section 5.1). GEL continues to seek opportunities for more efficiency through its operational activities and its change management approach.

At the same time, total operating costs must be put into context by identifying those which are controllable and those that are non-controllable. The non-controllable costs are those that are used in the methodology of CPT as referred to in section 4.9 of this document.

Figure 1 below gives an indication of the evolution of controllable costs in relation to non-controllable costs since commercialisation

Figure 1: Operating Costs – Controllable and Non-Controllable

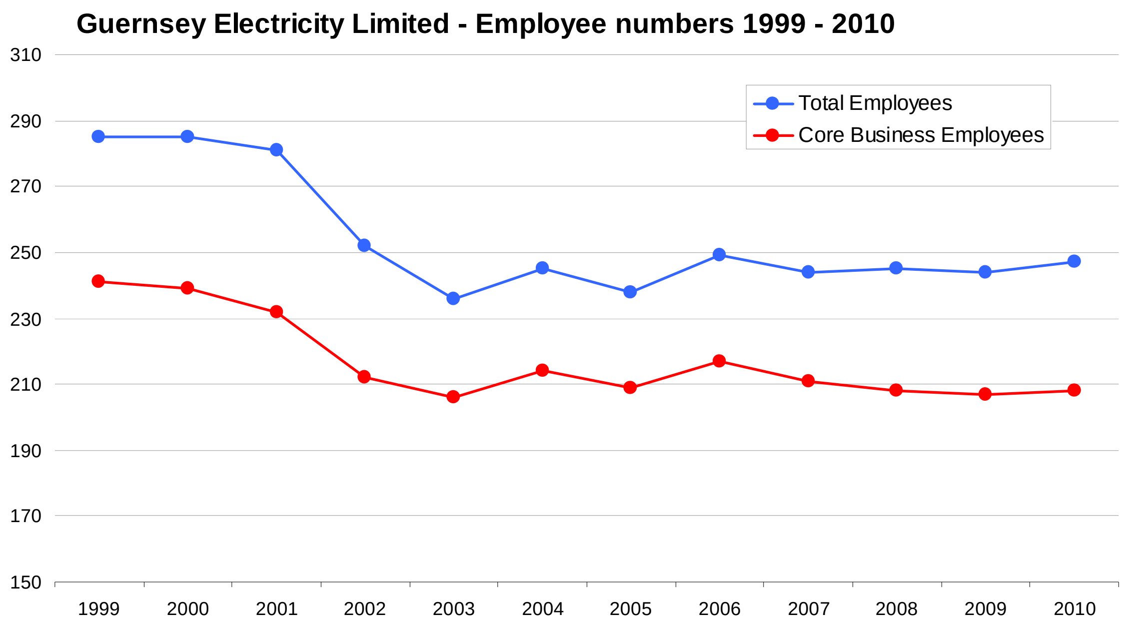


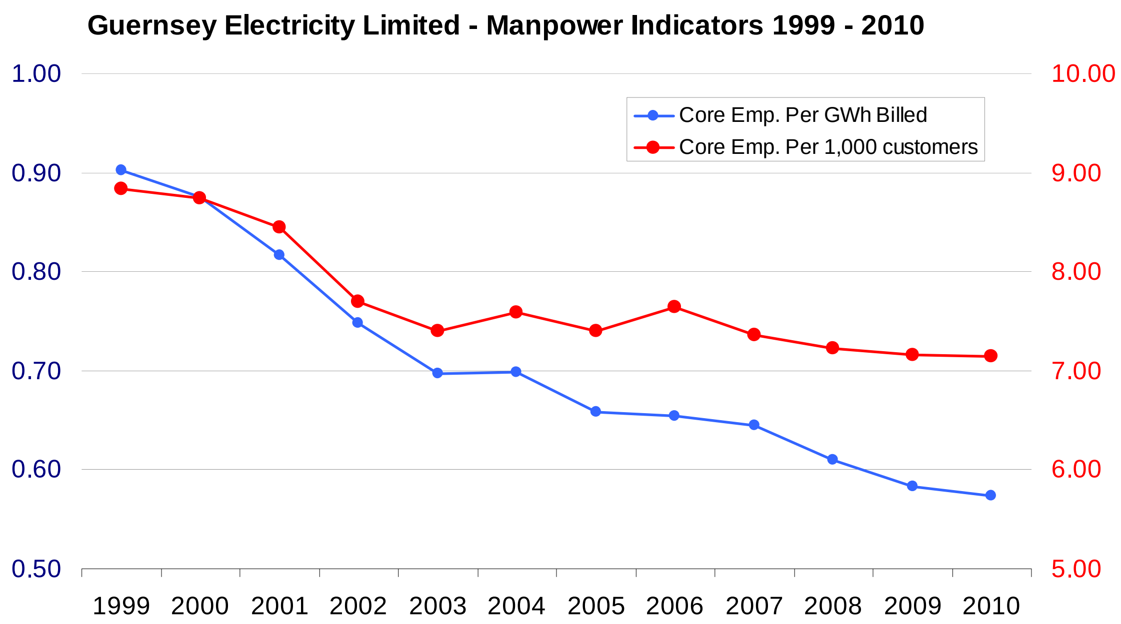


The controllable costs are clearly a diminishing proportion of the total cost with GEL's actual for 2011/12 representing only 39% of the total operating costs (in 2001/02 such costs represented 54%).

The approach which the OUR hopes is *"pragmatic and high level"* for forecasting future operating cost levels is in fact flawed, inappropriate and without valid justification.

In respect of staff numbers and productivity, the following two graphs indicate the significant head count reduction and the productivity of those staff in relation to units billed.





These issues in the Draft Decision relating to operating costs allowance forecasts are of such great concern to GEL that they cannot be accepted in their present form. Placing GEL in such a situation can be avoided by removing this from the Final Decision for the one year covering the GEL financial year ending 31 March 2012.

GEL welcomes the OUR's recognition of the States of Guernsey taxation policies which are increasing indirect taxation, for example, Tax on Real Property (TRP), in terms of step changes in costs. However GEL has a growing market and a very significant capital investment plan to support and factors such as these also need to be recognised. Using Guernsey Post as a comparator for GEL is therefore inappropriate (see section 5.1).

The OUR's approach to seek to place more information in the public domain needs to have proper regard to the commercial confidentiality issues involved. In the Guernsey Energy market there are competitors who will use this public disclosure against GEL. Even if it were possible for the OUR to require all parties in the Guernsey energy market to disclose the corresponding information, there is still an issue as to what is appropriate public disclosure. GEL's statutory accounts and regulatory accounts are already available to all in a sufficient level of detail to understand the financial position of the company. There is <u>no</u> public disclosure by any party that is a competitor to GEL in the Guernsey energy market.

Since no organisation is ever 100% efficient, GEL has a policy of continually and pragmatically reviewing its operating efficiency and proposes a further review during 2011, the results of which will be disclosed to the OUR upon completion. If the OUR reviews that work and does not accept GEL's assessment, then GEL would suggest that at that stage an agreed terms of reference should be prepared jointly by GEL and the OUR for a consultancy study. If such a study concludes that further efficiency can be improved and proposes suitable measures then GEL will engage in the process with appropriate effort. In the meantime, the regulatory approach should await improved efficiency proposals based on evidence and practicality not speculative assessment.

4.9 Pass Through mechanism (CPT)

The DG indicates that he is *"not persuaded that GEL should be allowed to make its own price adjustments within year"*. However no reasons are given for this view. It is contrary to the findings of the Regulatory Policy Institute which go further to say that GEL should have a more extensive remit to set its own prices in the first instance – beyond just the setting of prices to true up forecasts within the year (e.g. on 1 October), which the OUR proposed not to allow.

The cost pass through allowances set out on the Draft Decision fundamentally change the basis upon which allowances for the recovery of non controllable costs incurred are calculated by the OUR. Whilst GEL found that the original basis required review, GEL is surprised and disappointed to find that the net effect of the OUR's examination is to redefine the CPT arrangement by which the recovery of non-controllable costs is determined. This appears to result in a materially lower recovery of the costs actually incurred by GEL. Most worryingly, the cost recovery rules are being changed to an inconsistent basis for different periods in the same price control. We would expect to see consistency of the treatment of costs through the four year price control period. As a track record for regulatory uncertainty and risk this sets a very concerning precedent. Furthermore the proposals are incomplete in not dealing fully with costs in respect of the year 2010-11. If the OUR do not alter their view, we will be presented with a Final Decision that is unclear as to how the balance from the price control period ending 31 March 2011 will be recovered in the future.

GEL notes the OUR's view that the proposed mechanism *"allows any price or currency hedging carried out by the company to be considered taken into account and it allows for shortfalls (or surpluses) in overall revenue to be recovered."* GEL seeks clarification from the OUR on whether commodity and currency hedges in their entirety will be allowed under the CPT formula. There should be no ambiguity on these or any factors regarding pass through arrangements. GEL's more detailed comments in these areas are dealt with in Section 6 and Annex C and the overall impact of these proposals upon GEL and its customers is highly material.

These are issues of such great concern to GEL that they cannot be accepted in their present form. Placing GEL in such a situation of not knowing if the effects of hedging activity in future years will or will not be allowed for by the OUR is not necessary. In the short term, this is because the price control can and should be set for just one year at the present time.

4.10 Summary

The summary section proposes that the main changes implemented as a result of the consultation are the following:

- Move to a single year price control for 2011-12 – GEL agrees with this approach as an interim solution pending the outcome of the States' Review;

- Apply price limits on a revenue cap rather than on a tariff by tariff basis – this is largely irrelevant to the proposed one year price control since tariff rebalancing awaits the new process to be set out by the OUR, which will not be completed until well after 1 April 2011;

- Request GEL to publish all its tariffs, including its buy back tariff – this can be considered;

- Trial the capex incentive mechanism on a one year basis – no trial is needed before identifying that the approach is fundamentally inappropriate and unworkable. In any case, it is not specified in the document what precisely is to be trialled; and

- Revise the cost pass through mechanism to simplify it and enable it to be applied sooner – GEL does not accept that the Draft Decision has fully considered the impact and solution for the recovery of efficient non-controllable costs.

5. Scope and Principles of the Draft Decision

5.1 Allowable Revenue

<u>Operating costs and efficiency</u>

The DG is proposing to apply efficiency, targets to GEL's operating cost submissions without any analysis of those costs. GEL's cost submissions take account of the fact that it will be undertaking more activity with broadly the same resources in areas where its business is growing and where a very significant level of capital expenditure needs to be planned, delivered and managed. The charts used on pages 17 and 18 of the Draft Decision are misleading since the figures being compared are on two different bases.

The OUR proposes that the figure on page 18 shows scope for efficiency savings but these figures are very old and go back to 1992. Even the most recent period relating to Water/Sewerage ends in 2005 - some six years ago. The data in the figure used by the OUR on page 19 is some 11 years out of date.

The OUR is mistaken to describe this data as *"a useful context"* for *"industries that in many important respects share common features with GEL"*. The data is not just very old but is based on contexts outside Guernsey and for very different utilities rather than a small integrated island-based electricity company in 2011. The UK context of these other sectors is very different from the situation pertaining to GEL at the present time. As just one example, GEL had already reduced total company staffing levels from 285 in the year 2000 to 247 in 2010 (276 to 232 Full Time Equivalents). The companies quoted also relate to very large organisations operating in jurisdictions with large numbers of customers. GEL conducts its business in a small island economy where economies of scale have already driven efficiency savings and optimisation into the organisation. The size and complexity of the business is such that further significant short-term efficiency savings can only be made by reducing or removing services or products.

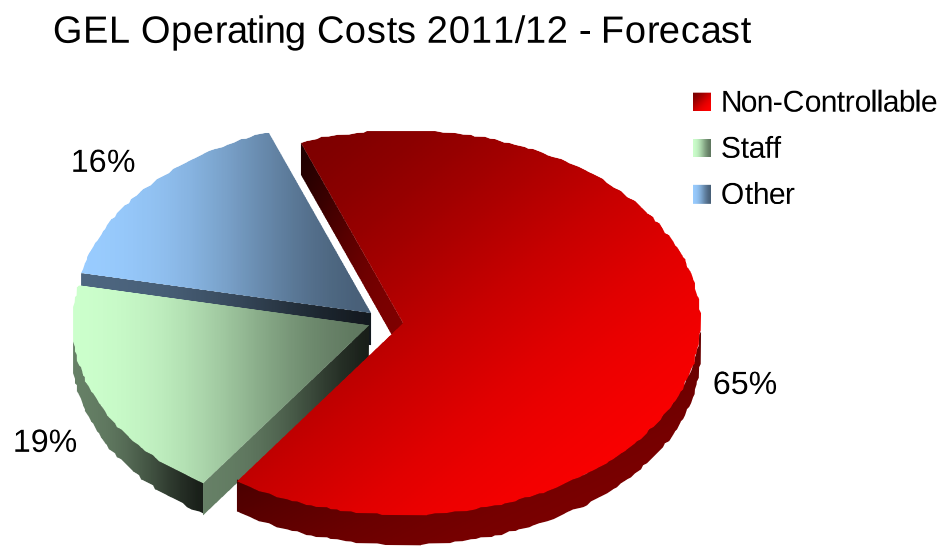
Based on the above, GEL does not agree with the presentation of the UK economic data made by the OUR and the assertion that the actual efficiencies achieved by the UK companies in anyway represents savings that could be made by GEL.

Guernsey Post is relevant in terms of geographical location but belongs to a sector with very different features to GEL's. The postal market is declining in volume rapidly whereas the electricity market is growing substantially year on year. The electricity sector is highly capital intensive in nature and is approaching a peak in the investment cycle with activity considerably greater than the cycle norm. GPL bears no similarity to such conditions and is having to consider service reductions in areas. It would appear that the only similarity is that it is also a States-owned utility operating in Guernsey. To offer GPL's 'target' efficiency savings as support for proposed efficiency savings at GEL does not provide evidence for potential savings. We understand that some of the potential savings for GPL might come from a reduction in service level.

In addition to the above comparison in relation to size and environment, the Draft Decision takes no account of the efficiency savings already made. Working practices and technology will filter through in all industries and, combining this with the economy of scale issues raised above, GEL has already seen its employee numbers drop substantially. This is in a business that not only transmits and distributes electricity but also generates and retails electricity, unlike the majority of the references given.

GEL already promotes continuous improvement and is one of the first utilities to introduce smart metering which again reduces operating costs in the long term. In GEL's core business there are few further opportunities to reduce costs and hence service levels without fundamentally affecting the security of supply of electricity. That is not to say that GEL is not looking for further optimisation of its assets and resources. For example, with CED, GEL is working on solutions to reduce or realign certain services which are currently provided.

As an organisation which is directed to add value to the island and its customers, GEL sets budgets which challenge the organisation to improve this value. It should be taken into context that well over 60% of costs incurred by GEL in the course of its activities are uncontrollable (65% forecast for 2011/12) and whilst we mitigate against risks that could adversely affect these costs, they remain uncontrollable.



Consistent with GEL's price control submission, all currently planned efficiency savings and optimisation of the organisation are included in our forward budgets. The target levels presented in the Draft Decision are, in our view, not only unrealistic but are unsupported. Any future efficiency targets should be based on objective efficiency reviews which take into account the operating environment in Guernsey and also the wider context of energy and States' policy.

To achieve the levels given in the Draft Decision could in reality mean reducing "real" actual controllable costs by over 20% over four years. Actual controllable costs are those that are not variable related to generation, such as, essential spares stock and consumables relating to running hours. Therefore, the only areas that in reality could be reduced are employees and this would result in a reduction of service level. Compare this to the requirement to build further resilience into key electricity infrastructure and it could appear that the unsupported efficiency targets are diametrically opposed to the civil contingency and energy policy directions for the island.

Since no organisation is ever 100% efficient, GEL has a policy of continually reviewing its operating efficiency and proposes a further review during 2011, the results of which will be explained to the OUR upon completion. If the OUR reviews that work and does not accept GEL's assessment then GEL would suggest that at that stage an agreed terms of reference should be prepared jointly by GEL and the OUR for a consultancy study. If such a study concludes that efficiency can be improved further and proposes suitable measures, then GEL will engage in the process with appropriate effort. In the meantime, the regulatory approach should await improved efficiency proposals based on evidence and practicality not speculative assessment.

In summary, GEL continually introduces efficiency savings into its operations and activities and will continue to do so in future. It is, however, against forcing through savings which adversely affect the value and service it offers to the island. It is GEL's opinion that without detailed and supported efficiency reviews, this will be the outcome.

GEL is not objecting to the proposed headline level of tariff increases on 1 April 2011 by the OUR but cannot accept the underlying efficiency assumption upon which the Draft Decision is based. This issue of allowing the company a proper operating costs allowance is of such great concern to GEL that it cannot be accepted in its present form. Placing GEL in such a situation is not necessary however, since the price control can and should be set for one year.

Regulatory Asset Base, Depreciation and Cost of Capital

"The current total regulatory asset base is £91.2m (NBV). This is split between assets inherited at commercialisation £65.8m and new assets £25.4m."

This fundamental was established in previous price controls and remains appropriate for the 2011/12 price control.

5.2 Core and non-core assets

This section of the Draft Decision raises some issues of principle without specifying: the precise matters being investigated by the OUR; the magnitude of the amounts involved; or the proposed remedy to any specific concerns. GEL has clarified the position on these matters which were incidental to the tariff data under consideration. This has subsequently been clarified following a meeting between GEL and OUR staff.

5.3 Level of Profits, Tax and Dividends

This section of the Draft Decision states:

“The level of profits “targeted” each year is determined by the return allowed on the regulatory assets and by the degree to which the company over or under achieves its efficiency targets and the level of delivery against any other incentive schemes in operation at the time.”

This theoretical position has never operated for the regulation of GEL, since past price controls have not made the necessary adjustments in a full and timely manner via the pass through mechanism such as to compensate for the much larger issue of the volatility of electricity import and generation fuel costs. Importantly, the OUR is not proposing to permit GEL to adjust tariffs within the year and furthermore, the proposed new CPT mechanism in the Draft Decision shows no feature which will change the dependence of GEL profitability largely upon factors outside its control, as a result of the current regulatory price formulae.

The shareholder’s expectations have not been met and this subject has been discussed many times with TRD. Whilst they have accepted some years in which there has been no dividend it is expected that a reasonable return should be achieved over a period of years.

5.4 Capital expenditure

GEL welcomes the absence of any adjustments to its capital investment plan.

Investments should however be included in the RAB at the time of the price control and reviewed at the time of the next price control. Between those time periods, the inclusion of capital expenditure in the RAB should not be dependent upon other events. Capital expenditure on core activities should be included in the RAB in the year of expenditure and then periodically reviewed.

GEL has a number of serious concerns with the OUR’s proposals. The most relevant OUR statements from the Draft Decision document are:

(a) *"The DG indicated in his earlier consultation his intention to allow the investment programme as proposed by GEL. There are no specific adjustments to this investment programme. However, the DG proposed that an incentive mechanism be set up to include investments in the company's RAB only when completed and, in the case of increased generation capacity, when required, in line with increased peak demand from customers to meet the N-2 security of supply obligation".*

(b) *"The DG has decided that in accepting GEL's proposed investment plan as it stands, there is a need both to monitor progress against that programme and to put in place an incentive mechanism to share the risks between customers and the shareholder.*

GEL should provide a more detailed summary of the investment programme setting out the investment profile of the main projects (those with a value of > £1.0 million), key milestones and the forecasts of (maximum) demand and other relevant performance measures that are driving the investment. This will need to be updated annually and reviewed by the OUR against the incentive mechanism set out below. The DG plans to publish the details in the Final Decision document in March."

Background to GEL's concerns

The high levels of investment GEL expects over the period 2010/11 to 2014/15 are largely driven by two major projects.

(a) GEL's participation with JEC in the construction of an additional Jersey/France submarine cable (Normandie 3).
(b) The construction of new local diesel generation capacity.

It is important to be aware of the practical effect of the statements in the Draft Decision. Statements (a) and (b) taken together direct that:

(i) GEL will not be permitted to make any return on investments until the assets these investments are designed to create are in service.
(ii) GEL will be penalised for the construction of generation assets whose full rated capacity is not immediately required.
(iii) The "incentive mechanism" will be trialled in 2011/12.

Delay of return on investments

The expected cash outflows submitted to the OUR in respect of these two above projects were as tabulated below:

Real Basis	2010/11 (£ millions)	2011/12 (£ millions)	2012/13 (£ millions)	2013/14 (£ millions)	2014/15 (£ millions)
Normandie 3	1.0	3.25	6.6	3.9	-
Diesel (2D)	2.95	2.95	2.95	2.95	-
Total	3.95	6.2	9.55	6.85	-

On this real basis profile and assuming project completion by the end of financial year 2013/14, the OUR statement (a) and the resulting delay in these investments being permitted to enter the regulatory asset base will have the effect of reducing GEL's annual revenue by:

[3.95 x 5.97% x 3 years] + [6.2 x 5.97% x 2 years] + [9.55 x 5.97% x 1 year]
= 0.707 + 0.74 + 0.57
= £2.0 million

Notwithstanding that the timing and amount of cash outflows may change, the principle that the OUR statement (a) contains, will result in a highly significant loss of revenue for GEL.

It is normal commercial practice in the development of major power system infrastructure to agree stage payments with contractors. To attempt an alternative payment profile so that no payments are made until project completion would not be in accord with accepted construction contract practice, since it would involve the contractor in unacceptable risk. Given that GEL, in agreeing to stage payments, will be proceeding in accordance with standard industry good practice, there is no reason why the OUR should seek to penalise the company for this behaviour.

5.5 Incentive Mechanism for Capital Investment

The relevant paragraphs of the Draft Decision are as follows:

"The most significant part of the investment programme is the installation of new generation capacity to meet forecast increases in peak demand. The DG proposes to reduce GEL's allowed revenue by an amount equal to the return on investment for each unit (MW) that peak demand falls below the level forecast by GEL.

Revenue adjustment = (MW shortfall/capacity increase)
x (cost of increase) x RoR

So, for example, if the investment required for an additional 12MW capacity is £10, and maximum peak demand is 2MW less than GEL's forecast, the adjustment would be:

Example adjustment:

2MW/12MW x £10m x 5.97% = £0.1m

The DG recognises that this mechanism is more appropriate in the medium or long term price setting process, when the ups and downs in peak demands and in forecasting will tend to average out over a number of years. Nevertheless, the DG proposes to include the mechanism in this one year price control to give an opportunity for the process to be trialled".

<u>The "incentive mechanism"</u>

In the sections above, GEL has clarified the effect of the OUR's statements. Consider firstly clarification (iii) above, that the OUR intend trialling their proposed "incentive mechanism" in 2011/12.

As the OUR are aware, neither of the two major projects discussed in (ii) are expected to be complete until – at the earliest – the financial year 2013/14. There will, therefore, be no additional capacity until 2013/14. Thus it is quite impossible for the "incentive mechanism" proposed to be trialled in 2011/12. The trial proposal is misguided and unworkable.

Notwithstanding that the trial proposal cannot work, the mechanism itself is also wholly unreasonable as the following analysis will demonstrate.

Elements of the "incentive mechanism"

The principle driver of the "incentive mechanism" is the ratio of maximum demand MW shortfall/capacity increase. For penalties to be avoided then GEL must seek to reduce the "MW shortfall" figure to the minimum value possible. Presumably the OUR intends that this must happen either by:

(a) Better forecasting
(b) Smaller capacity investments

Consider each of these matters in turn.

Maximum demand forecasting

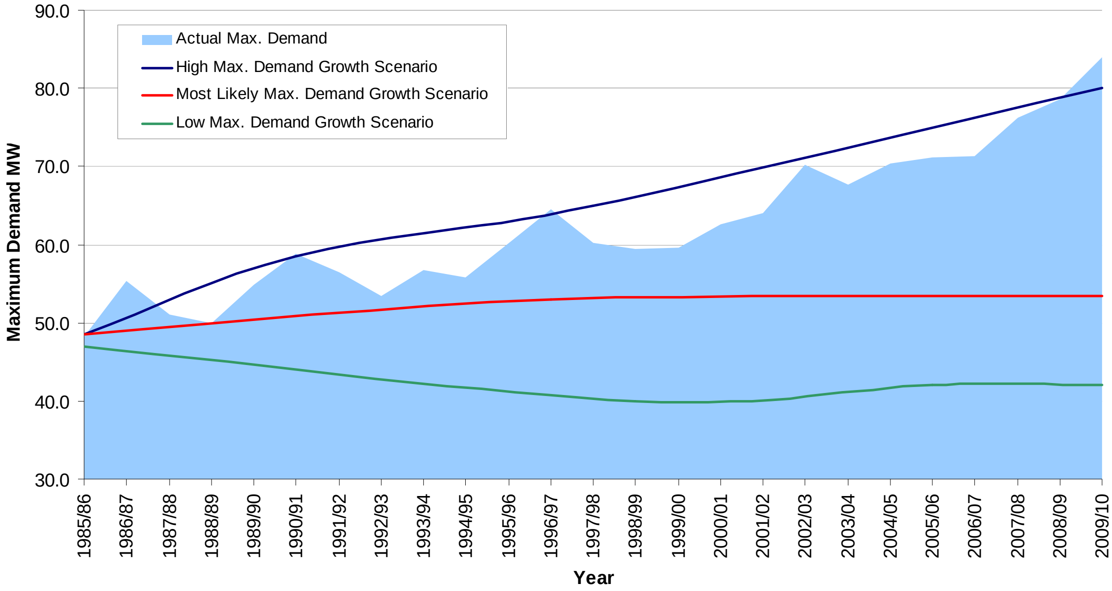
In considering the role of maximum demand forecasting it should be noted:

(a) That GEL does not control maximum demand; rather it is created and controlled by customers.
(b) Given that it is customer driven, maximum demand will be affected by a number of factors such as the weather, the state of the local economy and the completion (or otherwise) of major building development projects.
(c) Given these uncertainties then it is quite inevitable that no forecast will be accurate.

Set out below are some demand forecast graphs produced by extremely reputable firms of consulting engineers to demonstrate the uncertainties involved. It is generally acknowledged that preparing a fully accurate forecast is impossible, yet the OUR proposes to fine GEL for failing to achieve the impossible.

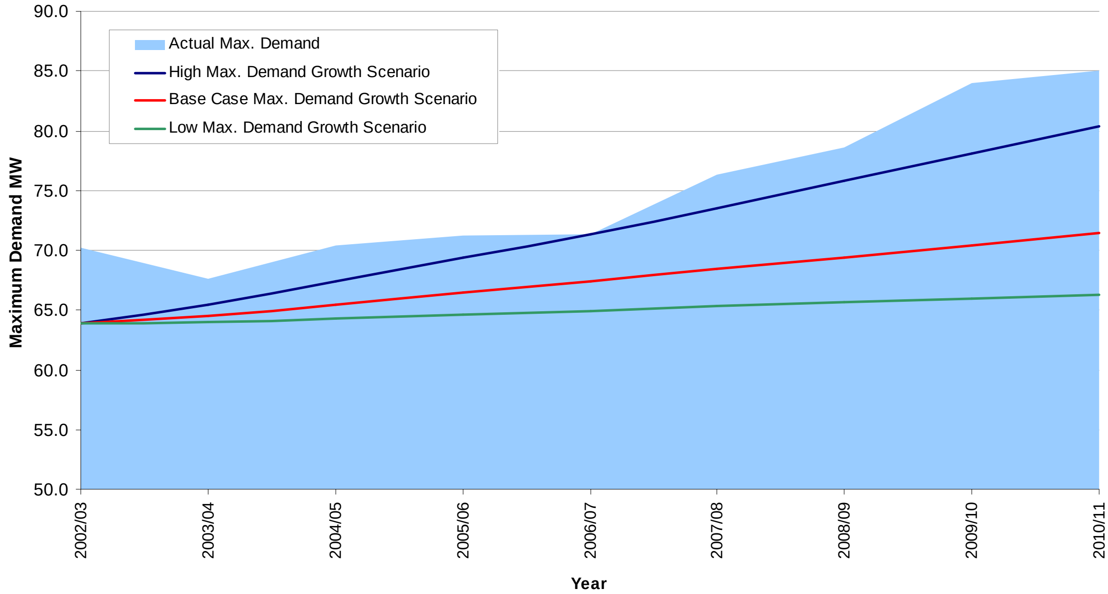
Consulting Engineers to SGEB - 1986

long term maximum demand growth forecasts for States of Guernsey Electricity Board (reproduced)



Consulting Engineers to CED - 2005

long term maximum demand growth forecasts for Department of Commerce & Employment Office of Utility Regulation (reproduced)



Smaller capacity investments

It is comparatively straightforward to recognise that an increase in maximum demand of, for example, 2MW per annum could be satisfied by installing a new 2MW diesel engine each year. Such a planting plan would, theoretically, be economically efficient since investments would be made in a smooth and timely manner and would exactly match the requirement. Unfortunately, economic theory and practical reality do not match. If GEL attempted to plant in such a manner its capital costs would increase since the installed cost per kW of small machines would be higher and its fuel and maintenance costs would also increase steeply, since the smaller machines would have lower thermal efficiency and greater operating costs per megawatt hour produced. The lower thermal efficiency would also lead to increased CO_2 emissions.

In addition to these problems, the footprint of such small machines would be larger for the installed capacity, which would rapidly lead GEL to require more land area. Inevitably there has to be a trade off between the conflicting requirements of “little and often” planting, with its optimised investment flows and “big and seldom” planting, which ultimately has lower capital and operating costs but with lumpy investment profiles.

These matters were discussed at considerable length with the OUR’s consultants, PB Power, who concluded, on balance, that the practical advantages of using large machines in the output area of 17MW justified their purchase. If this is the case then it is inevitable that there will be a step change in capacity at the time a new generator is commissioned, so that for a period, capacity will significantly exceed both actual and forecast demand.

The OUR’s Draft Decision states that GEL’s investment plans have been accepted, so the track of capacity is known, with the inevitable short term excess of capacity over demand. Yet the OUR still proposes to fine GEL for the provision of capacity which it has agreed to and which is required to meet customers’ needs. GEL regards such a mechanism as perverse and wholly unreasonable. If the Final Decision document contains such a mechanism then the decision will not be acceptable.

<u>Summary</u>

The proposal of an incentive mechanism in the case of increased generation capacity to include investments in the RAB only when required by increased peak demand from customers is unreasonable for five main reasons. The proposal would mean that:

(i) should a winter be more mild than average (as we have experienced in January and February 2011) and electricity demand is consequentially lower, that in GEL will be penalised – essentially as though GEL were responsible for the mild weather;

(ii) should a reduction in demand occur as a result of a general economic downturn or large demand reductions from a small number of large customers, that GEL will be penalised – essentially as though GEL were responsible for those general economic and specific commercial eventualities;

(iii) that GEL will be rewarded under no circumstances and yet faces an unpredictable penalty;

(iv) GEL will therefore be incentivised perversely to err on the side of delaying spending wherever possible since GEL faces a penalty if investment is early and so is less likely to be penalised if investment is late. This bias to delay investment is contrary to customers' interests; and

(v) the proposed penalty rate is so large that GEL's already volatile profitability performance will not only be subject to the vagaries of pass through cost fluctuations but will also be materially afflicted by random changes in demand due to a range of factors including the weather.

Since the OUR's proposals are perverse and unworkable in their present form, it is premature to publish further details of GEL's investment plans in the Final Decision. Furthermore, the proposed approach of an annual incentive mechanism with publication and review on an annual basis – when review at periodic price controls is sufficient – is not a case of limited regulation which is proportionate to Guernsey.

The DG recognises that the proposal could only really be contemplated over a period of several years and yet then proposes that it could be adopted and "trialled" for a single year on 2011-12. Such a position is unworkable in GEL's view and adds unnecessary and unreasonable uncertainty to GEL's revenue forecast for no benefit to GEL or customers.

5.6 Save to Spend

Section 4.2 above is also relevant to this section.

GEL notes the OUR's comments on sufficiency for financial investment in this section. GEL strongly believes that the package of proposals in the Draft Decision presents a volatile and uncertain basis upon which any company might be expected to invest.

In this section of the Draft Decision the DG states: *"It is therefore possible that if circumstances change, he would need to allow GEL to increase prices to help finance future investments"*.

This appears to leave GEL potentially in a position of cash flow risk with an ambiguous regulatory position statement as the solution. As for any business, GEL needs as much certainty as possible and under the current regulatory framework, uncertainty is being created unnecessarily. This is not good for Guernsey and GEL hopes that the OUR will seek to focus solely upon completion of a very small number of issues in the Final Decision so as to reduce the uncertainty and risk faced by GEL from the regulatory framework, while it is being fundamentally reviewed by the States.

6. Cost Pass Through

GEL has been having such fundamental difficulty with the operation of the pass through arrangements under the 2007-2011 price control that in August 2009, GEL was compelled to ask the OUR to undertake a complete review of the price control model. The Draft Decision now takes a view on the treatment of pass through costs across a range of relevant issues, at variance to the formulae and fundamental bases set out in the Price Control Final Decision of February 2007 for the period 2007 to 2011.

GEL believes that the OUR's proposals on cost pass through contain a number of features in the Draft Decision document which are inappropriate. These are:

- the continued disallowance of exchange rate costs for the period 2007/08 and 2008/9 even though the OUR proposes to allow such costs for later years – this is inconsistent and punitive in effect;
- the redefinition of legitimate fuel oil costs as being on the basis of consumed fuel oil rather than delivered fuel oil only at the very end of a four year price control – this is inconsistent and retrospective in nature and is punitive in effect;
- the introduction of the concept of adjustment only if GEL is worse than benchmark, e.g. hedging, i.e. no symmetry;
- there is no acceptance of smoothing the recovery of additional non-controllable costs over more than one year;

- the re-setting of pass through allowances for the year 2009/10 to a revised basis from the one originally applied – this adds a regulatory precedent creating considerable and unnecessary regulatory uncertainty for the future;
- the lack of substantial progress in identifying clearly the proposed pass through costs for 2010/11, even though actual data is available for the majority of that period and forecast data can be used until the full year of data is available in a few months' time;
- the specific and new treatment of pass through costs for the year 2010/11 for treatment either according to the original definition of pass through costs or according to the one now proposed for the first time in the Draft Decision Document (or possibly another version yet) – this potentially compounds the essentially arbitrary nature with which GEL's costs are being revisited retrospectively without the absolute clarity and consistency of treatment which could reasonably be expected by a regulated company;
- the isolation of pass through costs for the year 2010/11 for treatment either at an October 2011 tariff change in isolation or in 12 months' time – which appears not to take into account the extremely large and unsustainable tariff increases in October 2011 which this would imply;
- no certainty of the balance of costs incurred (but not recovered) in the four year price control ending 31 March 2011, or any time of recovery;
- on page 26 of the Draft Decision reference is made to "Delayed income". This is misleading as the value of unbilled units referred to is fully accounted for in GEL's statutory and regulatory accounts; and
- GEL is not being allowed to smooth price changes for customers. GEL is mindful of the impact of substantial increases in electricity tariffs on the Guernsey economy but is not being allowed by regulation to smooth price increases over time.

The DG notes that *"general regulatory practice is to treat each new price control as a complete review of the financial position of the business".* This is correct with regard to determining future revenue levels. It is not standard practice to change the definition of allowable costs relating to periods in the past and apply them retrospectively for the first time, for the past period, only at the price review. This retrospective approach undermines the regulatory framework, since the company can then have much less certainty of its future financial position if this type of regulatory practice is conducted at the time of a price review.

There are at least three different bases underlying the different figures presented in tables on pages 24 to 26, whereas the focus of the accompanying words appears to be the updating of GEL's estimates over time. We have provided regular updates on the estimated figures and the October 2009/10 estimate required an update because the least cost generation / import production mix was different - reflecting changing wholesale costs. The OUR should make visible within its Draft Decision that it has proposed to change the bases of its CPT calculations. Such visibility is required since these changes could have a material effect upon GEL's revenues and customers' prices.

This issue of the variable and shifting treatment of pass through costs is of such great financial significance and such fundamental concern to GEL that it cannot be agreed to in its present form. The DG's Final Decision the OUR should set out its details for any treatment of all pass-through costs unambiguously, both in terms of principles and the bases of all values used. It is recognised that the actual 2010/11 values will not be available until after 1 April 2011, but we already have 10 months of actual data and so the OUR's proposals based upon this data could be explicitly included.

The OUR have repeated to GEL that 2007/08 and 2008/09 calculations are closed. This results in an inconsistent treatment of the company's costs within the same price control period and unjustly penalises GEL. If the principles applied in one part of the price control period are correct in the OUR's view, then those principles should be correct for application across all 4 years consistently.

7. Draft Decision

The OUR states that the price proposals for future years in this section *"serve as a guide to what is likely to happen to future prices but will not form part of this price control"*.

GEL is unclear as to what might or might not occur if wordings as vague as this remains in the Final Decision document. Under such circumstances, GEL would be unable to make commitments to its stakeholders.

Given the States' Review, GEL calls for the operation of a 1 year Price Control with the only clarification required of the OUR being interim tariff levels to be announced for 1 April 2011. There is no need for the OUR to go beyond this scope in the Final Decision. All other matters should be dealt with following the States' consideration of Regulatory Reform for the electricity sector which is planned to go the States later in 2011. Elements which *"serve as a guide to what is likely to happen"* beyond this time are not appropriate for the Final Decision and should be dealt with outside the formal conclusion of this price control.

8. Next Steps

We note:

(i) the OUR's deadline of 4 March for the receipt of responses to the Draft Decision document,
(ii) the implementation of tariff changes from 1 April;
(iii) the need for the OUR to consider responses received;
(iv) the need for the OUR then to revise and publish its Final Decision proposals;
(v) the need to give reasonable notice for customers; and
(vi) the need to allow GEL time to consider its acceptance or otherwise of the Final Decision

It is therefore clear that the OUR's proposals are highly unlikely to be modified and implemented on time unless the arrangements are reduced in scope to a very considerable degree. This would be consistent with GEL's firm view that nothing other than the headline tariff levels on 1 April should be agreed, pending the outcome of the already-planned States' Review of the entire regulatory framework for electricity.

Annex A – Tariffs

GEL has no suggested amendments to this table.

Annex B – Financial Tables

Page 28 of the OUR document 11/04 and its Annex B show two related tables. Both tables cover each of the five years starting 2010/11 and are all estimates. 2010/11 is the last year of the current 4-year price control period which ends on 31 March 2011. The year 2011/12 is the single year for which the proposed new price control applies.

The document states that:

"The DG is inclined to formally set the price control only for the single year, 2011-12. Figures for later years should therefore serve as a guide to what is likely to happen to future prices but will not form part of this price control. The overall price limits will be those set out in the table below. Please note that the revenue requirement is stated in real terms (i.e. without inflation for future years)."

GEL therefore treats all of the data in the financial tables very seriously since although the proposal is only for a single year price control, the approach is designed to roll forward and the figures guide what is likely to happen in future for GEL.

The OUR has since suggested in discussions that this interpretation might be incorrect and under recognises the degree to which the approach and the data for the final 3 years is not proposed. GEL seeks absolute clarity from the OUR in the Final Decision as to what is part of the decision which can either be accepted or rejected. GEL believes that only the headline tariff level for 1 April 2011 should be included and the future price control for GEL should be considered after the States' Review.

In the main document the concept of regulatory control is to be changed to be through an allowed revenue cap as opposed to the more traditional allowed price formula. The more traditional approach is the approach for the existing 4-year price control which ends 31 March 2011 which sets individual tariff price levels.

The table shown on page 28 is expressed as an RPI + X decision for the year 2011/12. Clarification has been sought from the OUR subsequent to the release of the Draft Decision document and the OUR has stated that moving to an allowed revenue cap would not be considered for 2011/12, but appears to be for years 2012/13 and beyond. The allowed revenue basis therefore now irrelevant to individual tariff relativities for the one year price control for 2011/12.

The table in Annex B covers the underlying financial parameters used above and an efficiency target. GEL comments upon this target within the Opex section of this response. The table clearly shows incremental increases to the efficiency assumption each year – which is consistent with the description of the annual efficiency improvement targets in the main part of the Draft Decision. GEL has based its response upon these statements in the Draft Decision. The OUR has since indicated in discussions that this basis might not be correct. GEL would like to request absolute clarity on this matter and that the targets are removed in the Final Decision from the OUR.

The Draft Decision is clearly presented at the bottom of the table as a 6.3% tariff increase over all tariffs. However it is still unclear whether this is a fixed figure or is one which could vary with some inflation assumption.

The table on page 28 shows the Required Revenue (real) of £47.1 million which is expressed in nominal terms, i.e. the value of money in that year. The formula for this is again Opex plus depreciation, plus a return on assets, but no recovery of prior non-controllable costs yet to be charged. The allowed Revenue of £48 million for 2011/12 is expressed correctly in real terms, i.e. uses 2010/11 base value of money. The figure is actually £48.8 million per the OUR model (which is prior to discussed amendments between OUR and GEL, which result in a value of £49.4 million), and this represents the required revenue per the formula with a prior year non-controllable cost recovery estimated at £1.6 million which is determined from one of the new Cost Pass Through (CPT) methodologies under consideration. The overall change is shown as the Price Adjustment which is 2.8 percent, which when added to an assumption of RPI of 3.5% results in the 6.3% tariff increase.

However for the table which forms Annex B both the 2010/11 and 2011/12 values are in nominal terms and as submitted by GEL. The two values that were not submitted by GEL were the efficiency assumption of £0.8 million for 2011/12, and the CPT of £1.6 million.

Also our information shows Opex (Other) for 2011/12 as being £14.5 million (including the latest information provided to the OUR) rather than £14.8 million.

GEL hopes that the above clarifications are helpful in establishing the detailed consistency of the modelling and descriptions in the Draft Decision document. Consistency and the absence of ambiguity will be essential features of the Final Decision in order for GEL to be able to make the necessary assessments.

Annex C – Cost Pass Through

In Annex C at page 32 of the OUR Draft Decision document there is the statement that:

"The OUR will implement a revised approach to Cost Pass Through (CPT) which will:

- *Enable faster pass through of costs*
- *Maintain a relatively simple and straightforward approach*
- *Allow verification of the relevant figures"*

GEL supports these principles.

However during the 4 years since the Final Decision by the OUR in February 2007, there have been a number of variations used in the calculation of a fair recovery of the costs which are defined as "non-controllable". This category of cost relates to the wholesale import of energy from France, and the procurement cost of oil for on-island generation.

We attach Table 1 which shows the changing considerations from 2007 to date. The latest versions are particularly relevant as GEL seeks a consistent and stable regime so that regulation can provide complete clarity of what will be the value of the non-controllable costs that the business is able to recover from electricity customers in the future. The determination of the basis and value of these costs is critical to GEL's consideration of acceptance or otherwise of the Final Decision as the current price control comes to an end. However the remaining cost recovery will arise in a future period and therefore future price controls. The phasing and therefore the timing of recovery is not determinable at this stage. GEL seeks an arrangement whereby it can smooth the effect of volatilities in energy markets so that these are less problematic for customers.

Following discussions with the OUR we now understand that the statement on page 32 that a recovery would be implemented in October does not necessarily include October 2011. We understand that it is only to be interpreted as a statement that an adjustment could be made following the agreement of the actual costs incurred in the accounts of GEL for the preceding 31 March financial year.

GEL is in agreement with the principal of recovery adjustments being based on the actual finalised data. However to improve the timing of recovery an estimate of the expected outturn for the financial year can be determined by 31 December of the calendar year prior to the 1 April tariff change. Taking this estimate into consideration for a 1 April change would be prudent to allow for any difference on the forecast outturn against the actual data, when they are known. There would be a need to determine when this approach can start as we move from one price control to another.

Table 1: Cost Passthrough
Changing Basis
(Yellow shading highlights point of change)

Element	Feb 2007 Decision	Submission of actuals for 07/08 & 08/09	Submission of 09/10 estimate Oct 09	Submission of 09/10 actual and 10/11 estimate Dec 2010	OUR Jan 2011	OUR draft decision Feb 2011
- Fuel						
litres delivered	✓	✓	✓	✓	x	x
average delivered ppl	✓	✓	✓	✓	x	x
litres consumed	x	x	x	x	✓	✓
average consumed ppl	x	x	x	x	✓	✓
HFO/USD hedging	x	x	x	x	✓	✓
- Import						
actual base price	✓	✓	✓	✓	✓	✓
forecast risk premium	?	✓	✓	✓	x	x
actual risk premium	?	x	x	x	✓	✓
forecast coefficients	?	✓	✓	✓	x	x
actual coefficients	?	x	x	x	✓	✓
forecast RTE	?	✓	✓	✓	x	x
actual RTE	?	x	x	x	✓	✓
forecast losses	?	✓	✓	✓	x	x
actual losses	?	x	x	x	✓	✓
forecast fx rate	?	✓	x	x	x	x
actual fx rate	?	x	✓	✓	✓	✓
edf trading (hedging)	x	x	x	x	✓	✓
efficient base price	✓	✓	✓	✓	x	x
sharing factor	✓	✓	✓	✓	x	x
- Revenues						
unit revenues	✓	✓	✓	✓	x	x
total revenues	x	x	x	x	✓	✓
sharing factor	✓	✓	✓	✓	✓	x
deflating actuals	✓	✓	✓	✓	x	x
inflating forecasts	x	x	x	x	✓	✓

Cost Recovery Implications of changes (£)

07/08	5,001,977	5,496,642	5,496,642	3,382,857	3,487,465
08/09	3,506,814	4,951,502	4,951,502	5,489,434	5,591,149
09/10	10,068,916	13,501,103	13,501,103	8,913,173	9,097,920
Total	18,577,707	23,949,247	23,949,247	17,785,464	18,176,534

The above figures demonstrate the highly variable regulatory allowance for CPT which is produced by the different regulatory bases which have been used to date.

Annex C.1 - Cost Pass Through Calculations

The table referred to above shows the variation in values that could arise depending on the basis adopted. For the 3 years ending 31 March 2010 figures of between £18 million and £24 million arise due to the different methodologies. This is a very wide uncertainty range which is being brought about by regulation and exceeds the other uncertainties ordinarily faced by GEL.

GEL expresses its concern to the OUR that there are now 3 variants of the pass through mechanism being considered which causes the company considerable uncertainty. These are:

(i) The original calculation as adopted after the last price control decision has been used for financial years 2007/08 and 2008/09;

(ii) A revised calculation has been proposed for 2009/10 based upon fuel consumption rather than fuel deliveries, inclusion of HFO hedging, allowance for exchange rate fluctuations, asymmetrical import benchmarking, retention of the 85% revenue adjustment but a change in the basis of revenue from unit revenues to total electricity revenues; and

(iii) A revised calculation as used for 2009/10 but without the 85% revenue adjustment.

The OUR have stated that the principal of pass-through should be to recover costs as incurred and reported in the accounts. For example, using a consumption basis for oil rather than deliveries. The latest proposals from OUR are driven from a profit and loss basis and principles, as opposed to the cash basis included in the OUR's Final Decision of February 2007. This change adds to the uncertainty faced by GEL since it implies that such changes might occur in other unpredictable areas in future.

Following a price control reopening, GEL would expect to see a consistent and fair treatment of its costs for all years in the previous price control period. This is not the case in the Draft Decision.

Annex C.2 - Symmetry

GEL notes the symmetry principle proposed, but the implications of the final methodology will still mean that costs will be recovered or credited in a future period. At meetings with the OUR subsequent to the Draft Decision document it has been stated that only the methodology will be determined in the Final Decision, that the actual amounts to be recovered or credited will be determined in the future, and only after that will the timing of the adjustments be determined. GEL supports the principle of symmetry to be included in the Final Decision but cannot accept the ways in which GEL's revenue allowance remains unclear.

Regarding the import benchmarking in the 2009/10 calculations, the regulatory accounts import figure was lower than the benchmark and that was the figure that had been used. GEL understands that if this figure had been higher than the benchmark then the benchmark value would have been back in the calculation. GEL notes this explanation however the use of the benchmark in this way is a departure from the previous use of the benchmark. It appears that GEL would retain no benefit from improving on the benchmark but would only be able to recover a proportion of costs if they exceeded benchmark.

The OUR have expressed their acceptance of "plain vanilla" hedging structures and agreed that there should be symmetry in any arrangements to pass-through - both gains and losses on such hedging arrangements. The OUR have however expressed concern as to how losses on such hedging arrangements could be made and will question in future the pass-through of costs incurred with any more complex structures. GEL's hedging policy adopts best practice. GEL's hedging policy does not and should not provide 100% cover for the forecast forward risk or exposure, and relevant hedging will never create 100% certainty of price.

The document also refers to materiality in this section but that issue is commented upon below.

Annex C.3 - Materiality

GEL recognises the principle of materiality, but a materiality level of £1 million is far too high, particularly for a one year price control. As an indicator of the degree to which £1m is too high, it would equate to 35% of the level of operating profit – as set out in the OUR's model. GEL recommends the adoption of a materiality within the range £250k to £500k for one year. GEL notes the events of February 2011 in the Middle East and North Africa which emphasise once more the volatile markets with which GEL has to contend. If these market disturbances persist then GEL will need to update its forecasts appropriately.

Annex C.4 - Timing

Page 34 of the Draft Decision document states that changes to tariffs as a result of CPT will be made on 1 October. Please see GEL's previous comments which demonstrate that the workings of CPT have yet to be agreed. Also further work is required to determine the value to be recovered and the timing of recovery. GEL's financial year ends on 31 March, and a budget is prepared every year, which is then updated to a projection during the year. However it is recognised that the actual cost values are not known until after the year end. In a prior decision on CPT, a forecast of the CPT was used initially, to be corrected when the actual values were known. GEL recommends that this approach of using a forecast - which is then corrected for the actual at a later date - gives better timing between incurring CPT costs and the recovery of these from customers. Therefore the forecast would be an interim approach and a correction decision would be made on the actuals.

GEL would not propose to be submitting its regulatory accounts by 31 July, since it needs its statutory accounts to be adopted at its AGM in July each year. This means that the regulatory accounts cannot be finalised until after that date. However, if the CPT is based on the regulatory P&L account only going forward, then a version of that - subject to the adoption of statutory accounts at the AGM - could be used to progress CPT in a timely manner. With one month's notice being required to customers, a change at 1 October would need to be declared on 1 September. A change at 1 January could be declared with more notice in October or November. GEL would recommend a way forward involving at least consideration of 1 October tariff changes with respect to CPT and based upon the regulatory P&L account.

Annex C.5 - Worked example

This section introduces the concept of “cost pass through applications” and notes that the proposal only applies to applications after 1 April 2011 and onwards - with 2010/11 being the first year to be considered.

The numbers in the table presented do not add up, but the principal is noted whilst clarification is sought in the Final Decision. This principle is different in broad terms because the Revenue adjustment is as stated Total Revenue difference, whereas the CPT for 2007/08 and 2008/09 was calculated only on unit revenue differences and of those differences, only 85%. The proposed method is more complete and is simpler. The example does not illustrate any treatment of volume variance in terms of growth (plus or minus) from forecast. We would need clarification of the intentions for the principles behind the example and an unambiguous explanation as to how it would be implemented.

GEL have repeated their query to the OUR on whether any pass-through values which are granted can be carried forward to a subsequent year - in order to smooth price increases to customers. The OUR have not yet provided any clarification.