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PMG/MM

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Mr J Curran
Director General
Office of Utility Regulation
Suites B1 and B2
Hirzel Court
St Peter Port
Guernsey
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Dear Mr Curran

Guernsey Gas Limited's (GGL) Response to the Office of Utility Regulation's (OUR) Draft Price Control Decision for Guernsey Electricity Limited (GEL)

We are writing in response to the recent publication of OUR's Draft Decision on GEL's Price Control (OUR06/20). Our comments take into account both the information published in the document and the additional help and guidance you provided at our meeting on the 10th January 2006. We would like to take this opportunity to thank you and your staff for listening to our concerns, and for your helpful and constructive responses.

Overview

Before commenting upon the specific proposals within the draft decision notice, we would like to make the following general points on the overall effects of the proposed price control.

The proposed price control will not result in commercially viable, cost reflective electricity tariffs.

As explained in our previous submissions, GGL competes with GEL in the space and heating markets. At present, we do not compete on a level playing field, as GEL's tariffs are set well below what a commercial operator would have to charge in order to fully recover its costs and earn a market based rate of return. The proposed price control does nothing to redress this imbalance.

GEL will be allowed to earn only a 'nominal' rate of return of 0.549% on its historic RAB. Even the rate of return allowed on the New RAB has been set at the lower end of the proposed range. This means that GEL will continue to have the competitive advantage of not having to earn market based returns on either the Old or New components of its RAB.

As a result GEL tariffs will continue to be artificially held below commercial levels. This will act to perpetuate the following problems:

- Electricity tariffs below true commercial levels will unfairly prevent effective competition within the energy markets.
- Setting electricity tariffs below true commercial levels will continue to expose customers to the risk of a significant price correction at some point in the future.
- GEL will not adopt the disciplines of a commercial organisation.
- GEL will continue to undervalue the cost of capital. The IEP noted that GEL is extremely capital intensive by EU or UK standards and indicated that this is as a result of employing a low cost of capital (reference the IEP's final report, page 7 items 26 and 28).
- Electricity tariffs below true commercial levels will encourage demand side waste.
- Setting electricity tariffs below true commercial levels will act to discourage the development of alternative, environmentally friendly, means of electricity generation.

The proposed price control will not require GEL to restructure its tariffs on cost reflective principles

GGL is concerned that the discretion that GEL has to set its tariffs within the revenue cap permits it to set off peak tariffs that are not cost reflective. This amounts to predatory pricing, where electricity is sold below cost to deliberately weaken GGL's competitive position.

The IEP appears to have recognised GGL's concerns in the following statements from its final report: 'GEL competes with GGL...', page 3 item 9; 'Customers should face efficient tariffs at the margin' page 9 item 35; 'tariff decisions should reflect economic principles', Annex C item 1; 'the resulting variable part of customers tariffs would be set at efficient levels' Annex C item 9.

However, OUR has not recognised GGL's concerns in its proposed price control.

We have subsequently notified OUR, via a written communication dated 14 December 2006, that we believe GEL's off peak tariffs could be in breach of their licence conditions 13, 17 & 20.

GGL has provided evidence to OUR that our order book for new connections is suffering as a consequence of the unfair competition from off peak electricity. An extract of this evidence is included as Appendix A.

GGL is concerned that GEL's off peak tariffs may offend against future State of Guernsey Competition Legislation.

OUR has suggested that any tariff review is complex and would need to consider the impact of a tariff correction upon existing GEL customers. GGL recognises this concern but would emphasise the need for urgent and immediate action. As time passes more customers are choosing electric heating based upon false economics driven by artificial prices. The number of customers that are choosing electric heating based upon artificial prices will affect GEL's peak maximum load which in turn will impact upon the n-2 policy.

GGL welcomes the statement OUR made at the meeting on 10 January that it now intends to look at the issue of tariff rebalancing early in quarter 2 of 2007.

The proposed price control does not provide any additional incentives for GEL to act commercially

The draft proposals do not address the inefficiency and disincentive to act commercially created by GEL's substantial cash reserves.

GEL's substantial cash reserves are an inefficient means of providing funds for a commercial business and act as an easy option or insurance policy to cover for under performance.

The cash reserves are recognised as belonging to GEL's customers. The reserves are not being invested efficiently (see page 10 item 50 of the IEP draft report). The reserves should either be returned to customers or utilised by T&R for a purpose that would benefit islanders as a whole, for example in education or health services.

GGL believes that few Guernsey residents understand the scale of the cash reserves and the opportunities being missed. This is an area where OUR could have raised public awareness on the matter through consultation.

GEL's continued retention of the cash reserves perpetuates inter-generational inequity whereby the previous generation subsidises the next's electricity supply costs.

The IEP's final report recommendation 1 states: "T&R should establish a clear rule for cash reserves ...", recommendation 2 states: "T&R should establish the dividend to be paid by GEL..." .

OUR's draft decision does not allude to what, if any, decisions T&R has made regarding GEL's cash reserves or future dividend distributions. We understand that OUR's position is that it cannot disclose any information with regard to T&R's decisions. Nonetheless, we are concerned that T&R may set rules for accessing the cash reserves and a dividend policy that do not reflect the behaviour of a commercial organisation.

The cost reductions required by the proposed price control may not be realistically achievable

It is difficult for any reader of OUR's draft decision to assess whether or not the recommended costs savings are realistically achievable as the document does not quantify the amount of anticipated savings. Using available information we have estimated that the required savings will be in the order of £4million per year by the end of the price control period. This represents a saving of circa 25% on GEL's current direct controlled costs. GGL is concerned that this level of savings may not be realistic and as a result OUR is under estimating the tariff increase required.

We understand that GEL is of the view that the proposed tariff increase is not sufficient. The cost saving required of GEL are at the upper end of the range quoted in OUR's Consultation Paper (OUR 06/17 - table 7.3). In our previous submissions we have pointed out that GEL will not have the cost saving opportunities that arise from the economies of scale available to, for example, large UK utilities.

We understand that OUR is basing the required savings on the views of an independent consultant. We note however, with some concern, that the consultant's report has not been made available for consultation as part of this review.

We anticipate that the level of savings required may require significant staff redundancies. Adverse public and political reaction is likely to halt or hamper forced redundancies. We would raise the question as to whether labour representatives have been fully consulted on the possible effects of the proposed cost savings.

The draft decision makes no mention of funds to be set aside for restructuring and therefore query whether restructuring costs may have to be funded from the cash reserves and whether this is an appropriate application of these reserves.

GGL's primary concern regarding the proposed cost savings is that unrealistic savings targets will further contribute to electricity tariffs remaining below commercially viable levels, with the shortfall funded from cash reserves, and the adverse impact that this will have on GGL's competitive position.

We are disappointed that the areas and levels of savings assumed by OUR have not been included in the consultation process.

The basis of OUR's draft decisions are not transparent, as an inappropriate level of confidentiality has been maintained over GEL's information.

The level of confidentiality offered to GEL in the OUR consultations is, we believe, without precedent. GEL is a publicly owned monopoly utility business. Apart from limited competition from GGL in water and space heating it faces no other competition in any of its business sectors.

This lack of transparency makes the consultation process meaningless. This is made evident by the fact that GGL is the only third party that has participated in the process. We expect that other parties would engage in the process if more information was made available and the consultation documents were presented in a more accessible way. For example, we expect that labour representatives would have commented on the possible effects of the proposed cost savings had these been made more transparent.

Comments on Specific Proposed Decisions

In the remainder of this response we address each proposed decisions in turn. The reference numbers refer to the relevant paragraph in OUR06/20.

5.1 Form of regulation

The DG proposes an incentive regulation of the price control (i.e. RPI-X or RPI+Y) to regulate GEL's retail price with a provision for an annual adjustment mechanism to achieve pass-through of fuel and imported electricity prices.

We agree that incentive regulation (RPI-X or RPI+Y) is an appropriate form of regulation for GEL's prices. This is subject to our concern about GEL's ability to achieve the targeted cost savings contained in the draft decision and the urgent need for tariff re-balancing.

We support the decision to provide a cost pass-through of fuel and imported electricity costs. We have requested OUR to provide information on the mechanics of the cost pass-through adjustment, but, at the time of writing, we have not received a response. We requested this information on the basis that GEL is a price setter in the energy market. We need to know if the price signals GEL sends out are real or as a consequence of the cost pass-through mechanism.

5.2 Scope of the price control

The DG proposes to include the above tariff charges by Guernsey Electricity Limited within the scope of the price control and apply the same percentage price change to each. It is proposed that GEL may re-balance its tariffs during the control period subject to the DG's approval.

GGL does not accept that the same percentage price change should be applied to each tariff. Tariff re-balancing needs to be performed as a matter of urgency. GGL has argued its case on this matter in the overview above, in previous correspondence with OUR and at our meeting on 10 January 2007. We welcome OUR's statement that it will consider the need for rebalancing of tariffs early in quarter 2 of 2007.

GGL previously requested OUR to include the GEL Standby Tariff in its review. GGL is of the view that this charge is unfair and without precedence, hence it should be removed. In its draft decision notice (OUR 06/20) OUR accepted that the Standby Tariff should be included in the review. However, as the proposed price control will apply the same percentage increase to all tariffs, the effect will be to increase this tariff by 18%. We urge OUR to reconsider this outcome.

This Standby Tariff does not generate significant revenue for GEL and could be removed without any material impact. Removing the charge would be well received by the 3 customers that have chosen to generate some of their electricity using environmentally friendly CHP technology.

5.3 Relevant Price Control Period

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

We would generally support a regulatory period of 5 years or longer. A longer regulatory period provides certainty for investors and sufficient time for incentive mechanisms to be effective.

However, in the instance of this review, we believe that a number of fundamental issues have not been addressed. In particular, we refer to the issues raised in the first part of this submission. We are desirous of the opportunity to readdress these important issues sooner, rather than later, and therefore we are advocating for a shorter period of three years to apply to this price control.

5.5 The Regulatory opening asset value – RAB (historic)

The DG proposes that the value of RAB (historic) is £72.5m which will be rolled forward on an annual basis indexed by RPI.

We support the decision to value RAB (old) based on the book value in 2002 and to index it each year to the RPI. However, the figure quoted is less than we would have expected and we request that OUR publish the detailed calculation of RAB (historic) from 2002 to 2007.

5.6 Cost of Capital – RAB Historic

The DG proposes a cost of capital on RAB (historic) of 0.549%.

We disagree with this proposal. This low return will ensure that GEL's tariffs do not approach that of a true commercial operator in the short to medium term. The problems of pricing GEL's tariffs below true commercial levels are stated in our overview above.

Determining the cost of capital based on the returns in a single year (2001/2) is flawed. GGL and GEL have both stated in their response to the OUR consultation document that the period chosen by OUR does not represent a pre-commercialisation operation. As noted in our earlier correspondence, GEL's profit was not stable at the time. GEL's return on capital had declined in 4 years from 11.009% in 1998/9 to 0.549% in 2001/2. GEL's financial position in 2001/2 cannot be regarded as sustainable. Our analysis showed that this decline was entirely due to GEL not increasing its tariffs in line with its costs. We agree with GEL that a return based on the average of the period prior to commercialisation would be more representative of the pre-commercialisation. GGL understands that OUR has made its decision based upon the IEP's recommendation no 5. However, GGL seek confirmation that the IEP was fully aware of the trend of profits and returns for GEL, that the timeframe used to calculate the return on RAB (old) was not a full financial year and that the returns for that timeframe do not represent the typical pre-commercialisation returns.

GGL believes that OUR may have misinterpreted the State's guidance with respect to GEL's financial targets. We refer to the guidance contained in Appendix 3B of the National Audit Office Review of Commercialisation and Regulation in the States of Guernsey 2005, i.e. "whilst drawing a balance between seeking a commercial return on the resources employed and the effect on the community of any increase in charges which may result". GGL does not believe that this guidance means that the average levels of bills in 2002 should be used as a starting point. GEL's tariffs in 2002 were unsustainable. When the States of Guernsey issued this guidance it was surely not its intention to protect Guernsey electricity customers from the effects of increases in worldwide energy costs.

5.7 The Regulatory opening asset value – RAB (new)

The DG proposes that the value of RAB (new) is £17m which will be rolled forward on an annual basis indexed to RPI.

We support the draft decision in respect of RAB (new).

Again, we would like to see the detailed calculation of RAB (new) from 2002 to 2007.

5.8 Cost of capital –RAB (new)

The DG proposes a cost of capital on RAB (new) of 5.97%.

We are disappointed with the DG's proposals that do not represent a commercial return.

We believe OUR has underestimated the risks of operating GEL in the very small, low growth and isolated environment of Guernsey. The scale of GEL is such that a "Small Company Premium" should be added to the rate or return. Our view is that this premium should be at least 1%.

The DG has chosen a cost of capital at the low end of those declared in the OUR consultation paper (OUR 06/17). GGL supported the approach set out by OUR in it's consultation document and propose adopting the middle case of 6.84% plus a 1% small company premium giving a total of 7.84%.

OUR's decision appears to ignore the three increases in the Bank of England rate that have occurred since August last year and has settled on a rate of return that is now only 72 basis points above the current bank rate.

GGL request OUR to revisit this decision.

5.9 The Regulatory Depreciation Schedule of RAB (historic)

The DG proposes a regulatory depreciation schedule for RAB (historic) over the period of the price control as follows; (numbers excluded from text).

Whilst we cannot comment on the actual figures, we support the inclusion of depreciation as a cost. We cannot understand why the actual figures have not been published.

5.10 The Regulatory Depreciation Schedule of RAB (new)

The DG proposes a regulatory depreciation schedule for RAB (new) over the period of the price control as follows; (numbers excluded from text).

Whilst we cannot comment on the actual figures, we support the inclusion of depreciation as a cost. Again, we cannot understand why the actual figures have not been published.

5.11 & 5.12 Capital expenditure and Operating costs

We are not in a position to comment on the capital and operating costs assumed as the actual figures have not been published. Again we note that this is not normal practise and GEL is being granted a much higher level of confidentiality than is usual.

GGL's assessment is that the proposed reduction in GEL's operating costs is not realistically achievable. Our own estimate is that GEL may have to reduce its operating costs by about £4million per year by the end of the price control period. This may well require a reduction in its workforce of about a third. We doubt that this can be achieved by natural wastage and that there will be a significant restructuring cost arising. The fact that this is not mentioned in the draft decision is a concern, as it suggests that all parties may not have properly considered the full implications of the proposals.

We hope you find our comments constructive and helpful. We again thank you for including us in this review. If you have any questions or queries with regard to our response, please don't hesitate to contact me.

Yours sincerely

P M GARLICK
Managing Director

Appendix A

Evidence provided to the IEP and OUR with regard to examples where GGL have lost heating load to GEL

The following are examples of recent situations where electricity has been selected for space and water heating as opposed to gas. This is a recent trend as a result of the artificially low GEL tariffs. To understand the scale of this problem Guernsey Gas win approximately 300 new connections per year. The list indicates that we could lose approximately half of our normal quota of new connections to electricity.

If necessary we can provide full details of the sites and addresses for the examples given below.

STATES OF GUERNSEY HOUSING REFURBISHMENT PROGRAMME

Over the last 3 years 100 gas combination boilers have been installed on 5 separate States of Guernsey housing refurbishment programmes to meet space and water heating requirements.

On the latest refurbishment programme for 32 dwellings, electricity has been chosen for heating and hot water. One of the reasons given for not continuing to use gas as a main source of heat was running costs versus electricity.

GUERNSEY HOUSING ASSOCIATION

Over the last 3 years 150 gas combination boilers have been installed in Guernsey Housing Association properties to meet space and water heating requirements.

Recently we have been informed that 8 apartments originally specified to have gas have been re-specified for electric heating. We have been informed the reason for the change is running costs. The Guernsey Housing Association are also building 78 apartments at the old Bus Garage at the Grand Bouet, at this stage they have been unable to commit to gas and are performing a running cost analysis.

COMPROP FLAGSHIP DEVELOPMENT, ADMIRAL PARK

Over recent years gas has been installed in a number of apartment/flats developments for space and water heating. The most recent development of this kind nearing completion is the Flagship Development on Admiral Park. Electricity has been chosen for space and water heating on this development as a result of an M&E consultant's recommendation, again they highlight the running costs of electric heating is now similar to that of gas.

ROYAL HOTEL SITE

This again was an apartment development. In Phase One we were successful in providing 68 units of accommodation with gas combination boilers to meet their space and water heating requirements.

On the second Phase the developer has elected to use electricity for space and water heating for the 48 residential units due to the perceived lower running costs versus gas.