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PMG/AC

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Mr J Curran
Director General
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Suites B1 & B2
Hirzel Court
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Dear John

Re: Response to OUR Consultation on Guernsey Electricity Price Control - Guernsey Gas response to the OUR document 11/04 – Draft decision

We welcome the draft decision proposed by the OUR. In particular we welcome the progress that has been made on the cost pass through of GEL's energy costs and also the acceptance of the need to review tariff structures. Although we support the proposed one-year price control, this is in the context of the recognition of the need to resolve some fundamental regulatory issues so that a more stable framework can be put in place for the future. There is clearly a need to resolve whether GEL will continue to be financed through the Save to Spend policy; the extent to which past under-recovery of fuel and power purchases will be claimed; whether the RABold/RAB new methodology provides GEL with sufficient funds to finance its functions; and the extent to which the growing peak demand is the direct result of under-pricing electricity, particularly in the heating market.

1. Structure of the price control

GG support the OUR draft decision with regard to the form and scope of the price control for the period suggested. In particular we welcome the move to a revenue cap, which is in accordance with the recommendations of the European Commission. This form of control should incentivise GEL to promote the economic and efficient use of electricity.

GG are fully supportive and welcome the proposal for an investigation to determine whether GEL's tariffs are cost reflective, reasonable and in accordance with States policy. We seek clarification that the term 'in accordance with States policy' would include an assessment as to whether GEL's tariffs and services meet with the objectives set for all stakeholders, regarding the commercialisation of GEL including the objective set for the States and the OUR. We would like to be given the opportunity to input to the terms of reference for such a review. We believe that the proposed review should not be constrained by the confines and boundaries of the current tariff structure and needs to analyse consumption and electricity costs in relation to the time of day. The review should, where appropriate, determine if the individual electric supply services provided by GEL are cost reflective, reasonable and in accordance with States policy. As the OUR are aware, GG are concerned that GEL's off peak tariffs are attracting heating loads that add to, not detract from, GEL's peak load. In its response to OUR 10/13, GEL identified its heating load as one of the main causes of its increased peak demand. The supply of electricity for heating purposes is a service that we would strongly recommend is investigated. Heating loads are served by various GEL tariffs for example the SE12, the heat pump, the non peak and superheat tariffs. GG provided various economic assessments with regard to electricity supplied for heating purposes in our submission to the OUR dated 3 December 2011, all scenarios assessed indicated financial losses for GEL with regard to the provision of electricity for heating. Our concern is that for example if a review of the SE12 off peak tariff is performed, potentially loss making services such as the provision of electricity for heating may be masked by other financially viable services such as the promotion of the use of general house hold appliances outside of peak times which obviously detracts from the peak load condition. GG are aware that such a detailed study will take significant resource, we emphasise our main point of concern is that electricity provided for heating maybe being sold below costs. Our secondary issues are associated with GEL's standby tariff for customers who choose to generate their own electricity and the buy back tariff. If GEL and OUR do wish to reduce the amount of resource that such a detailed study may demand, GG are willing to consider pragmatic solutions to addressing our concerns.

GG are supportive of the DG's request for GEL to publish all tariffs. GG would welcome a review of the criteria and application of the GEL Standby tariff, installed capacity charge, for customers with their own generating plant and the criteria and application of the buyback tariff. Clearly customers with their own generating plant are adding to security of supply and not reducing it. We seek clarification if this is the OUR's intention. Also, GG would welcome the opportunity to review GEL's explanation as to the criteria and application of these tariffs.

2. *Monitoring and Compliance*

GG agree with the intention to minimise the regulatory burden. However, GG are concerned with regard to adopting a strategy that allows GEL to set its own tariffs without sufficient safeguards in place to protect customers and competitors from GEL abusing, consciously or subconsciously, its dominant position in the energy market.

In the event that the OUR allow GEL to set its own tariffs within an overall revenue cap, GG would recommend that the OUR be prepared to react quickly to properly investigate complaints associated with GEL's behaviour and or operations that could be in breach of the objectives set for the OUR and the States in The Regulation of Utilities (Bailiwick of Guernsey) Law 2001. GG would also recommend that the States of Guernsey C & E department are cognisant to the fact that GEL could have the opportunity to abuse their dominant position in the energy market and should therefore be willing to quickly engage in investigating complaints from GEL's customers and or competitors. We remain concerned that the RPI recommendation to provide relevant safeguards for consumers and competitors by the introduction of competition legislation will not be implemented or quickly enacted.

3. *Finance-ability and Save to Spend*

GG have formed the impression that beyond the original political decision there is little support for the 'Save to Spend' policy. If this perception is correct, GG believe that the OUR should request a political review of the decision.

In the event of continued political support for the 'Save to Spend' policy and given the OUR's opinion that GEL have spent material sums of the fund on noncore projects, (perhaps inefficiently and in a non-commercial manner) GG support the OUR's proposal to continue to the work to ring fence this reserve.

As per our submission of 3 December 2010, if the circumstances were that the various stakeholders (GEL, T & R and the OUR) failed to agree on what were appropriate uses for the funds and a there were a lack of controls in place, GG maintain the opinion that the funds going forward should be based upon the actual position. Given GEL's ownership model, ultimately and effectively all stakeholders are working for the taxpayer, there appears to be a collective responsibility. We cannot understand given the current ownership model how the proposed decision to calculate the funds as though funds that have been spent have not been spent will develop a positive output; we assume it will not affect the shareholder as the shareholder does not act like an investor; it will not impact upon GEL or their executives as they don't have commercial pressures; the decision will merely move the burden from GEL's customers to the tax payer. This will create inequity, it seems that householders who use oil, coal or gas for heating are being asked to subsidise those who use electricity for heating.

GG would also question the political decision that an appropriate use of the save to spend fund is to delay tariff increases, the Independent Expert Panel warned that under pricing of electricity relative to world fuel prices is likely to result in a miss allocation of resources to the detriment of living standards. GG believe that the OUR should also request a political review of this decision.

GG do not feel that the OUR's approach with regard to refusing to revisit the RoR on pre-commercialisation assets is reasonable in that the OUR claim the matter was resolved by the IEP (Independent Expert Panel) in 2006 and no new evidence has been provided. Whilst it is factually correct that a recommendation of the IEP was adopted by the OUR we would remind the OUR that neither GEL or GG agreed with the approach at the time. GG would also question the context and scope within which the IEP solution was developed. The IEP highlighted various options and models in their draft report, no explanation has been provided as to why their alternative proposals were rejected. GG would like to understand what were the drivers that lead the IEP and the OUR to choose an RoR of 0.549 % for pre-commercialisation assets. GG can conceive a set of constraints that left the IEP with little option but to apply such a model i.e. the strict interpretation of the political decision that commercialisation in itself should not lead to a change in average bills. GG would like more detail with regard to how the IEP's decision was formulated, for example GG would question :-

- When the political direction with regard to the bills was being considered did the States understand how the OUR would interpret their decision i.e. to base the RoR on a single, and we believe an unrepresentative year, did the States realise that this was a year in which GEL were under recovering due to increased input costs.
- If the States were cognisant of the affects of their decision at the time; and
- Given the change in the States, the Island's different economic circumstances and GEL's poor financial performance, if the States would now choose to review their decision.

Given the above States direction on bills; the OUR's strict and absolute interpretation of the direction with regard to bills; the 'save to spend policy'; the political and regulatory decision that the cash reserves belonged to GEL's customers, but the reluctance to consider returning the cash surplus to the customer; and T&R's non commercial dividend targets for GEL, GG believe that the IEP's options were severely limited. GG would question if the current financial structure is what the IEP would have recommended if they had not have been constrained by the aforementioned circumstances. Moreover we do not consider that the allowed return of 0.549% on RAB old generates sufficient funds for GEL to finance its functions. In particular that is does not generate sufficient surpluses to allow the Save to Spend Reserve to grow to meet expected capex.

Hence, GG do not believe that the issue of setting a RoR on pre-commercialisation assets was or has been adequately addressed. We believe that the OUR's approach of refusing to revisit the decision is wrong and not in keeping with the good regulatory practices of openness and transparency. If, as we believe we have demonstrated, there were flaws or misunderstandings with respect to the decision, it should be reviewed regardless of the passage of time. If the political decisions and interpretations were as intended and the IEP were not unduly constrained then the OUR should be confident to have open dialog, if for no other reason than to demonstrate openness and transparency. We do not find the OUR approach of refusing to talk about the decision helpful.

With regard to the return on new assets we suggest that the OUR adopt the cost of capital used by Ofgem, together with a small company premium of 1% as typically allowed by Ofwat. Other regulators have adopted this approach. Adopting this as a policy would reduce the regulatory burden in Guernsey in line with the RPI report recommendations and also give GEL and others some certainty with regard to future decisions.

4. *Capital Expenditure & incentives*

GG support the OUR's intention to pursue alternative approaches to defer or reduce the need for GEL to have significant plant investment, to reduce the cost of the investment programme and its impact upon customers bills. GG recommend that the OUR requests GEL to fully investigate the drivers for the increase in peak demand and that GEL ensures that the drivers are cost reflective services. GG also recommend that the OUR review GEL's approach with regard:-

- GEL's treatment of customers who choose to generate some of their own electricity, a barrier to competition in the generation market.
- GEL's buyback tariff, again a barrier to competition in the generation market.
- GEL's connection charges, GG believe the claims made by GEL in the OUR investigation to the effect that electric heating does not add to the peak load need to be challenged as does GEL's basis for an economic appraisal, reported to be based upon revenue and not margin or profit.

With regard to the last point, if correctly reported in the OUR investigation, this could indicate a more serious problem within GEL with respect to analysis, understanding and their financial appraisal system.

5. *Tariffs*

GG support the OUR's request for GEL to supply more tariff information and to determine whether there is a need to review or rebalance some of the tariffs currently offered by GEL. However GG would like to emphasise the associated issues previously highlighted:-

- Issue highlighted in point 1, the review should not be constrained to tariffs but should consider the electric supply services offered to ensure that they are cost reflective.
- Issue highlighted in item 2, with regard to the need for safe guards to ensure that GEL does not abuse its dominant position in the energy market to detriment of competition or customers.

With reference to the proposed request that GEL assesses how different customers value the various levels of security of supply and how such values could be communicated to tariffs, GG do not believe that this work will is likely to lead to a worthwhile output. GG believe customers are unlikely to be able to value security of supply in a robust way, the concept of tariff structures to reflect different levels of security of supply seem overly complicated and burdensome. GG would question if this concept has ever been adopted in other jurisdictions. GG are of the opinion that the level of security of supply in Guernsey should be a political direction formed through consultation with the various stakeholders.

6. *Carbon intensity*

GG have provided a significant amount of data and information to the OUR on this topic. In summary there are several methods that could be used to assign a carbon intensity to imported electricity. They are all correct, they all have a sound basis and that they are all used in different jurisdictions for various purposes. The issue that the Guernsey Energy Policy and the OUR face is adopting methods that are appropriate for the application in question. Already in Guernsey different values are adopted for different purposes.

GEL seem to suggest that the component of imported electricity should be assigned a carbon intensity as that released into the French grid by GEL's current supplier EDF. In the OUR draft decision it is stated that the EU Labelling Directive 2003/54/EC is viewed of particular relevance. GG would challenge if there is any evidence of this type of approach being used in any other jurisdiction to inform Energy Policy decisions of the nature being considered here.

GG do not intend to repeat the information and data already provided to the OUR on this topic. However we do feel it is appropriate to comment on GEL's submission, in summary:-

- GG do not believe that the ASA decision has resolved the issue of the relative carbon intensity of Guernsey heat sources. The decision did not specifically consider the carbon intensity of electricity used for heating purposes in Guernsey. GG would also like to make the OUR aware that GEL withheld carbon emissions data for the period relevant to the ASA investigation i.e. 2008/09 and 2009/10. This information has only just been made available to us and acts to prove, in our opinion, that the GG advertisement claim was valid. We believe that if this information had been made available it would have been highly likely to influence the ASA decision in our favour.

- GEL wish to assign a carbon intensity of 44 g of CO2 / kWh to imported electricity, this is not consistent with the above ASA decision.
- With reference to appendix 1, item 2 and attachment B. GG are encouraged that GEL now recognise that the carbon signature of European grid electricity changes with the time of day, this is a significant step forward. GEL refers to an ADEME document dated 14 January 2005. GEL should be aware that there have been material changes to Europe's electricity market since this report. GG would advise GEL and OUR to research more recent findings.
- Throughout GEL's submission and in other forums GEL claim that the majority of electric heating systems in Guernsey use storage technology and that they use electricity outside of peak hours and thus are low carbon. GG believe these claims need to be evidenced, our counter position is that GEL's peak and off peak tariffs are not the most appropriate indicator of carbon intensity. We remain to be convinced that a significant majority of heating systems in Guernsey have a material heat store capacity, GEL's claims seem to contradict their actual peak load experience, GEL's peak loads occurring in cold weather winter conditions.
- GG would question if GEL's calculations for the carbon intensity of on Island generation takes into account heat recovery, if so we are of the opinion that detailing the calculation method and assumptions would be helpful to this debate.
- GEL's view that an EdF average carbon signature for their generation fleet is an appropriate value to use for policy purposes, for informing fuel switching decisions and for assigning to electric heating is in conflict with various reports and expert advice. For example comments, reports and research work undertaken by AEA, Poyry, ADEME and RTE. We consider these sources of information to be more relevant than the ASA for this matter.
- GG have reviewed the emissions data submitted by GEL to the OUR as Appendix I, Item 4, Page 4. GG cannot compute the 5-year rolling average figure that GEL have calculated, it appears to us that GEL have excluded the 2009/10 figure, if GG are correct we believe that the GEL submission should be amended and recirculated.

In their submission, GEL suggest that the taxpayer, not GEL's customers, should pay for the cost associated with increasing imports of electricity as GEL believe the total population would benefit from reduced emissions. GG therefore strongly recommends that a proper and full analysis is performed to consider the ultimate carbon emissions associated with imported electricity, potential fuel switching and electricity used for heating purposes to ensure that the taxpayer is not burden with costs for actions that actually **increase global carbon dioxide emissions**. A proper analysis needs to be performed to ascertain the actual cost of carbon abatement, if indeed the strategy that GEL advocates will abate global carbon emissions.

GG are aware that the issue of carbon intensity continues to be a source of frustration. We believe that some stakeholders still do not fully understand the debate in relation to energy used for heating purposes. We believe that the most efficient way of moving this forward would be for GEL, GG and others if they wish to put their case forward in an open forum and if disagreements remain appoint an independent review to determine the ultimate carbon emissions associated with the use of electricity used for heating purposes in Guernsey. GG would welcome the opportunity of explaining our position to the GEL directors, Executives and non-Executives, as based on the responses given by GEL they do not appear to have fully considered our position, hence we continue to provide an open door invitation to them to enter into an open debate on this issue.

7. *Operating costs*

GG agree with the OUR's objective of attempting promote efficiency within GEL as there seems to be a lack of efficiency drivers given the ownership model. GG are unable to make a considered comment with regard to the target level declared within the draft document as we do not have access to the relevant information and data. GG maintain that any efficiency improvement targets should be fair, reasonable and based upon a sound analysis; we do not feel given the small Island dis-economies of scale that large organisation bench marks can be applied.

8. *Pass Through Mechanism*

GG are not aware of the details of the disputes between the OUR and GEL with regard to the pass through mechanism other than alluded to by the C & E report into regulation conducted by RPI. However it is clear from GEL's accounts that it has not been fully recovering it fuel and power purchase costs. The RPI report uses the problems encountered with the pass through mechanism as an example of where "the regulatory system has failed.....". The RPI review concluded that this matter has not been handled satisfactorily, this being the case we do not believe it is reasonable for the OUR to suggest that ultimately the tax payer should pick up the bill. It would not be acceptable for householders who use coal, oil or gas for heating to be asked to retrospectively subsidise those who use electricity for heating. Therefore we consider that GEL should retrospectively recover all of the shortfall, although we appreciate that for practical reasons this might need to be spread over a number of years.

The concept of a pass through mechanism is established and common place. The purpose is to ensure that a regulated company is able to recover legitimate efficient costs, input costs, which are beyond its control. GG cannot appreciate how GEL and the OUR can calculate materially different values with regard to GEL's under recovery, in our opinion this discrepancy needs to be investigated and resolved as a matter of urgency. As and when GEL and the OUR can agree a figure it should in theory be recovered in **full** as soon as practicable. GG believe in theory it should be recovered as soon as possible, however given what could be a substantial impact upon customer bills we can understand why GEL and the OUR would wish to phase in the recovery. GG would like it recognised that this phasing in should be considered as a one off and special arrangement that has been necessitated as a result of the inability of GEL and the OUR to reconcile this issue and should not set a precedent or be repeated. We would like to emphasise that the **full** efficiently incurred increase in input costs should be recovered, not just a proportion of these costs. The OUR have declared in the draft decision that they do not intend to re-visit the cost pass through amounts for prior years (2007/8 and 2008/9). GG believe that the OUR need to explain and defend why they are minded to take this decision. If the full costs are not recovered ultimately the tax payer will again be subsidising the electricity consumer due to the inefficiencies of the various stakeholders who are all ultimately employed by the tax payer. As noted above this would be an unfair cross-subsidy between electricity consumers and consumers of other fuels.

We do consider that every effort should be made to ensure that this problem does not occur in future years. Given the volatility of the energy markets and the limited scope for hedging fuel/power purchases, given that GEL has a licence obligation to buy the cheapest on the day, consideration should be given to changing tariffs within year if circumstances have changed. In order to provide an incentive to ensure that the OUR are adequately incentivised to address cost pass through issues in the future, GG recommend that any valid outstanding CPT claims should be indexed by inflation.

9. Conclusion

In principle we support the move to a revenue cap, we welcome the commitment to resolve the issues with the cost pass through arrangements and the proposal to review tariff structures. Our support is conditional upon the details, as highlighted in the above sections.

We look forward to the resolution of the many issues over the next year in order; that GEL's financial situation can be improved for the benefit of the tax payer; that customers and competitors can be assured that there is no cross subsidisation between the services and tariffs offered by GEL; and that GEL are not abusing their dominant position within the energy market.

We are as always available to meet to discuss any matters that arise from this response.

Yours sincerely,

Paul Garlick
Managing Director
Jersey Gas/Guernsey Gas Co. Ltd.