Guernsey Electricity Limited's Price Control

Draft Decision

Document No: OUR 06/20

December 2006

Office of Utility Regulation
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1. Introduction

This document sets out a proposed price control for Guernsey Electricity Limited ("GEL"). The price control period proposed is four years, commencing 1st April 2007 and ending 31st March 2011. An RPI-X form of price control is proposed, with a pass-through of allowed fuel costs and imported electricity costs provided for. An annual adjustment mechanism will facilitate the cost pass-through calculation in which differences in volumes forecast and outturn are taken into account. A proposed price increase of 18% in April 2007 is proposed with no change in tariffs thereafter for the next three years, based on forecasts made and subject to pass-through and other annual adjustment mechanisms as set out in this document.

The draft price control follows consideration of all matters relevant to ensuring that it provides for a sustainable electricity provider whilst providing consumers with a level of certainty that their tariffs cover only those costs efficiently incurred. Since publication of the price control in 2005, the OUR has worked closely with all stakeholders including GEL, Treasury and Resources Department ("T&R") and Commerce & Employment ("C&E"). The Director General ("DG") has also sought the input of an Independent Expert Panel ("IEP") who has advised the DG on an optimal framework given States policy. The T&R Department ("T&R"), as GEL's shareholder, in response to the same IEP's recommendations has also provided a significant contribution to the setting of this price control through its clarification of its expectations of GEL. Efficiency targets are based on the recommendations by PPA, a power consulting firm, who has advised the DG following a review of GEL's generation business.

This draft decision follows the consultation document OUR 06/17 on GEL's forthcoming price control. An assessment of responses to that consultation is included in Section 4. Following consideration of any comments on this draft decision, the DG will finalise GEL's price control that will come into effect on 1st April 2007.

This consultative document does not constitute legal, commercial or technical advice. The Director General is not bound by it. The consultation is without prejudice to the legal position of the Director General or his rights and duties to regulate the market generally.

2. Structure of the Paper

2.1. Structure

The structure of the paper is as follows:

Section 3:	summarises the legal framework of this price control;
Section 4:	assesses responses to OUR 06/17;
Section 5:	sets out the principles proposed for GEL's price control and presents aggregates of the components of allowable revenue proposed under the price control;
Section 6:	assesses the key element of GEL's financeability, namely the level of GEL's future 'Save-to-spend' cash reserves;
Section 7:	summarises the price increases proposed;
Section 8:	sets out the next steps in the process.

2.2. Responses to the Consultation Paper

The DG received responses to the consultation paper from:

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

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

2.3. Deadline for responses

Interested parties are invited to submit comments in writing on the matters set out in this paper to the following address:

Office of Utility Regulation
Suites B1& B2
Hirzel Court
St Peter Port
Guernsey
GY1 2NH

Email: info@regutil.gg

All comments should be clearly marked "*Comments on the Guernsey Electricity Limited's Draft Price Control Decision*" and should arrive before 5pm on the **19th of January 2007**.

In line with the policy set out in Document OUR 05/28 – "*Regulation in Guernsey; Revised Consultation Procedures*", non-confidential responses to the consultation are available on the OUR's website (www.regutil.gg) and for inspection at the OUR's Office during normal working hours. Any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However, the DG regrets that he is not in a position to respond individually to the responses to this consultation.

3. Licensing Regime and Legislative Framework

3.1. Overview

The legislative framework underpinning the regulatory regime for the electricity sector is governed by:

- The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 (the "Regulation Law");
- The Electricity (Guernsey) Law, 2001 (the "Electricity Law");
- The Electricity (Guernsey) Law 2001 (Commencement and Amendment) Ordinance 2001; and
- States Directions to the DG adopted by the States of Guernsey[1].

The Electricity Law defines the three activities that constitute the electricity supply chain under the current legislative framework, these are;

- the generation of electricity;
- the conveyance of electricity across the electricity network; and
- the supply of electricity directly to homes and businesses.

These terms, are defined in the Electricity Law and govern the current licensing framework which is outlined below.

3.2. Current Licensing Regime

The States of Guernsey has issued a number of States Directions to the DG in relation to the licensing of electricity activities in Guernsey. In accordance with those Directions the DG issued the first licences for electricity generation, conveyance and supply to the incumbent electricity company – GEL - on 1st February 2002.

The market for generating electricity is, in principal, open to competition. In terms of conveyance, under the current regime no other operator can lay electricity cables and anyone generating electricity must therefore use the existing electricity network of GEL to convey that electricity from their generation plant to customers. In terms of supply, only GEL may sell electricity to end customers.

3.3. Legislative Background to Price Regulation

Section 5(1) of the Electricity (Guernsey) Law, 2001, provides that the DG may include in licences such conditions as he considers necessary to carry out his functions. The Law specifically provides that such conditions can include (but are not limited to) conditions regulating the price premiums and discounts that may be charged or (as the case may be) allowed by a licensee which has a dominant position[2] in a relevant market[3].

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

In accordance with these provisions, the “Electricity Licence Conditions” include the following condition 20.2:

“The DG may determine the maximum level of charges the Licensee may apply within a relevant market in which the Licensee has been found to be dominant. A determination may;

- *(a) provide for the overall limit to apply to such charges;*
- *(b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; and*
- *(c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.”*

This condition allows the DG to regulate the prices that a licensee charges for its electricity services in a way and for a period that he deems appropriate, provided the licensee has a dominant position in the relevant market.

As set out in a previous OUR document (OUR03/07), Guernsey’s retail electricity market currently possesses a monopolist/dominant operator that also has a dominant position throughout the electricity supply chain. This position of economic strength is unlikely to change in the near to medium term. In this context it is essential that the social objective of maintaining the affordability of electricity provision, thus underpinning economic growth, is safeguarded. In the absence of competition, price control is widely accepted as the most appropriate tool to achieve this.

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

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

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

“A dominant position in relation to a relevant market shall be construed as it would be in the United Kingdom under the Competition Act 1998, but with the substitution, where appropriate, of references to the Bailiwick for references to the United Kingdom.”
The Competition Act 1998 utilises the definition of dominance that has developed under European Community Competition Law.

4. Assessment of Responses to OUR 06/17

OUR 06/17 set out a number of specific issues on which the DG sought views prior to implementing a price control for GEL. The questions posed in that consultation document are set out below with a summary of respondents' views on each of these issues together with the DG's consideration of those views.

Q1) The DG consulted on whether an RPI-X form of price control remains an appropriate approach to the regulation of GEL's prices or whether an alternative is more appropriate.

Guernsey Gas Limited
GGL support the DG's view that in principle an RPI-X form of price control is appropriate but is of the view GEL's power and fuel purchase costs as well as changes to direct taxes or duty costs should be allowed as a cost pass-through. GGL argue that an RPI-X form of price control should mean GEL is indifferent to the level and structure of each individual tariff and the OUR must ensure that each individual tariff is set on sound economic principles and not used to disadvantage competitors or to distort the energy market. GGL maintain an absence of market incentives on GEL require a number of additional measures for incentive regulation to work, namely:

- an effective system of management incentives and budgets for both capital and operational expenditure; and,
- removal of surplus cash from GEL's control and control on GEL's access to the 'Save-to-spend' reserve.

Guernsey Electricity Limited
GEL is of the view that an RPI-X form of control is appropriate for those elements of its cost base for which RPI is relevant, but considers a pass-through formula for international fuel oil costs and imported electricity is more appropriate. GEL therefore argues for a form of control where customer price levels are set in advance for a period and an adjustment to prices is then available for the future, should actual import and fuel prices not equate to predicted price levels. GEL also believe the form of regulation should continue to be one of control of prices rather than revenues.

DG's assessment
The DG considers there is merit in setting a price control in the form of RPI±X but proposes that provision for a pass-through mechanism of fuel costs as well as imported electricity costs is made. In setting any pass-through mechanism, the DG places importance on ensuring any pass-through arrangement does not of itself materially favour one source of generation over another.

Q2) The DG sought confirmation that the relevant tariffs on which the proposed price control of GEL's core business is based over the next control period are those set out in section 5.2 of OUR 06/17.

Guernsey Gas Limited

GGL consider the price control should also include the two tariffs associated with CHP, namely, Buy-back tariff and Standby tariff, which GEL should routinely publish.

Guernsey Electricity Limited

GEL agrees with the scope of the control and the associated proposed list of tariffs but note it excludes the Boiler Tariff and elements of the Maximum Demand Tariff, namely installed capacity and power factor data were not covered. To facilitate future discussion on any tariff rebalancing, GEL sought to ensure that the price control direction is framed so that a re-balancing of tariffs could take place during a six-year period. This is subject to assurances GEL says it would provide on intended total revenue being unaffected by the rebalancing and also subject to satisfactory re-assurance by GEL that any re-balancing was justified on the grounds of improving the cost reflectivity of tariffs to customers.

DG's assessment

The DG notes GEL's comments and will provide for the reopening of individual tariffs for purposes of tariff re-balancing. In the case of the Buy Back Tariff, GEL's marketing information indicates that rates will be agreed on application to GEL. The DG expects GEL to negotiate commercially mutually acceptable agreements and if no such agreement was acceptable then either party could request the OUR to intervene. The DG does not therefore intend to include the Buy Back Tariff within the scope of the price control. The Standby tariff (installed capacity), which is already published by GEL, as well as the power factor tariffs, are less predictable charges to some extent and the scale of funds involved is small. For completeness, the DG has however proposed to include these within the scope of the control and applied the average growth rates of other GEL tariffs in order to forecast levels of revenue realised from these customers.

Additional Issue – Financeability

GEL believe there is an over-emphasis and a dominant focus on "cash" and "save-to-spend" issues at the expense of profitability and dividends, when considering company finances under the price control. In GEL's view, both of these factors need to be given a balanced role in the regulatory perspective of GEL's finances. GEL does not agree with the proposal by the OUR to use "the level of cash in the save-to-spend reserve" as the "key variable on which to assess financial viability" and therefore place "less weight on accounting accruals and provisions such as depreciation". In its view such an approach could result in no dividends being made to the shareholder for the foreseeable future which in their view is inconsistent with the IEP Report. GEL are also of the view there are a range of risk management issues that need to be taken into account by the shareholder when it determines the level of cash reserve that is necessary.

DG's assessment
The National Audit Office (NAO) reviewed the outcomes of commercialisation and the operation of the regulatory framework that supports it, in a report to T&R and C&E Departments dated September 2005. Appendix 3 of that report set out recommended principles for the States as Shareholder in the commercialised enterprises, including GEL. One of the underlying principles it recommended was:

- *"An incentive framework that links rewards explicitly to profit and value performance over the long term."*

The price control framework provides for an outcome where, if GEL achieves its regulatory efficiency targets, and if all approved investment is financed out of the Save-to-Spend cash reserves, the business will be profitable over the period of the price control. Exceptional events may occur and in these circumstances GEL may submit a case for review of tariffs set by the DG. However the DG believes, in light of the funding arrangements for GEL, that the level of Save-to-Spend cash reserves is an important indicator for the regulator to focus on.

Additional Issue – Monitoring and Compliance

Guernsey Electricity Limited
GEL argue for compliance arrangements that are simple and transparent and which will result in certainty over pricing decisions. GEL however maintain that arrangements proposed by the OUR last year had not been provided and requested a draft set of arrangements to be made available for comment by GEL prior to a final decision. GEL also expressed concern that the new price control could be so complex as to require increased regulatory compliance requirements in the future contrary to the "lighter touch" trend for regulation on Guernsey envisaged by the States of Deliberation in May 2006.

DG's assessment
OUR 05/31 stated that the aim of the compliance procedures for the price control over the period 1st January 2006 to 31st March 2007 would be to ensure that GEL met its obligations under the price control. Due to the nature of the final price control decision (i.e. a 15-month period) – demonstrating compliance was relatively simple. GEL was only required to demonstrate that price increases on 1st January 2006 and on 1st April 2006 did not exceed RPI + 1.7% on each occasion[4]. The Monitoring and Compliance arrangements were therefore clearly set out and straightforward, without involving a set of arrangements that required consultation.

In terms of the price control commencing 1st April 2007, compliance with the maximum level of tariffs set will require GEL to ensure its tariffs do not exceed the levels set by the DG. This is in line with current practice.

It is apparent that fuel and imported electricity costs are a significant proportion of GEL's overall costs. A pass-through mechanism has therefore been provided. Such a mechanism has the potential to alter the level of allowable revenue for future years of the price control period should outturn differ materially from that assumed at the time of the final decision. The information required by the DG for these purposes is

[4] RPI was the latest available 12 month figure as published by the T&R Department.

detailed in Annex B. It is proposed that prior to the end of each financial year, annual maximum tariffs will be announced by the DG in the event this pass-through arrangement as well as any incentive/penalty mechanisms that the DG may put in place result in material changes to allowable revenue.

Finally, GEL will need to report on outturn actual costs on an annual basis, at an aggregate level, for all of the main cost categories. Rather than wait until the end of the four year-price control, it is preferable that this data is provided on an annual basis. The data needed for the control is information that one would normally expect to be recorded by GEL in the course of its day-to-day management of the business, and should therefore not present any regulatory burden.

Q3)The DG sought views on the appropriate length of the next price control.

Guernsey Gas Limited

In general GGL agreed that setting a long price control is appropriate for RPI-X type regimes to provide a time frame in which to realise efficiency gains. GGL recommended a price control period of no more than 3 years as it believes the arrangements for GEL are still in transition and an unduly long price control create risks in that the OUR may not be able to correct any problems that may emerge.

Guernsey Electricity Limited

GEL confirmed it seeks a six year price control. However, it maintains an appropriate length of price control can only be agreed if the form of price control has a simple form of pass-through of import and fuel price variances and should not be of the RPI±X format for all costs.

DG's assessment

The DG considers that in light of responses to the consultation and, in particular, given the price control framework is still relatively new for GEL, it is prudent to set a price control of no more than four years. This has involved striking a balance between the need for stability in GEL's business planning, and the risk of unforeseen issues emerging over a lengthy price control period as highlighted by GGL. It also ensures that a further price control can be undertaken closer to the peak investment periods forecast by GEL to ensure that should any significant adjustment be required, a clear time window exists for doing so.

[CONFIDENTIAL TO GEL]

Q4) The DG sought views on the appropriate allocation of capital investment costs incurred by GEL over the period from 1 February 2002 to 31 March 2007. In particular, whether they should be allocated to RAB (historic), RAB (new) or some alternative

Guernsey Gas Limited

In GGL's view it is appropriate to use the net book value at the time of commercialization as the opening RAB (historic) and GGL supports the recommendation of the IEP that investments post commercialization should all be treated as RAB (new). GGL's view is that the choice of any date other than 1st February 2002 is essentially arbitrary.

Guernsey Electricity Limited
GEL maintain that the IEP made recommendations regarding two categories of assets according to two time periods – commercialisation and subsequently, and did not propose that the period between commercialisation and the next price control period (April 2007) should be treated as a separate third period. In GEL's view the post commercialisation rate of return (RAB new) should apply to all core assets since 1 February 2002.

DG's assessment
The DG would note that the purpose of the IEP report was to inform the DG's further consideration of the longer term price control for GEL – and not to actually set the control. The DG has noted the views of respondents and therefore proposes to allocate all capital investment costs incurred by GEL over the period 1 February 2002 to 31 March 2007 to RAB (new).

Q5) The DG invited comments on the proposed approach to the implementation of the Panel's recommendations in establishing GEL's regulatory asset bases, RAB (historic) and RAB (new).

Guernsey Gas Limited
In principle, GGL accepted the IEP's proposal of a split asset base and differential rates of return (subject to its preference for an alternative approach where a commercial return is provided for all GEL's core asset base with a provision for customer dividend).

Guernsey Electricity Limited
GEL welcomed the proposal to base a return on an asset base approach and supported the two-tier approach to asset valuation, with the proviso that the values used were supportable as reasonable estimates that are stable over a period of time. GEL does not believe single point values of assets and returns provide reliable estimates. GEL maintain the issues of roll forward of the proposed two asset categories can only be properly responded to within the context of the OUR's price control model and therefore did not respond in detail on the arrangements proposed in the consultation document. GEL also indicated that the consultation indicated capital investment to the date 31 March 2007 would be required as an input but noted this value will not be available until after the price control is due to come into effect.

DG's assessment
A split asset base is proposed in this draft decision and referred to in this document as RAB (historic) and RAB (new). These will form the basis for provision of the respective costs of capital of the business consistent with the IEP's recommendations. The DG has a record of GEL's historic investment as well as asset lives of those investments. These investments by GEL were used to set the value of RAB (historic) at £72.5m and the basis for this figure will be passed to GEL to ensure the data is robust for purposes of setting RAB (historic). The DG has also received GEL's proposed capital expenditure for the 2006/07 year. Despite the fact that this is a forecast, it is expected to provide a robust basis for setting of RAB (new) which, as stated above, is based on GEL's capital expenditure from 1 February 2002 to 31 March 2007 comprising RAB (new). RAB (new) is therefore estimated at £17m net of depreciation based on capital investments costs and the lives of the relevant assets. GEL is invited to review the basis for this figure to ensure the data is robust for purposes of setting RAB (new). The two RABS will be indexed by inflation.

Q6) The DG requested views on whether the accounts submitted to the States on Wednesday 10 July 2002 for the period 1 April 2001 to 31 January 2002 are appropriate as a basis for implementing the Panel's recommendation regarding the rate of return on which RAB (historic) might be based? Comments were also sought on the use of the surplus (after depreciation) as at end of period 31 January 2002 as the basis for assessing the return to shareholder and therefore the cost of capital for RAB (historic).

Guernsey Gas Limited
GGL agreed that the balance sheet as the 31st January 2002 is the correct source for setting RAB (historic). On the question of assessing the return, GGL's view is that OUR should, at least, make a correction to include a winter quarter given the annual report covered a period of only 10 months. GGL proposes either the winter quarter from 1st February 2001 to 1st April 2001, or alternatively from the 1st February 2002 to 1st April 2002.

GGL however recommends an alternative approach on the basis that GEL's returns over recent years have not been stable and their suspicion that GEL's performance over 2001/2 was affected by the impending commercialisation. GGL provided analysis of the sources of GEL's reduced profitability from 1997/98 to 2005/06 and concluded that the downward trend in GEL's profits in this period is entirely due to its prices not keeping pace with its increased costs, particularly energy costs. GGL therefore question whether basing the return on RAB (historic) on a spot year is representative. GGL believe that GEL was reluctant to increase prices in the run up to commercialisation, when it should have and suggest it would be more representative of the pre-commercialisation return for OUR to determine the allowed return on RAB (historic) on the profit over a number of years (say 5-10) prior to commercialisation.

Guernsey Electricity Limited
GEL accepts the IEP's recommendations in this area, but does not agree with the reasoning and the approach that the OUR proposes for implementation. In GEL's view the financial return figure cited in the consultation is too specific to be a

reasonable approximation of GEL’s returns in the period leading up to commercialisation. GEL instead advocates a return figure calculated over a longer time period, believing this would provide a more robust implementation of the IEP’s recommendations in this area and address the unique and extraordinary items influencing GEL’s accounts and returns in that one period. GEL notes that the OUR’s figure relates to a 10 month period, rather than to a 12 month period. GEL believes that if the return of 0.245% cited in the consultation document is considered nominal then it is a significant negative value when expressed in real terms. GEL calculates relevant values for a return as follows for the 12 month periods to the dates;

Table 1:

Year Ending	Return (%)
March 1998	7.096
March 1999	11.009
March 2000	6.132
March 2001	2.128
March 2002	0.549
Average	**4.807**

GEL proposes that this average figure for return is adopted, but taking account of the exceptional items arising from the BCCI liquidation, this might adjust the above average figure downwards to 4.3%, which would be acceptable to GEL.

DG’s assessment

The purpose of setting a return on investment expenditure prior to commercialisation was not to provide a commercial return to GEL’s shareholder for these assets. The IEP’s recommendations 4 and 5 state that:

“*The RAB at the time of commercialisation should be set equal to the balance sheet asset value at that date*”; and

“*The allowed return on these assets should be determined in a way which leaves average bills at that date uncharged*”.

It is apparent that the IEP proposed a point estimate of the asset value and consideration of average bills was also referenced to a specific date. An interpretation that the IEP intended for the asset values and allowed return to reflect the situation leading up to commercialisation is not consistent with these recommendations. The DG therefore proposes to take the surplus in GEL’s profit and loss account for the 2001/02 financial year less any allowance for exceptional items such as those arising from the BCCI liquidation. This figure will be divided by the value of the net tangible assets of the business at the end of that period. The cost of capital derived from this ratio is, based on GEL’s submission, 0.549%. It is proposed this will be the cost of capital provided on the asset base referred to as RAB (historic), and the asset base will be indexed by inflation each year, thereby providing a nominal level of return to GEL.

Q7) Comments were sought on the validity of the approach to assessing GEL's risk-based discount rate as set out in section 6.2.2 of OUR 06/17.

Guernsey Gas Limited
GGL supported the approach set out by the OUR and cannot see any logical reason not to accept the middle case. GGL are concerned that GEL actually uses the WACC as a discount rate for its investment decisions and propose the OUR should undertake periodic spot checks as part of its compliance and monitoring programme.

Guernsey Electricity Limited
GEL welcomed recognition that a real pre-tax WACC should be applied to new investments and its own consultant's work supports figures within the range of 5.97% to 7.81% (both real values). However, GEL advocated the low value within the range suggested in the consultation so that the impact on prices for future customers is not too marked as new assets replace old assets. GEL was concerned that the OUR may propose too low a value to pre-commercialisation returns and possibly returns on new assets that are too high – leading to instability for customer price trends.

DG's assessment
GEL is a business that is underwritten by the States of Guernsey, meets its capital expenditure only from cash reserves, is vertically integrated and has a high level of excess capacity to meet security of supply demands. On the other hand, as an island economy access to raw materials and other scarce resources, such as staff, are elements of risk for GEL that other electricity businesses are not generally exposed to. On balance however the DG considers GEL is subject to a lower level of risk than the average electricity provider and has therefore chosen the lower of the three cases on which to base a rate of return to the business. The DG therefore proposes to take 5.97% on which a return on RAB (new) is based over the period of this price control

Q8) Views were invited on the feasible depreciation allowance for RAB (new) and the implication of no depreciation allowance for RAB (historic).

Guernsey Gas Limited
GGL's view is that it is essential that RAB (historic) is depreciated, otherwise the assets will remain on the books long after they have been removed or been replaced. GGL's own estimates suggest that, on the basis that RAB (historic) is depreciated as a single item, it would be depreciated over about 25 years. GGL believes the OUR should allow the depreciation on RAB (new) based upon the estimated technical or economic life of the assets concerned.

Guernsey Electricity Limited
GEL's view is that the approach set out in the consultation would result in regulation which is disproportionate to Guernsey circumstances since the OUR is not proposing to allow depreciation based upon historic cost accounting. GEL argue that depreciation not already charged to the profit and loss account in respect of existing assets should be allowed both for statutory and regulatory purposes. GEL suggests that the OUR adopts an approach to price control modelling that includes a

depreciation charge in its regulatory analysis. GEL consider that depreciation on historic and new assets should be treated in the same way.

DG's assessment

It should be noted that in a regulatory price control, the term 'depreciation allowance' is an amount provided for in the company's allowable revenues for the upkeep, improvement and replacement of capital assets. The terminology has contributed to a degree of misunderstanding reflected in responses to this question. Consultation on the possibility of no depreciation allowance for RAB (historic) was not intended to suggest this asset base would not be depreciated, but that no capital allowance need be allocated in the roll-forward of this particular asset base. The DG proposed the option to allow for such costs of upkeep, improvement and replacement of these assets in the roll-forward of another asset base, i.e. RAB (new). The allowance would be based on the average future capital expenditure needs of the business. This presented an alternative basis for a depreciation allowance since it would be based on future capital expenditure needs rather than historic expenditure, which is the case with a standard 'depreciation allowance' provision. A regulatory depreciation schedule set on the basis of the asset lives of those capital investments comprising RAB (historic) and RAB (new) is not expected to differ materially from the average future capital expenditure by GEL and either could be used.

The DG however proposes to depreciate the assets comprising RAB (historic) and RAB (new) based on the asset lives as provided by GEL. These will form the two regulatory depreciation schedules provided for in GEL's allowable revenue. The RAB (historic) asset base will therefore decline over time as depreciation charges lower the value of these net assets, given all new investment will be added to RAB (new). The net effect will therefore be to raise the value of RAB (new) and reduce the value of RAB (historic) as essentially new assets are required to replace those older assets categorized under RAB (historic).

Q9) The DG sought comments on the appropriateness of drawing upon a mix of approaches to assessing GEL's potential for efficiency savings given his duty to regulate in a manner proportionate to Guernsey, and the different nature of cost.

Guernsey Gas Limited

GGL generally supported the classification of GEL's costs set out in the consultation. GGL were however wary of OUR making comparisons between the performance of GEL and of much larger utilities referred to in the consultation document as the scope and opportunity for efficiency savings in smaller utilities in GGL's view is much less than in larger utilities. GGL proposed the OUR should make a realistic assessment of the potential for efficiency savings for GEL and would recommend making comparisons with Jersey Electricity, which is partially privately owned.

Guernsey Electricity Limited

GEL have responded that the suggested top down approach to overall cost levels proposed in the consultation document does not take account of GEL's circumstances and the bottom up analysis of generation costs contains uncorrected errors. GEL therefore do not believe the predicted cost savings from efficiency will be achievable.

In terms of top-down assessment, GEL believes the examples of efficiencies achieved by other organisations are not appropriate benchmarks as it considers these examples arise from very different organisations to GEL, in different jurisdictions and in different sectors to itself. GEL also consider that these businesses did not go through the changes experienced by GEL pre-commercialisation in which it is argued GEL made substantial change and cost savings. GEL therefore maintains such benchmarks are too harsh and price regulation based on these would not be proportionate to the circumstances in Guernsey. The consultation does not in GEL's view identify the similarities of these businesses to itself and believes the differences outweigh the similarities to the extent they render such comparisons of no value.

DG's assessment
Given these comments this appears to raises doubts whether proportionality to Guernsey's situation is realistically achievable to the extent envisaged by the States since the approach raises significant objection from GEL. The extent to which GEL does not accept that benchmarks can be a valid basis for changes to its business unless an extensive level of scrutiny of those comparators is made would in practice lead to an approach that would be little different from a detailed bottom-up appraisal of the business. This would appear to resist States' objectives and the threshold of detailed analysis acceptable to GEL in this area is not transparent.

The DG believes that a variety of approaches is required, with each approach proportionate to the costs being examined.

[CONFIDENTIAL TO GEL]

[CONFIDENTIAL TO GEL]

The approaches taken for the various cost categories are described in the relevant parts of Section 5. The DG believes the approaches taken are proportionate and sound.

Q10) The DG consulted on the appropriate benchmarks available on which to base efficiency targets in the area of overhead costs, and in particular whether the setting of an efficiency target for these costs based on proportions in 2001/02 is appropriate.

Guernsey Gas Limited
GGL believed it was not in a position to comment on the efficiency of GEL's overheads, however it was of the view that the OUR should ensure that only the overheads associated with the core business are allocated to the price control, suggesting standard methods of cost allocation, such as 'Activity Based Costing', could be used.

Guernsey Electricity Limited
GEL's comments are summarised in the Confidential Annex A to its response. GEL maintained that activities and costs in the year ended 31 March 2006 and to date confirm its view that the proportions in 2001/2 are inappropriate bases for the setting of future efficiency targets.

GEL consider that since the period relates to a pre-commercialisation situation when the scope of activities in that area of the business was very different to what has been required since commercialisation there are a number of business activities and operational functions which are now required which would not be included in the benchmark cost proportions if the year 2001/02 is used. GEL's view is that such an approach would have the effect of setting future allowances below efficient cost levels.

DG's assessment
The DG has based future allowed costs based on GEL's current projected costs for the year 06/07. The DG has noted that this figure is below the allowed revenue for this cost category in the current price control period. The future allowed costs in the first two years are based on the allowed costs, rather than the actual costs. In effect this allows GEL higher revenues than projected costs as a reward for getting to a lower cost base than previously allowed. This is consistent with good regulatory practice and provides an incentive for the regulated company to beat allowed costs.

Q11) The DG invited views on the conclusions of PPA's efficiency review as set out in consultation document OUR 06/17.

Guernsey Gas Limited
GGL did not believe it was in a position to comment on this question.

Guernsey Electricity Limited
GEL's response to this aspect was contained in a Confidential Annex B to its main response. An assessment of GEL main points is made below

DG's assessment
[THIS SECTION IS CONFIDENTIAL TO GEL]

Q12) The DG sought views on a means of implementing a robust pass-through arrangement for fuel costs.

and

Q13) The DG also invited views on the appropriate pass-through arrangements for imported electricity prices for the next price control.

Guernsey Gas Limited
In GGL's view GEL faces uncertainty on the costs and volume of fuel purchased for on-island generation and recommend an approach where the cost of fuel is estimated from the price of fuel indicated by the futures market, together with an end-of-year reconciliation of any variance. GGL emphasise the importance of fuel costs together with the associated marginal operating costs should be accurately allocated to the relevant tariffs. GGL supports a full cost-pass through of the imported electricity costs, provided OUR is satisfied that the contract represents best practice.

Guernsey Electricity Limited

GEL believes proposals can only be understood through the regulator providing a provisional estimate of all pass-through correction amounts through an agreed formula. GEL states it seeks a simple form of regulation which is proportionate to the circumstances of Guernsey and has concerns that the implementation of the type of annual correction mechanisms being considered by the OUR could result in very onerous compliance arrangements in the future. GEL believes that a mechanism is required, which simply calculates the difference in fuel cost that would have been allowed by the OUR if the actual fuel price levels had been known in advance, when setting the price control. GEL's view above on the pass-through of fuel costs apply to the pass-through of imported electricity prices.

DG's assessment

[THIS SECTION IS CONFIDENTIAL TO GEL]

Q14) Views were invited on the criteria on which the level of 'Save-to-spend' cash reserve for the period of this price control might be based. In particular, respondents are invited to comment on whether criteria should be set in relation to identified capital expenditure needs over a defined time period.

Guernsey Gas Limited

GGL agree with the IEP that 'Save-to-Spend' is an unusual and probably an inefficient method of financing GEL but accept that it is the current policy set by the States of Guernsey. GGL suggest that the cash reserve should be set at a level based on projected capital expenditure. Since, in its view, capital expenditure forecasts are to some extent uncertain GGL believes cash reserves should be set at a level that recognizes this uncertainty. GGL suggests the OUR undertake a longer term cash flow analysis to establish the level of the reserve at the end of the current period and in theory this cash flow analysis should cover a complete asset cycle.

GGL cite the NAO referring to a complete asset cycle of 25 years which they consider is also the asset life of the cable and the likely life of RAB(historic). GGL cite Ofgem practice which has typically undertaken a high level 20 year cash flow model to test the sustainability of its price controls and cash flow position over the longer term and propose an approach along these lines. GGL did not believe it is in a position to judge whether a rolling ten-year analysis is reasonable in the circumstances but believes a reasonable allowance for normal working capital should be provided for but should not be included as part of the 'Save-to-Spend' reserve.

GGL also consider it a priority that the rules by which GEL can access the reserve are clearly understood. In the absence of such controls, GGL believe there is a risk that GEL will use the reserve to underwrite poor performance, and in their view continue to fund investments with questionable economics. GGL agrees that the reserve should not be used by GEL to fund non-core investments.

Guernsey Electricity Limited

GEL maintain that the IEP's Recommendation 1, which deals with GEL's cash reserves states that T&R should specify the required level of cash reserves and once T&R has considered the matter and made its decision known then GEL would expect to target delivery of that level of reserve. GEL therefore concludes this needs to be set out by T&R in order for matters to progress in this area and the OUR's questions 14, 15, 16, 17 & 21 – which relate to the above areas – are not legitimate matters for regulatory decision and consultation, if the IEP's recommended approach is to be adopted.

GEL also suggest that profitability and dividends are matters upon which the OUR should also have consulted, arguing they are key financial indicators which deserve equal consideration to the issue of cash reserve levels. GEL maintains that it is clear from the IEP's comments in particular, in Annex A of its report, that the OUR's role was envisaged as one of implementation in the areas covered by those parts of the Financial Framework and that the IEP expects GEL to be profitable.

GEL does not consider the adoption of a "Save-to-Spend" policy as involving a "premium to customer tariffs". Consideration of cash reserves for the price control should in GEL's view be restricted to the funding needs of the core business, and confirming that there is no cross subsidy between core and non-core. GEL also express concern the OUR will set tariffs solely with regard to the cash levels required for capital expenditure each year.

In terms of monitoring, GEL proposes a "service standard" approach for a band range, with exception reporting to the shareholder – this being copied to the OUR for further regulatory consideration, if necessary. GEL supports the OUR's proposal not to involve itself with the significant resources that would be required to estimate and predict risks of cash levels falling below those required for planned capital expenditure. GEL maintain that the proper governance of risk management of cash levels lies between the company and the shareholder and regulatory involvement in this area is unnecessary and would be inconsistent with a "light handed" form of regulation which is appropriate for Guernsey.

DG's assessment

The DG notes from GEL's response to OUR 06/17 in this question and subsequent questions posed by the DG for comment in the area of Save-to-Spend, that GEL had interpreted Recommendation 1 of the IEP's report in a particular way. The IEP were therefore approached to clarify precisely its recommendation on this point to ensure there is no risk of misinterpretation.

The IEP have stated its recommendation means the following:

"*T&D specifies a RULE which OUR then takes into account in setting the price control. Given that T&D's background policy is save-to-spend, the rule is likely to be linked to the required investment* ***but it is for OUR to determine what that amount is****, bearing in mind that it should be least cost at the relevant discount rate. It would not be consistent with this allocation of responsibilities if T&D said - accumulate a reserve of £X to pay for a new interconnector which GEL says will cost £X, when OUR had determined that the least cost investment were other and might only cost say £X/2.*" (emphasis added).

The DG considers GEL have misinterpreted the IEP's recommendation in this area and he proposes that the price control will be set to achieve the shareholder's rule on the basis for financing GEL's capital expenditure programme but will apply this to achieve a level of cash reserves he considers satisfies the shareholder's objectives in this area. The DG has not been presented with the details of GEL's proposal for a service standard approach for a band range and exception reporting as suggested by GEL and welcomes further expansion on this aspect in GEL's response to this paper.

Q15) Comments were sought on the appropriate level of cash reserves at the end of 2016/17.

Guernsey Gas Limited

GGL refers to its answer to question 14, stating its view that the technically correct approach is to analyse the investment plan over a complete asset cycle. GGL does not believe it is in a position to judge the appropriate level of reserve in 2016/17 as this will depend on the expected profile of planned investments.

Guernsey Electricity Limited
GEL reiterate the view that the target level of the "save-to-spend" reserve is a matter for the shareholder – as it contends is recommended by the IEP. In GEL's view the time horizon suggested by the OUR of the period to 2016/17 is appropriate for overall modelling purposes within the price control process but is quite arbitrary and therefore conclude the suggestion to aim for zero cash at that point in time is also arbitrary.

DG's assessment
The DG's assessment under question 14 is relevant here also. In addition the shareholder has written to GEL and stated that:

"The Department is of the view, and accordingly instructs, that the Company:
- *Maintain a Save-to-Spend policy such that sufficient cash reserves are held to fund future capital expenditure."*

The DG has provided for capital expenditure by GEL over the period of the price control of £19.7m. Cash reserves have been forecast and are sufficient to fund this investment over the price control. Consideration has also been given to the level of Save-to-Spend reserves against capital expenditure accepted over a ten-year time horizon. With the proviso that these reserves are used for the purposes of capital expenditure applied for by GEL and agreed with the DG and that GEL achieves the efficiency targets set by this price control, this draft decision satisfies the above rule by the shareholder.

Q16) Comments were invited on ring-fencing of a 'Save-to-spend' reserve and, the 'Distributable surplus' and the options for implementation. In particular views were sought on realistic and verifiable means of implementing and monitoring any ring-fencing approach.

Guernsey Gas Limited
GGL's view is that a sensible arrangement needs to be put in place to address any 'distributable surplus' in excess of the 'Save-to-Spend' reserve and agrees that the 'Save-to-Spend' reserve should be ring-fenced. GGL also consider GEL should be set an annual target for net payments into and out of the reserve derived from OUR assumptions. Where GEL wants to exceed these targets, then GGL's view is that approval for the variance should be sought from OUR and T&R. GGL consider the OUR should monitor GEL's capital expenditure each year and the net payments into and out of the reserve and that it may be appropriate for the net payments to be included as one of the management targets. GGL's view is that the proposed arrangements may well continue to generate cash in excess of that needed to fund 'Save-to-Spend' and have concerns that if GEL has access to unlimited cash it will have no incentive to achieve, let alone out-perform efficiency targets set by OUR, while in its view the incentive to over-invest will remain.

On the basis of the financial framework, GGL concludes T&R has no wish to increase the dividends it receives and therefore suggest a full commercial return on the entirety of GEL's assets, with provision for a customer dividend. GGL's view is that a customer dividend is a sound and acceptable way to address the surplus cash that GEL has accumulated and will continue to accumulate and is essential for allocative efficiency to ensure the 'distributable surplus' is not used to directly subsidise prices. GGL's preference is for any surplus the OUR determines in the 'Save-to-Spend' reserve is paid out promptly (i.e. before the start of the new price control) as a customer dividend. In GGL's view this would be a positive outcome for customers from the OUR price control review and also serve to mitigate any increase in tariffs arising either directly from the price control review or from the re-balancing of tariffs. GGL was also of the view that a further benefit would arise if future customer dividends reflected any out-performance of GEL, as customers would see this is a benefit from commercialisation.

Guernsey Electricity Limited

GEL maintain that this area is one that was only an observation of the IEP, not one of its seven Recommendations and that the use of cash reserves is a matter for the shareholder, as are any decisions regarding dividends. It considers this view is explicitly recognised in the Recommendations made by the IEP. GEL also contend the OUR is incorrect in saying "*a situation where the shareholder makes no decision and leaves funds within the cash reserve is not an alternative provided for in the Panels recommendations...*". GEL argue that the IEP made seven Recommendations, none of which covers this point and made clear in its Recommendations 1 & 2 that dividends are a matter for the shareholder and is therefore not a regulatory issue for consultation but rather a matter for the shareholder.

GEL maintain the OUR has adopted a speculative interpretation of the IEP's work in this area and that the OUR should only focus on the Panel's 7 Recommendations for the price control preparations and assumptions. GEL is of the view that if GEL's shareholder were to accept the IEP's Recommendations of a two-tier asset base with a lower than commercial rate of return on the historic base, then this is ample evidence that the shareholder is abiding by the States Direction to protect customers from high prices. Under these circumstances, GEL maintain the company can expect to be profitable, and to produce dividends, leaving T&R to take a view on how to deal with the Cash Reserves. GEL's maintain its view on the use of a relatively low rate of return on post-commercialisation assets is consistent both with T&R's requirement to show restraint in pricing and with the behaviour expected of a publicly owned utility.

DG's assessment

The DG proposes that it is for the shareholder in the first instance to provide sufficient safeguards to ensure inefficiency is not subsidised through subsidy from the shareholder's cash reserve. A lower or higher than expected level of 'Save-to-Spend' reserves can arise for a variety of reasons. The shareholder has indicated it will provide its own checks and balances through budget discussions and reviews. On this basis the DG proposes to rely on such a system and will review the situation with the shareholder during the latter stages of the next price control to assess whether changes are needed.

Q17) Comments were sought on the appropriateness of a 10 year time horizon or some other alternative time horizon.

Guernsey Gas Limited

GGL refer to previous responses noting that in theory the OUR should consider a complete asset cycle and would not favour a shorter time horizon.

Guernsey Electricity Limited
GEL state that the time horizon of 10 years was proposed as it was preferable to the OUR's 25 year time horizon in its price control model and remains GEL's view. It does not consider that any target level of cash reserves set by the shareholder should necessarily occur at that point in time and that the time horizon for cash levels should be driven by the "save-to-spend" policy, not the regulatory price control model. GEL contends that time horizon should be specified by the shareholder, in accordance with its role to implement the "Save-to-Spend" policy, and consistent with the IEP's Recommendation 1.

DG's assessment
On the specific time horizon period considered appropriate, GEL have stated that:

"… the prime requirement that dictates the period for an electricity business such as ours is the capital investment programme. As a capital intensive business we must examine the periods which contain large investment in capital assets, which for us means the years when we either enhance the cable link or buy new engines for our on-island generation. In the 10 years from 1 April 2007 to 31 March 2017 we are assuming a plan to do both…. I am, therefore, of the view that a 10 year horizon be adopted."

There seems a clear argument by GEL in support of a 10 year time horizon for purposes of ensuring the business is adequately financed in terms of the level of 'Save-to-Spend' reserves.

The implication of States policy that GEL's capital expenditure needs are funded entirely from cash reserves is that the scale of cash reserves relative to GEL's future capital expenditure needs beyond the next price control period require assessment by the DG. GEL's financeability beyond the next price control period and the need to avoid excessive corrections to cash reserve levels through price changes are specific considerations in this regard. It would not be appropriate, for example, if the DG set prices that ensured cash reserves were adequate to fund GEL capital expenditure over the next price control period, but these reserves were so depleted that major price rises were needed in future to fund GEL's capital expenditure needs beyond this period.

The role of the shareholder as conveyed above by GEL is also not consistent with the IEP's recommendations in this area. GEL's interpretation of the shareholder role is one where it implements 'Save-to-Spend' policy to the extent that the shareholder sets the level of cash reserves and the relevant time horizon. The OUR has a statutory role in ensuring GEL's capital expenditure is efficient. A shareholder role that extends to setting the actual level of cash reserves over a given period, which the DG must observe in any price control, is not reflective of the DG's statutory duties in this regard as it would, in effect, determine the level of capital expenditure allowable by the regulator over future years. Clearly, such an approach is not tenable in the commercialization framework provided by the States.

The DG proposes to adopt a 10-year outlook in assessing GEL's financeability, in particular the level of 'Save-to-Spend' reserves available to the business beyond the price control commencing 1 April 2007.

Q18) Comments were sought on the Panel's recommendation that the variable element of electricity tariffs should be based on commonly accepted economic principles, also reflecting the risk-based WACC.

Guernsey Gas Limited

GGL fully supported the IEP's recommendations. In its view GEL should be indifferent, generally, to the structure and level of individual tariffs as they are just a vehicle for recovering its allowed income. In this environment GGL's view is that there is a risk that GEL could set tariffs on the basis of expedience rather then reflecting the fundamental economics and it falls to the OUR to ensure that GEL's tariffs are cost–reflective and based on sound economic principles. In GGL's view the variable rates in the tariffs should take into account:-

- The incremental cost of power purchased from EDF and any fuel purchased for on-island generation;
- Incremental operating costs incurred, including losses on the network;
- The Long Run Marginal Cost (LRMC) of back-up generating capacity as required by the security of supply policy (current n-2).

GGL also raise issues as to whether GEL has over-sold the volume of off-peak electricity and whether off-peak demand is really contributing to peak demand. In GGL's view any adjustment should be made to standing charges or capacity charges as discussed in question 20.

Guernsey Electricity Limited

GEL's preference is that the outcome of the price control should be presented by all parties in as simple terms to customers as possible. GEL also comment on customer dividend issues, and maintain that the IEP made no recommendation regarding either a customer dividend or the structure of charges to customers. GEL believes that the OUR's considerations regarding per kWh and fixed charge issues risk unnecessary complexity when trying to explain a new price control to customers.

DG's assessment

The principle that tariffs should properly reflect the cost of service provision is sound and one the DG would wish to see progressed. The implication of making such adjustments, if necessary, would however require a pragmatic assessment of the benefits and time period over which such changes might be introduced. GGL appear to hold the view that some GEL tariffs are not cost reflective and regards the matter as more urgent. The evidence base available to the DG for assessing detriment to GGL is however weak and for this reason the DG sees no justification to set a deadline for GEL to implement any rebalancing of tariffs as part of this proposed decision. The DG does however welcome GEL's request to provide for rebalancing of its tariffs over the period of this price control. For purposes of this price control the DG does not therefore propose to assess the potential for rebalancing of GEL's tariffs. He will look to work with GEL to identify the appropriate time for any such review. The DG also agrees with GEL's preference for tariffs that can be presented in simple terms.

19) Comments were sought on the Panel's recommendation that the effect on GEL's allowed revenue of the lower allowed return on pre-2002 assets (net of depreciation on those assets) should be reflected in fixed or capacity charges that do not affect consumption decisions.

Guernsey Gas Limited
GGL support this recommendation as in its view it should avoid distorting allocative efficiency. GGL also notes that this approach is likely to benefit small consumers the most, which would be socially beneficial.

Guernsey Electricity Limited – see response to Q18
GEL's comments in response to question 18 apply equally to question 19.

DG's assessment
The DG considers that the same arguments relevant to question 19 apply to the issue of reflecting allowed return on RAB (historic) in fixed or capacity charges and will seek to have these issues considered during any rebalancing exercise by GEL.

Q20) The DG invited views on whether all customers should share in the capital costs required to maintain a security of supply level above a margin of 35% or whether these should be allocated to those customers placing such demands on capacity margin.

Guernsey Gas Limited
GGL propose that OUR determines the LRMC cost of n-2 and agrees that OUR should examine the cost of n-2 and ensure that the costs are passed through to the appropriate tariff. In GGL's view there does seem to be some scope for GEL to finesse the allocation of the cost of security of supply as in its view:-

- There does seem some merit in undertaking an LOLP calculation to determine risk level and to allocate costs;
- Off-peak electricity should only be sold up to the level that it is not increasing peak demand; and,
- GEL should set its tariffs to encourage distributed generation (such as CHP) on the island, which are efficient and increase security of supply.

GGL for example accepts that GEL needs to provide back-up supplies to any individual CHP installation, but considers it unlikely that they would all be off at the same time, and GGL therefore believe GEL's tariffs should reflect the real diversified risks to the business rather than treating each installation as a separate risk. GGL advise against making savings by reducing the level of security of supply noting that other fuels are dependent upon a reliable electricity supply as most oil or gas boilers will not work without power. GGL endorse the continued use of the n-2 policy.

Guernsey Electricity Limited
GEL believes that the supply security position of the island and the contributions towards the cost of these by different customer groups is not an urgent matter for

consultation under the price control and argue that this matter need not be addressed at the current time.

DG’s assessment
The DG agrees that the issue of priorities dictate that assessment of this issue is best covered as a subject for review at a later stage rather than implemented as part of the current price control.

Q21) The DG consulted on whether the current management incentive plan for GEL does focus on appropriate measures and seeks comments on whether management incentives elsewhere provide useful references for best practice.

Guernsey Gas Limited
GGL consider that in the absence of commercial pressures from investors it is essential that sensible management incentives are put in place as it is normal practice in regulated companies for regulatory objectives, both quantitative and qualitative, to inform the company as targets for individual managers. GGL indicate that many regulated companies routinely report to all staff their performance against regulatory targets and standards which helps ensure meeting regulatory targets is a collective endeavour, involving all of the staff. GGL consider that such a regime is essential for GEL in the absence of external market pressure. GGL however maintain it is for GEL management, supported by T&R and C&E to set such targets and the OUR’s role should rather involve provision of advice on the appropriate range of targets.

Guernsey Electricity Limited
GEL argue that incentives are a matter for T&R to consider and believes the shareholder is best able to judge the circumstances of appropriate and best practice relevant to Guernsey Electricity. GEL would support the OUR in applying a suitable mechanism which is simple and automatic in terms of pass-through costs but expresses concern that any mechanism which is more complex than that in the current price control will increase the burden of regulation, contrary to the “lighter touch” regulation expected following the States of Deliberation debate in May 2006.

GEL also has concerns that a new mechanism might have the effect of fundamentally altering the form of price control and maintains clarification is required, since there is no indication that a fundamental change to the nature of the price control is envisaged by the OUR. GEL sees no reason to change the form of control from one where customer price level are set in advance for a period and a simple adjustment to prices is then available for the future, should actual import and fuel prices not outturn at predicted price levels. In GEL’s view the form of regulation should continue to be one of control of prices rather than revenues.

DG’s assessment
The DG agrees with the IEP that there should be an alignment of regulatory objectives with management incentives. GEL appears to argue that such alignment is provided already through T&R oversight. There is no anticipation that for purposes of this price control T&R would wish to implement a system of management incentives as proposed by the IEP and the DG has not sought this for purposes of implementing this

price control. In the DG's view it seems preferable at this stage to monitor the achievements of regulatory objectives by GEL management and review this before future price controls.

Q22) The DG invited views on the issues and potential mechanisms for annual adjustments during the price control period.

Guernsey Gas Limited

GGL consider that in principle, GEL should be allowed to pass-through costs beyond its control, and it is therefore appropriate to allow a cost pass-through of power and fuel purchase costs, subject to some safeguard to promote efficient purchasing. GGL is also of the view that the RAB and prices should be linked to a routinely published index of general inflation, where it believes best practice is to use mid-year factors for prices and year-end indices for RAB. GGL's view is that it is inevitable that there will be a difference between the actual revenues and the allowed revenues and that it is general practice that small differences (1-2%) can be carried over from one year to the next, with a penalty if the differences are excessive (say >5%). GGL also cite tariff years being often different to price control years, enabling companies to set tariffs so they straddle price control years which helps minimize any variances. GGL is of the view that since energy policy for the island is still ongoing it is important that OUR should not pre-empt any of the measures or initiatives that might come out of this review and recommend the provision of a cost pass-through for any direct taxes, duties or levies on either fuel or emissions resulting from the energy policy review.

Guernsey Electricity Limited

GEL's comments in response to question 21 apply equally to question 22.

DG's assessment

In reviewing GEL's costs, and proposing the costs and resultant tariffs contained in this draft decision, the DG has also considered the quality of service provided. It is typical for regulated electricity companies to face incentives and penalties as incentives to improve quality in areas of concern to customers and the regulator. Guaranteed standards are another example of revenue penalties being incurred by the regulated company for failure to meet agreed standards.

The third element in any performance measurement, as well as cost and quality as mentioned, is timeliness of delivery. As customers provide the funds for capital and operational expenditure, new services should be delivered on time.

In the January 2006 – March 2007 Price Control, the DG approved capital expenditure for the period as part of an overall capital expenditure of £2.05m on an Automated Meter Reading project, whereby all customers would have a "smart meter" on their premises. Such a system brings a range of benefits, including accurate meter readings and a tool for GEL to better monitor its network and reduce faults as a result of improved information.

In approving the expenditure, the account of the business case put forward by GEL as well as the expected delivered benefits to customers was assessed. The proposals from GEL at the time in the business plan were for a four-year rollout following successful technical testing. In order to fully derive the benefits outlined in the business case, it is important that any rollout plan is delivered within the period outlined. Extending this period will incur extra costs, as stated by GEL, in a number of ways, including the costs of running two systems at once, as well as fixed meter reading costs incurred over a longer period.

By May 2005, 2,000 AMR customers were connected to the network, and by mid-December 2006, as part of a wider rollout strategy this figure has almost reached 5,000. GEL has stated that the current forecast rollout programme is due to be completed by the March 2011, a five year rather than a four year rollout as originally envisaged. The DG is not aware of any analysis of the extra costs associated with a five year rollout compared to a four year rollout programme, which he would have expected.

While GEL has developed plans up to the rollout stage, the DG is concerned at the lack of any detailed plan for the full rollout of AMR system. The rollout schedule and expenditure also appears inconsistent with GEL's submitted capital expenditure. It is in the interests of all customers that the rollout is completed within the rollout period, to ensure that all customers benefit, and that tariff options enabled by the AMR system can be introduced at such a point.

The DG is therefore proposing that any delays to the full delivery of the project should incur a financial penalty. This is akin to a customer placing an order for goods, with an agreed delivery date. A service provider who fails to meet these dates will tend to lose customers to competitors – however, for a product delivered by a monopoly supplier, no such threat exists. In such a circumstance it is appropriate for the regulator to protect the interests of customers by incentivising GEL to deliver the project on time.

GEL has provided the following rollout plan:

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

This amounts to an extra half-year compared to the original plan, as the DG assumes the final 3,500 meters will be completed by the middle of the financial year 2010/11. For the period of this price control the DG proposes a penalty of £40 per meter for each meter not installed when compared to the rollout schedule above. This compares to the approximately £100 that each customer is paying through tariffs for these meters. The DG also proposes that the penalty will only apply if the total number of installed meters is less than 95% of the target. However if the penalty is incurred it will be applied to the full shortfall number.

The end year targets are therefore as follows:

Financial Year	No of Meters Installed Single Phase
2006/07	6,500
2007/08	12,500
2008/09	18,500
2009/10	24,500
2010/11	28,000

The last year in the schedule includes a completion date six months into that year. Any incurred penalty will be prorated, i.e. half the penalty will be incurred, with the date of comparison being the scheduled completion date rather than the year end. GEL will incur no financial penalty if the rollout is completed within this schedule.

5. Principles of GEL's Price Control

5.1. Form

Proposed Decision

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

5.2. Scope

It is proposed that any price change is applied consistently to all tariffs and that the scope of the price control will include the following services:

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

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

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

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

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

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

- Heat Pump Tariff:
    - Unit charge;

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

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

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

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

Proposed Decision

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.

5.3. Relevant price control period

Proposed Decision

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

5.4. Monitoring and Compliance

The aim of the compliance procedures will be to ensure that GEL meets its obligations under the price control. This overall aim has the following objectives:

- to minimise the resources required for compliance and monitoring, both from GEL and the OUR; and
- to ensure maximum transparency and certainty for GEL to make its pricing decisions.

Compliance with the maximum level of tariffs set will therefore involve GEL ensuring its tariffs do not exceed the levels set by the DG. This is in line with current practice.

It is apparent that fuel and imported electricity costs are a significant proportion of GEL's overall costs. A pass-through mechanism has therefore been provided. **[THIS SECTION IS CONFIDENTIAL TO GEL]** . The information required by the DG for these purposes is detailed in Annex B. It is proposed that prior to the end of each financial year, the DG will confirm the annual maximum tariffs based on this pass-through arrangement as well as any incentive/penalty mechanisms the DG has put in place.

Finally, GEL will need to report on outturn actual costs on an annual basis, at an aggregate level, for all of the main cost categories. Rather than wait until the end of the four year-price control, it is preferable that this data is provided on an annual basis. The data needed for the control is information that one would normally expect to be recorded by GEL in the course of its day-to-day management of the business, and should therefore not present any extra regulatory burden. However the DG will discuss the precise nature of any information required with GEL prior to the finalisation of the price control decision.

Allowable Revenue

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

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

The principles used by the DG in each of the above issues have been discussed in detail in Section 4. This section presents the resulting values from the principles adopted.

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

Proposed Decision

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

5.6. Cost of capital – RAB (historic)

The value of RAB (historic) is proposed as £72.5m as at 1 April 2007. The basis for a cost of capital on this asset base is set out in Section 4.

Proposed Decision

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

5.7. The Regulatory opening asset value - RAB new

Proposed Decision

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

5.8. Cost of capital – RAB (new)

The value of RAB (new) is proposed as £17.0m as at 1 April 2007. The basis for a cost of capital on this asset base is set out in Section 4.

Proposed Decision

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

5.9. The Regulatory Depreciation Schedule for RAB (historic)

Proposed Decision

The DG proposes a regulatory depreciation schedule for RAB (historic) over the period of the price control as follows:

2007/08	**2008/09**	**2009/10**	**2010/11**
[ ]	[ ]	[ ]	[ ]

5.10. The Regulatory Depreciation Schedule for RAB (new)

Proposed Decision

The DG proposes a regulatory depreciation schedule for RAB (new) over the period of the price control as follows:

2007/08	**2008/09**	**2009/10**	**2010/11**
[ ]	[ ]	[ ]	[ ]

5.11. Capital expenditure

The DG has assessed GEL's capital expenditure proposals. Several capex projects were provided for in the price control over the period 01/01/2006 to 31/03/2007 but were not undertaken. GEL has cash reserves from which to fund capital expenditure and the DG would expect that over the 2007/08 year GEL would complete the capital expenditure programmes submitted for purposes of the current price control commencing 1 January 2006. This expenditure will be added to RAB (new) in the year it occurs. Given the structure of the current price control and since GEL's capital funding is provided for from cash reserves, there would not appear to be an argument to recoup the capital expenditure provided for, but not used, through reducing future allowable revenue[5]. Such issues will however be relevant for the price control commencing April 2007.

[5] In a standard price control, depreciation charges would have been set higher than necessary and a return on RAB would have been inflated since they were based on a RAB higher than the outturn.

A consequence of GEL not spending its cash reserves in the time period it originally proposed is that interest was earned on those funds that were not originally accounted for in GEL's allowable revenue. GEL therefore received a higher level of income from this source than was assumed in the current price control. As a consequence a higher level of allowable revenue was provided for than necessary. The DG proposes to address this by reducing GEL's allowable revenue for the price control commencing 1 April 2007 by the amount of interest earned on the funds in cash reserves not employed for the proposed capital expenditure.

The DG has accepted GEL's capital expenditure as submitted for purposes of setting the four year price control, with GEL's capital expenditure forecasts thereafter used to inform a level of Save-to-Spend reserves at prudent levels to undertake a combination of investment in on-island and interconnector generation capacity. This will be reviewed in further detail when the price control commencing April 2011 is set. This period will cover the peak investment period for GEL and more accurate information will be available on which to assess these investment programmes.

However the DG will require from GEL a description of the various capital expenditures projects associated with the submitted expenditure. This will enable the DG to better understand the nature of the projects being undertaken over the price control period and ensure that the expenditure has been spent as allocated and with the required outcome.

Going forward, and in particular for future price control periods, the DG expects to undertake more detailed analysis of the degree to which any capex is consider efficient. This will be particularly relevant in the period beyond 2011 as major capex is planned for that period. This is standard regulatory practice and ensures that customers are provided with a level of assurance that they are only being asked to fund investments that are efficient and related to the core activities of GEL.

Proposed Decision

The DG has accepted a capital expenditure submission by GEL over the period of the price control as follows:

	2007/08	**2008/09**	**2009/10**	**2010/11**
Generation	[ ]	[ ]	[ ]	[ ]
Conveyance	[ ]	[ ]	[ ]	[ ]
Supply	[ ]	[ ]	[ ]	[ ]

5.12. Operating costs

Operating expenditure – Generation and Imports

A key component of GEL's operating costs is in the provision of electricity to the Island, either through generation On-Island or imports through the interconnector. The key features of GEL's forecasts are:

- a mix of volumes between on-island and off-island of approximately [ ] import and [ ]% on-island generation (including works power) over the period 2007/08 to 2010/11;

- based on a forecast for Powernext baseload prices of €[ ]/MWH for 2007, €[ ]/MWH for 2008, €[ ]/MWH for 2009, subsequently increasing by €[ ]/MWH per annum;
- HFO prices forecast by GEL at [ ]p/litre remaining constant for the next four years; and
- A Euro to Pound exchange rate forecast at between [ ] and [ ].

The efficiency review of GEL's generation business by PPA, in particular the accuracy of GEL's dispatching model, is highly relevant to the issue of what the efficient mix of generation might be in the future. The relationship between Powernext baseload prices and the price of HFO is a variable informing PPA's recommendations about which GEL have particular views. These views were considered in Section 4 and the DG's proposals in this area are set out in Annex C. The proposals conclude that a robust approach to assessing GEL's concerns was to:

a) base an assessment of the efficient mix of on-island vs off-island generation for 2007 on the 2007 prices for HFO and Powernext as submitted by GEL, and
b) For 2008, 2009 & 2010, assume the prices as submitted by GEL for 2008 (both HFO and Powernext) remain constant in nominal terms.

This differs from GEL's own forecasts in that the path for Powernext base load prices beyond 2008 is higher under GEL's own forecasts. The DG has also evaluated the exchange rate submitted by GEL and concluded this range is likely to be too low. Sensitivity analysis was conducted across a range of exchange ratios and an exchange rate of [ ] is taken as a robust input to this analysis. This rate is therefore forecast for the period of the price control.

The volume mix based on what the DG considers are more prudent assumptions about the level and differentials between Powernext base load prices and HFO prices is therefore [ ]% import and [ ]% on-island generation as discussed in more detail in Annex C.

OPEX-Other

The DG's assessment in Question 10 is relevant to this element of GEL's costs. The DG has based future allowed costs based on GEL's current projected costs for the year 06/07. The DG has noted that this figure is below the allowed revenue for this cost category in the current price control period. The future allowed costs in the first two years are based on the allowed costs, rather than the actual costs. In effect this allows GEL higher revenues than projected costs as a reward for getting to a lower cost base than previously allowed. This is consistent with good regulatory practice and provides an incentive for the regulated company to beat allowed costs since if allowed costs are immediately reduced to meet the new lower level, the regulated company has no incentive to get to a lower cost.

[THIS SECTION IS CONFIDENTIAL TO GEL]

Proposed Decision - Total Operating costs

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

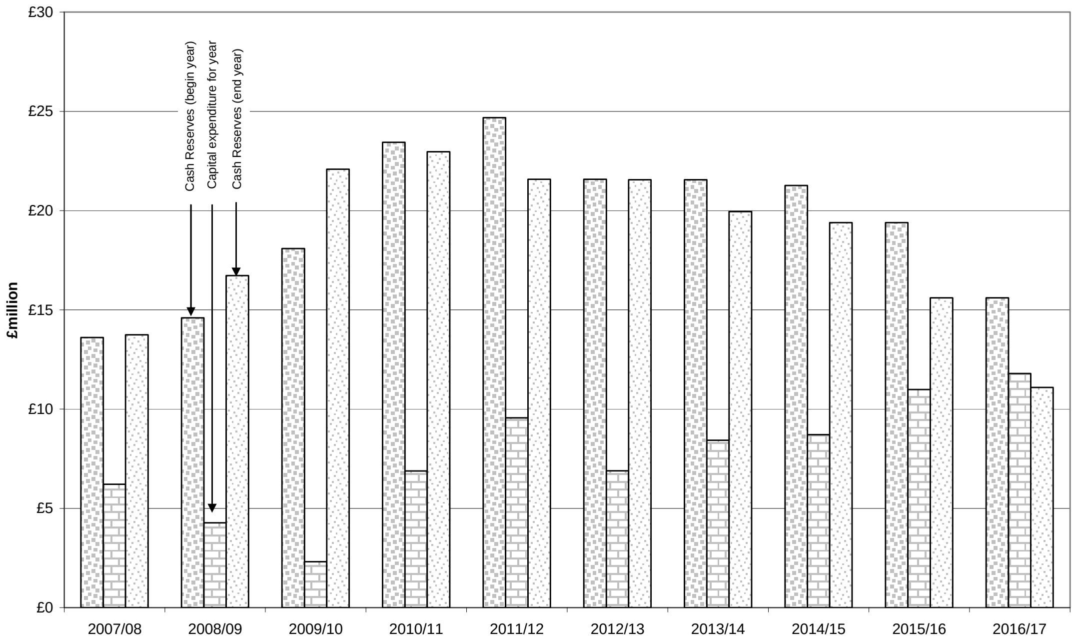
	2007/08	2008/09	2009/10	2010/11
Total operating costs	[ ]	[ ]	[ ]	[ ]

6. Save-to-spend cash reserves

As recommended by the IEP, T&R as the shareholder has set out a rule establishing the appropriate level of cash reserves required under the Save-to-Spend policy.

The DG has applied this rule on the appropriate level of Save-to-Spend reserves by analysing the future path of GEL's cash reserves against the levels of capital expenditure over a 10-year time horizon from 1 April 2007 on the assumption that GEL operates at efficient levels as required under this price control. Figure 6.1 below illustrates the relationship between these two variables. This shows GEL will have sufficient cash in its Save-to-Spend reserve to fund future capital expenditure and satisfies both the rule established by T&R and the DG's key criterion for financeability of GEL's operations.

Figure 6.1: Save-to-Spend reserves and Capital Expenditure (2007/08 to 2016/17)



For this draft decision the DG proposes to allow all surpluses after tax and dividends to be added to the Save-to-Spend reserves. However, a situation where Save-to-Spend reserves rise to levels beyond that required will raise regulatory issues. The IEP have advised that provision should be made for a customer dividend in the event the shareholder requires less than a full commercial return. The shareholder has not made such a provision for this price control and the materiality of the issue for this price control appears low in any event. For future price controls, the DG considers that should this become a material issue in terms of raising Save-to-Spend reserves beyond necessary levels the DG would have to either consider allowing a less than commercial return on RAB (new) or provide for a customer dividend allowance in some form.

7. Conclusion

The conclusions of the DG's assessment in this draft decision paper are based on the most recently published RPI figure by the States which is 3.5%. This may differ from the latest available RPI figure when GEL announces its next price change. On this basis the DG proposes to set the price control for 1 April 2007 at a level of RPI+14.5%, which equates to a change in tariffs of 18%. Forecasts for inflation have been assumed for subsequent years of 3.6% (2008/09), 3.5% (2009/10) and 3.4% (2010/11).

Proposed Decision

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

1st April 2007 – 31st March 2008:	RPI + 14.5% (18%)
1st April 2008 – 31st March 2009:	RPI – 3.6% (0%)
1st April 2009 – 31st March 2010:	RPI – 3.5% (0%)
1st April 2010 – 31st March 2011:	RPI – 3.4% (0%)

8. Next Steps

GEL has been provided with a copy of the price control model to inform its response to this draft decision. It is proposed that GEL will submit the data required for the annual adjustment mechanism in the form of a spreadsheet, which will apply the formula as set out in Annex B to the OUR by the end of November of each year of the price control.

The DG will, following consideration of any comments received to this draft decision, publish the final decision in February 2007. The final decision will set out the exact changes in tariffs that will take effect from 1st April 2007.

The deadline for responses is 19th of January 2007.

Ends/

Annex A – Summary of Key Elements of Price Control

[SOME INFORMATION CONFIDENTIAL TO GEL]

	2007/08	2008/09	2009/10	2010/11
Assumed revenue				
Assumed Capital expenditure				
Depreciation provided				
Assumed Operating expenditure				
Cost of capital (RAB – historic)	**0.549%**			
Cost of capital (RAB- new)	**5.97%**			
Cash Reserves (forecast for 31 March 2011)	**£23m**			
Cash Reserves (forecast for 31 March 2017)	**£11m**			
Assumed inflation	**3.5%**	**3.6%**	**3.5%**	**3.4%**

Annex B – [CONFIDENTIAL TO GEL]

Annex C – [CONFIDENTIAL TO GEL]