International Energy Group

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The Director General
Office of Utility Regulation
Suites B1 & B2
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27 October 2005

Dear Sir

COMMENTS ON THE REVIEW OF GUERNSEY ELECTRICITY LIMITED'S PRICE CONTROL

We have read with interest the draft decision document number OUR 05/23 released last month and would comment as follows:

Timing and Conduct of the Review

1 It seems inappropriate to pre-judge the outcome of a States debate on the policy letter to be presented by Commerce & Employment on something as fundamental to the review as the options for meeting the future generation needs of the Island.

In our view it would have been more appropriate to agree an interim price review with GEL for the 1 December 2005 and delay the issue of the draft decision document until the policy has been confirmed by the States.

2 The Report from the National Audit Office, following their review of the whole question of commercialisation and utility regulation in Guernsey, has yet to be published. This report, originally due to be released in May 2005, has been delayed and is, we understand, due to be published shortly. Whilst not wishing to prejudge this report ourselves we would be very surprised if it did not include comments and views relevant to the conduct of GEL, in particular in relation to potentially anti-competitive policies on pricing and capital.

Again, in our view, it would have been more appropriate to await publication of the NAO report before issuing the draft decision document.

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3 We note that the Director General does not feel he is in a position to respond individually to the responses to the consultation. We believe a true consultation should involve a two way response at least with those upon whom the results of the decision has a major commercial or competitive impact such as ourselves or financial impact such as the major electricity consumers. We would be delighted to have the opportunity to discuss the consultation with the Director General.

Structure and Process for Price Control

The document is very unclear on the question of return on assets and return on capital.

1 Under 7.1 OUR's view, stated as a fact, suggests that all assets have historically been acquired from a save to spend policy through a premium on electricity prices. Whilst we have no evidence to the contrary we doubt that during the whole of its period of state owned existence GEL has never received any state support in the form of grants, interest free loans, tax advantages or other means which would have effectively built capital investment from the taxpayer rather than the customer.

In any event we believe that in pure economic terms to allow no regulatory asset value and no depreciation thereon, as stated in 7.2, is basically flawed. Without sight of the financial models it is not possible to assess whether the inclusion of the proposed capex adequately replaces the requirement.

The historical cost of the assets in use in GEL is in excess of £111 million. The business is a long term business as is our own and the current and future replacement costs of those assets need to be incorporated into a long term plan, not over a short term price control period, to avoid serious spikes in revenue requirements in future periods of high capital expenditure.

2 It is not clear under 7.5 what is regarded as capital. We would assume from the comments on regulatory asset base that any assumed level of capital is either very low or in fact negative, and that the "allowed cost of capital" is in fact an assumed level of income.

3 The draft decision document appears to consider that GEL should be run as a 'not for profit' organisation. Not only is this a dangerous basis on which to run a capital intensive business where security of supply is paramount, we also believe it is anti-competitive and seriously disadvantages those businesses supplying energy on a commercial basis.

There is little doubt that the real capital employed in GEL is in excess of £100 million and that a return on that capital should be generated in order to avoid an anti competitive position.

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We believe that capital is owned by the States and that they should receive a return on that capital rather than subsidise electricity customers at the expense of the taxpayer. This is particularly relevant in the current circumstances where the States are attempting to cover 'the black hole' in revenues caused by the zero/ten tax proposals.

Conclusion

We believe that fundamental changes should be made to the draft decision document before it is finalised. The control should be levied on the basis of the long term plan and requirements of GEL with a commercially assessed regulatory asset base and after providing for a proper return on capital and distribution to the shareholder.

The price control decision should be deferred until the States have debated the options for meeting future generation requirements and concluded government policy thereon and the report from the National Audit Office has been published.

Yours faithfully

Mike Richards

M R Richards
Chief Executive
International Energy Group