

**ELECTRICITY REGULATION IN GUERNSEY**

**A Report prepared for Guernsey Electricity Limited**

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**6 February 2006**

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## **Electricity Regulation in Guernsey**

### **Main points of Report**

Guernsey Electricity (GEL) has asked me, as former UK electricity regulator, to examine electricity regulation in Guernsey and to consider possible modifications.

I have looked at three causes of concern in the electricity sector.

- The roles of Treasury and Resources Department (T&R) and the Office of Utility Regulation (OUR) overlap and some actions have been mutually inconsistent.
- OUR's actions have often been unduly onerous or unreasonable.
- The annual cost of regulation (£900,000) is greater than initially expected (£350,000), and in electricity it is 10 to 20 times the per capita cost in the UK.

Transferring regulation of GEL from OUR to T&R would resolve all three problems.

- It would produce a non-bureaucratic, low cost yet effective system of regulation.
- Other solutions may not effectively address the three present concerns.

Modifications to the regulatory framework would address the issue of regulatory actions.

- The OUR should be given a new duty to regulate in a way proportionate to the size and circumstances of Guernsey.
- Regulatory activities should be targeted only at cases in which action is needed.
- Possibilities for reducing the scope, intensity, intrusiveness and cost of regulatory activities should be actively pursued.
- The Utility Appeals Tribunal should continue but be given a limited time to determine an appeal, whereas appeal to the Royal Court would be more costly.

Reducing OUR's budget would address concerns about the cost and nature of regulation.

- A States general Direction could require the OUR to reduce its costs of operation.
- In view of the surprising absence of control of OUR's budget, T&R or Commerce and Employment Department should consider setting a budget for OUR.
- Electricity regulation is feasible within the initial £350,000 overall OUR budget.

Transferring regulation of GEL from OUR to T&R would be the best solution in Guernsey because it would resolve all three problems and because other measures cannot be guaranteed to do so. Failing this, the other measures set out herein would improve the situation.

## **Executive Summary**

### **PART ONE INTRODUCTION AND BACKGROUND**

#### **1. Introduction and background**

- 1.1 Guernsey Electricity has asked me, as former regulator of the UK electricity industry, to examine the nature and experience of electricity regulation in Guernsey and to consider possible modifications to it.
- 1.2 In 2001, the three States Boards (of electricity, posts and telecommunications) were commercialised to give them freedom to adopt more commercial practices. They were also subject to regulation by the Office of Utility Regulation (OUR).
- 1.3 The 2001 proposal for the regulatory framework commented that the initial costs of regulation would be less than 1 per cent of the turnover of the Boards. However, in 1999 the States originally envisaged a non-bureaucratic form of regulation with the Director General of Utility Regulation as the only member of staff and a total annual budget of about £350,000.
- 1.4 The States are presently reviewing commercialisation and regulation.
- 1.5 This Report looks at three potential causes of concern:
  - the overlap in roles between the States and the regulatory body with respect to States-owned commercialised entities
  - the actions of the OUR with regard to electricity regulation, and
  - the actual costs of regulation, both in total and for the electricity sector in particular.

### **PART TWO THE CAUSES OF CONCERN ABOUT REGULATION**

#### **2. Overlap of roles of States and OUR**

- 2.1 The OUR and the States each have the same range of objectives under the Regulation of Utilities Law 2001. In particular, both must protect the interests of customers with respect to prices. The OUR has exercised these functions, including via the price control process.
- 2.2 The States have given formal guidance to the Treasury and Resources Department (T&R) as shareholder of GEL. This includes the duty to set financial performance targets to deliver improved efficiency whilst drawing a balance between a commercial return and the effect on the community of any resulting increase in charges. T&R has exercised its role by requiring GEL to provide Five Year Plans updated on an annual basis, and by requiring prices to reflect a lower rather than higher rate of return on assets.
- 2.3 The responsibilities of OUR and T&R have overlapped considerably. There are parallel lines of regulation to ensure that a commercialised body acts in the public interest. In practice, the two organisations have exercised their responsibilities in

ways that have sometimes been mutually inconsistent on major decisions, notably with respect to tariffs in the electricity sector.

### **3. OUR's implementation of electricity regulation**

- 3.1 Although commercialisation has been a success in Guernsey, GEL has several concerns about the implementation of electricity regulation. These include the unduly detailed and onerous nature of regulation, the associated costs and time requirements, the uncertainty and undue restrictions resulting from certain regulatory decisions, and the blurring of responsibilities.
- 3.2 In my view, the OUR has adopted an unduly heavy-handed approach to electricity regulation. Some of its actions might be reasonable elsewhere, but seem inappropriate in Guernsey. Others of its actions are not normal regulatory practice and it is difficult to see the justification for them here. Yet other actions would be unreasonable whatever the size and nature of the sector being regulated.
- 3.3 In contrast, OUR does not seem to have acted inconsistently with normal regulatory practice in regulating the postal sector, not least in generally accepting price increases proposed by GPL. This has not been the case with GEL.

### **4. The costs of regulation**

- 4.1 The OUR's total cost of regulation in Guernsey has been about £900,000 per year, of which electricity regulation accounts for £180,000, about one fifth of the total. The OUR has five professional staff, so pro rata one member of staff is involved in electricity regulation.
- 4.2 GEL's total costs of regulation, including its own costs, are about double the cost of the licence fee. The total cost of regulation per electricity customer has been £13.53 per year, of which £6.40 is the cost of the OUR and £7.13 is GEL's cost of responding to this.
- 4.3 OUR's costs have been within the 2001 comment that its initial costs would be less than 1 per cent of the turnover of the licensees. However, under the States' original 1999 assumptions, the cost of regulation would have been £2.50 or £5.05 per customer per year, depending on the benchmark chosen.
- 4.4 The cost of electricity regulation in the UK is about £20m per year, or about £0.72 per electricity customer.
- 4.5 On a per capita basis, the cost of electricity regulation in Guernsey is some ten to twenty times the cost in the UK.
- 4.6 The same is true of the distribution price control reviews in the two countries.

## **PART THREE PROPOSED SOLUTIONS TO THE PROBLEMS**

### **5. Removing the overlap of regulation**

- 5.1 It would not be appropriate or realistic to remove a role for the States as shareholder. However, it would be straightforward to provide that the Regulation

- of Utilities Law 2001 did not apply to specified commercialised entities that remained in States ownership.
- 5.2 All OUR's present responsibilities could in practice be covered by T&R. There is scope for enhancing the T&R's present processes, for example by publication of a draft Five Year Plan for public comment and other consultation procedures.
  - 5.3 There might be concerns that this would be a backward step, but there is no reason to believe that T&R would fail to regulate commercialised entities properly because of government ownership. The proposed approach would not preclude the introduction of private capital in due course if the States so decided.
  - 5.4 Other developed small island countries have adopted a variety of apparently satisfactory ways of supervising their electricity sectors without setting up independent utility regulation authorities.

## **6. Modifying the framework of regulation**

- 6.1 Europe Economics' Report on the Ethos of Regulation has looked at four possible ways of improving regulation. This report looks in turn at those proposals.
- 6.2 If OUR continues to be headed by an individual regulator, it would be worth considering the possibility of the Director General appointing a panel of senior business people to advise him on price controls and other significant issues.
- 6.3 The OUR should be given a new duty to regulate in a way proportionate to the size and circumstances of Guernsey. In addition
  - a. regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent;
  - b. regulatory activities should be targeted only at cases in which action is needed.
  - c. regulatory activities should promote and not discourage flexibility, initiative, innovation and responsiveness to customer preferences within the regulated sector; and
  - d. possibilities for reducing the scope, intensity, intrusiveness and cost of regulatory activities should be actively pursued.
- 6.4 Giving the States powers of direction to OUR may not be a solution to the present problems of regulation but may have a useful role to play.
- 6.5 The Utility Appeals Tribunal should not be abolished, but should be given a limited time (perhaps 3 months) in which to determine an appeal. It would be conducive to more considered regulation if the OUR's determinations were not binding in the absence of agreement by the licensee. In this case the obligation to appeal would lie with the OUR.
- 6.6 If a new Competition Authority were established in Guernsey to enforce a new competition law, this could usefully supercede the OUR in regulating the States-owned commercialised sectors. Alternatively, incorporating the OUR within the same organisation as the Competition Authority would increase the range of expertise that could be brought to bear in utility regulation and enable utility issues to be seen in context.

## **7. Reducing the cost of regulation**

- 7.1 If the States are given a power to give general Directions to the OUR, one of their first Directions could usefully require the OUR significantly to reduce its direct costs of operation. In view of the lack of control on the OUR budget, Treasury and Resources Department, or Commerce and Employment Department as sponsor Department of the OUR, should consider setting and enforcing an appropriate budget for utility regulation.
- 7.2 As to the level of this budget, it would be possible to discharge the main tasks of electricity regulation within the original total OUR budget of £350,000 envisaged by the States in 1999. This would mean a budget of about £70,000 for electricity instead of £180,000.

## **PART FOUR SUMMARY AND RECOMMENDATIONS FOR POLICY**

### **8. Summary and recommendations for policy**

- 8.1 Three factors have contributed to the problematic nature of utility regulation in Guernsey:
- the overlap in roles between the States (T&R) and the regulatory body (OUR), as applied to States-owned commercialised entities
  - the heavy-handed actions of the OUR with particular regard to electricity regulation, and
  - the actual costs of regulation, both in total and for the electricity sector in particular.
- 8.2 Transferring regulation of GEL (possibly with GPL) from OUR to T&R would resolve all three problems at a stroke. Modifying the regulatory framework would address the problems of unreasonable regulatory actions. Reducing OUR's budget would address concerns about the cost of regulation and, indirectly, about its heavy-handed nature.
- 8.3 Transferring regulation of GEL from OUR to T&R would be the best solution for the particular circumstances of Guernsey. It would solve all three problems whereas other measures cannot be guaranteed to do so. Failing this, the other suggested measures would improve the situation. The three sets of measures are not mutually exclusive. That is, transferring regulation of GEL from OUR to T&R would not preclude the implementation of the other measures if the States wished to address any problems of regulation in the other two sectors.

## **PART ONE INTRODUCTION AND BACKGROUND**

### **1. Introduction and background**

#### **1.1 Introduction**

Guernsey Electricity Ltd (GEL) has asked me, as former regulator of the UK electricity industry, to examine the nature and experience of electricity regulation in Guernsey and to consider possible modifications to it.

Part One of this Report sets out relevant background, including the policies of commercialisation and regulation by the Office of Utility Regulation (OUR), and the ongoing States review of these topics. It identifies three potential sources of concern about regulation. These are

- the confusion and overlap in roles between the States (T&R) and the regulatory body (OUR), as applied to States-owned commercialised entities
- the actions of the OUR with particular regard to electricity regulation, and
- the actual costs of regulation, both in total and for the electricity sector in particular.

Part Two explains and evaluates these three concerns in turn.

- First, it looks at the roles and responsibilities of the States and the OUR and identifies some areas of overlap and mutual inconsistency for those commercialised entities that remain under States ownership.
- Second, it examines the way in which electricity regulation has actually been conducted, and outlines and evaluates some concerns of GEL.
- Finally, it compares the costs of regulation in Guernsey, particularly of electricity regulation, against the costs envisaged in the initial States policy and against experience in the UK.

Part Three proposes ways of addressing each of these concerns.

- A way of addressing the first concern is to transfer regulation of one or both of the States-owned commercialised entities from OUR to Treasury and Resources Department. This would remove the overlap between the roles and responsibilities of the States and OUR. It might be appropriate to enhance certain aspects of present supervision (e.g. in terms of public consultation processes).
- A way of addressing the second concern is to modify the statutory framework of regulation, including OUR's statutory duties, in order to facilitate the principles of Better Regulation in the circumstances of Guernsey. It is also possible to improve the present appeals mechanism involving the Utility Appeals Tribunal, rather than abolishing it. There is some discussion of the relationship with a possible Competition Authority.

- A way of addressing the third concern is to reduce the budget for regulation so as to encourage a less bureaucratic approach that is nonetheless consistent with discharging all the regulatory duties.

Part Four concludes that transferring the regulation of States-owned industries from the OUR to T&R would be the most effective way to deal with all three concerns at once. Failing this, the other two sets of measures would be conducive to ameliorating the situation. (The three sets of measures are not mutually exclusive, and could be applied to OUR's regulation of post and telecoms in the event that OUR no longer regulated the electricity sector.)

## **1.2 Background**

From the granting of the initial licence in 1898, electricity supply in Guernsey was provided by private ownership (initially Edmundsons and later the Guernsey Electric Light and Power Company). At first, any change in allowed price required a new law to change the original licence. Later, in 1917, provision was made for arbitration in the event that the company and the States were unable to agree a revised price. During the depression of the 1920s there was pressure to reduce prices, to which the company was unable to accede. The States bought out the company in 1933 to form the States Electricity Board.

During the late 1990s the States reviewed the status of the Electricity, Post Office and Telecommunications Boards. They came to the view that the status of these undertakings, as committees of the States, had inhibited their efficiency. They concluded that a change of status would give freedom to adopt more commercial style practices (for example, with respect to manpower limits and conditions of employment). In May 1998 the States agreed in principle to the commercialisation of the Guernsey Electricity, Posts and Telecommunications Boards, and to set up a system of regulation for all three Boards. They also decided to privatise the Telecommunications Board.

The Regulation of Utilities Law 2001 established the Office of the Director General of Utility Regulation, which was set up in October 2001. Subsequent laws commercialised the three Boards. Guernsey Telecoms Ltd and Guernsey Post Ltd (GPL) were set up on 1 October 2001. The Electricity (Guernsey) Law 2001 created Guernsey Electricity Ltd, which began operation on 1 February 2002 with all the assets and liabilities of the States Electricity Board (except for the revaluation of some properties). The successor companies to the three Boards were given licences that include various obligations and restrictions, including any controls on prices.

## **1.3 What kind of regulation was originally envisaged in Guernsey?**

In May 1998, when the States agreed in principle to the commercialisation of the Guernsey Electricity, Posts and Telecommunications Boards, they charged the Board of

Industry with recommending a system of regulation. Having taken advice and consulted, the Board of Industry set out its views and made its recommendations.<sup>1</sup>

The regulator would initially set price and service targets (in a way that would provide the owner with a reasonable return) and where appropriate manage the introduction of competition. The regulator would have a high level of independence.

There was a summary description of the process envisaged for regulating prices. The licensee would propose prices with justifications including a full statement of costs. The regulator would review this with reference to international practice and the conditions that apply in Guernsey, then would either accept or make a revised proposal on price. If the licensee did not agree it could utilise the appeals mechanism, though “this is not in the interests of the operator or the regulator and in most cases agreement can be expected to be reached”.

Amongst other things, “the Board sought a structure that was as simple as this complex subject could allow; and minimises resources and bureaucracy; ...” It recognised that the Island was simply too small to have individual regulators for each sector supported by a large bureaucracy of specialist staff. It therefore recommended “a single Director General of regulation (DG), supported by specialist consultancies, drawing on the advice of a specialist panel”. The Board also suggested the appointment of a consumer advisory panel..

It was necessary to have some mechanism of appeal against the regulator’s decisions. In the absence of anything corresponding to the Monopolies and Mergers Commission in the UK, an independent panel of experts could be set up with quasi-judicial powers.

The Board emphasised again the “key features of a regulatory approach which involve a single DG and advice from a set of specialist consultancies”. They would include “a non bureaucratic structure which can obtain specialist input on any area as and when required; a cost-effective solution with the DG managing the input of specialists on an on-call basis; and a focal point for regulation and routes for local opinion to be taken account of”.

The costs of regulation would be met by licence fees. “The main areas of expenditure would be the cost of specialist consultancy, the DG’s salary and the funding of any work commissioned by an advisory panel, and office accommodation.” The annual cost was likely to vary, with a period of intensive activity in the first year with heavy reliance on the consultancies. However, “the average cost of regulation could be in the region of £350,000 per annum.” This would “represent just 0.56% of the collective annual turnover (£62m) of the three Trading Boards.

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<sup>1</sup> *Regulation of Trading Organisations*, Report in a letter of 20 December 1999 from States Board of Industry to President, States of Guernsey, supported by President of States Advisory and Finance committee letter of 21 December. The States used the Report to support a number of decisions including “to approve the system of regulation as set out in that Report”. *Billet d’Etat* II 2000, 20 January 2000, pp. 6-26.

When the Advisory and Finance Committee put to the States the final proposal for the detailed implementation of the regulatory regime, it said that the Committee would fund the ‘shadow regulation period’ before implementation, and that the proposal made some allowance for further support taken from general revenue during the initial period of regulation. It commented as follows on the costs of regulation.

“Based on information provided by the Board, the direct costs of regulation recovered from license fees in the initial year of regulation represents less than 1% of the current turnover of the Trading Boards. If not immediately, then within a relatively short time the efficiencies gained from commercialisation should more than cover these fees. Any additional costs related to producing detailed and transparent financial information should not be considered as being a cost of regulation but as being an essential pre-requisite to the efficient management of the commercialised undertakings the core activities of which will be the provision of monopoly services.”<sup>2</sup>

The letter also said that “regulation must not only be effective but also deliver value for money and both bodies [Committee and Board of Industry] will carefully monitor those costs to ensure that this is the case”.

#### **1.4 States’ Review of commercialisation and regulation**

Two States Departments now have primary responsibilities for the commercialised utilities, namely Treasury and Resources Department (T&R) and Commerce and Employment Department (C&E). These departments have undertaken to review the outcomes of the commercialisation process and report back to the States on the results of the Review. They decided that the research and consultation processes should be undertaken independently, and in November 2004 put this out to tender.<sup>3</sup>

The objectives of the exercise were, inter alia, to enable the States to consider whether it wished to revise any elements of the commercialisation model, or to revise any of the practices that have been adopted within it. The Review would include an assessment of how effectively roles have been undertaken and policies have been implemented for the Strategic Direction for regulation and the implementation of regulation. The review would be undertaken by a combination of inputs, including a consultation process with stakeholders including the commercialised companies.

As a follow up to the initial work, in September 2005 C&E commissioned a supplementary study of the Ethos of Regulatory Legislation.

Comments received suggested that some of the perceived problems in relationships and levels of cost that arise from the implementation of the regulatory regime derive from the ‘ethos’ that is enshrined in the 2001 Regulation

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<sup>2</sup> Letter of R C Berry, Member, Advisory and Finance Committee to The President, States of Guernsey, 30 August 2001, p. 1271

<sup>3</sup> States of Guernsey – Invitation to submit proposal, Review of Commercialisation and Regulation, C&E, 25 November 2004. C&E subsequently commissioned a report from the National Audit Office (NAO). This report has not yet been made public, but I have seen a draft of that part referring to the electricity sector.

of Utilities Law in terms of the role and the authority/responsibilities of the OUR.<sup>4</sup>

C&E commissioned Europe Economics (EE) to carry out this study.<sup>5</sup> I have been given access to a draft of EE's report.

In November 2005 the OUR announced a Review of the License Texts of all the operators. It said that its review was "aimed at ensuring that regulation in Guernsey is proportionate and cost-effective".<sup>6</sup> Although this is potentially useful, and indicates the OUR's support for the principles of better regulation, it does not seem to provide a route for addressing those problems of regulation identified in the present report.

## 1.5 The present report

Guernsey Electricity Ltd (GEL) asked me, as former regulator of the UK electricity industry, to advise it on the OUR's recent price control process. In the light of the outcome of that process, and bearing in mind the States' review, it then asked me to examine the nature and experience of electricity regulation in Guernsey and to consider possible modifications to it.

My terms of reference do not extend to reviewing the principles and experience with respect to commercialisation. But I note that, in general, commercialisation in Guernsey seems to have been a success. All three commercialised entities have thereby been able to increase efficiency, flexibility and speed of decision-making. It is therefore important to ensure that regulation is consistent with this policy.

Independent regulation is generally accepted as necessary when a utility is privatised. But the appropriate role and method of regulation of a commercialised entity that remains in States ownership are less clear, especially for smaller countries. Experience internationally suggests certain problems. Here in Guernsey, the NAO has identified several concerns. Europe Economics says that

"Utility regulation in Guernsey has experienced worse problems concerning relationships and costs than one would have hoped to see, even recognising that any new policy as radical as commercialisation and the introduction of an independent regulator will inevitably cause some disturbance and resentment as previous methods are replaced.

EE's Report continues

"Although these problems doubtless spring in part from personalities, the legislation probably did make matters worse than they need have been. There are therefore some changes to the legislation that should be considered, in order to improve the prospects for a more cost-effective regime."<sup>7</sup>

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<sup>4</sup> Review of Commercialisation, Supplementary Study of Ethos of Regulatory Legislation, Introduction and Terms of Reference, C&E, 2 September 2005.

<sup>5</sup> *Supplementary study of ethos of regulatory legislation*, draft report, Europe Economics, 28 November 2005.

<sup>6</sup> Media Release, Office of Utility Regulation, 29 November 2005 and associated letters to licensees.

<sup>7</sup> *Supplementary study of ethos of regulatory legislation*, draft report, Europe Economics, 28 November 2005, paras 6, 7.

It is understandable that the States and the OUR are each concerned to ensure that lessons are learned from experience, and that principles of better government are properly implemented.

The present Report explores three potential causes of concern. These are

- the potential overlap in roles between the States and the regulatory body, as applied to States-owned commercialised entities
- the actions of the OUR with particular regard to electricity regulation, and
- the actual costs of regulation, both in total and for the electricity sector in particular.

Part 2 analyses these three concerns in turn. Part 3 looks at possible solutions.

## PART TWO THE CAUSES OF CONCERN ABOUT REGULATION

### **2 Overlap of roles of States and OUR**

#### **2.1 The duties and functions of the Office of Utility Regulation**

The Regulation of Utilities Law 2001 establishes the office of the Director General of Utility Regulation. It provides that in exercising their functions, the States and the Director General shall each have a duty to promote (and where they conflict, to balance) a series of objectives, which may be summarised as follows for the electricity sector:

- to protect the interests of consumers in respect of prices, quality, service level, permanence and variety of electricity supply
- to secure service provision to satisfy reasonable demands for electricity supply
- to ensure that electricity activities are carried out in such a way as best to serve and contribute to the economic and social development and well-being of Guernsey
- to introduce, maintain and promote effective competition
- to improve the quality and coverage of electricity services and to facilitate the availability of new electricity services, and
- to lessen, where practicable, any adverse impact of electricity services on the environment.

The Director General has various functions, including to advise the States generally in relation to utility activities through the office of the Department of Commerce and Employment (formerly the Board of Industry), to grant and renew licences, to monitor, enforce and modify licences, to levy fees, to receive and conduct inquiries and investigations on electricity activities.

In order to perform these duties the Director General has various powers, including to determine licence conditions, require the production of information and documents from licensees, determine universal services obligations to be imposed upon the licensee, and impose directions, requirements and sanctions.

The Director General, acting through the Office of Utility Regulation (OUR), has discharged these duties and exercised these functions through a series of investigations, decisions and reports. For example, in the electricity sector, the OUR has required GEL to provide information about its costs and future expenditure programmes and to introduce separate businesses and accounts; specified minimum standards for quality of supply; carried out or initiated investigations into future generation policy; carried out price control reviews; and determined maximum prices that GEL is allowed to charge.

#### **2.2 The duties and functions of the States as shareholder**

As just noted, the Regulation of Utilities Law 2001 provides that in exercising their functions, the States shall have the same duties as the regulator to promote (and where they conflict, to balance) the set of objectives summarised above.

The functions and powers of the States are of course different from those of the regulator. Nonetheless, insofar as the States act with respect to the commercialised entities, they have to be guided by the same objectives, though they may have to take into account other considerations as well.

The States have required the directors of the States trading companies to submit a strategic plan to the Committee (now T&R), and have specified in some detail what it should contain.<sup>8</sup>

6. (1) The directors of a States trading company shall, at such times or intervals as the Committee may require, submit to the Committee a strategic plan setting out:
  - (a) the financial and other targets to be achieved by the company in the carrying out of utility activities;
  - (b) the description and extent of the activities which the company proposes to carry out for which the company does not need a utility licence;
  - (c) the financial and other targets to be achieved by the company in the carrying out of the activities referred to in paragraph (b);
  - (d) the policies to be pursued by the company in the carrying out of utility activities and the activities referred to in paragraph (b);
  - (e) the company's proposals for any significant investment or divestment;
  - (f) any other significant matter or issue relating to the company's future plans in which the shareholders of the company would have a legitimate interest; and
  - (g) any other matter or issue which the Committee requires to be addressed by the plan.

T&R on behalf of the States has exercised its role as shareholder by requiring GEL to provide Five Year Plans each autumn, updated on an annual basis. These Plans cover operational and capital expenditure and pricing policies. In addition, the chairman and managing director of GEL are required to present a quarterly update including financials and any other major matter. T&R is able to comment on these Plans and to indicate any preferences or requirements on the companies. T&R also takes further action as it deems appropriate. GEL's statutory accounts and its regulatory accounts are published annually.

The same Ordinance (s. 7) provides that the States may give guidance of a general nature on the policies they wish the Committee to pursue in exercising its functions. With respect to the electricity sector, the States have given formal and specific guidance to T&R (formerly Advisory and Finance Committee) as shareholder of GEL.<sup>9</sup> The substance of this guidance is the following.

1. The business of GEL is the generation, distribution and supply of electricity (sometimes called core activities) and other related (non-core) activities.
2. Sufficient on-Island generation must be maintained to meet total demand in case of

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<sup>8</sup> States Trading Companies (Bailiwick of Guernsey Ordinance) 2001. GEL's Articles of Association have a similar obligation to prepare, agree and be bound by a strategic plan.

<sup>9</sup> The States of Guernsey, Billet d'Etat XXIV, 2001, 15 December 2001, Annex 3, p. 1612.

interruption to the cable link with France.

3. GEL is not to apply for a Telecoms licence.

4. Financial performance targets for GEL shall be set to 1) deliver improved efficiency in core activities, whilst drawing a balance between seeking a commercial return and the effect on the community of any increase in charges that may result, and 2) achieve as soon as possible a commercial return in non-core activities.

5. There are to be no sales of essential property or buildings without permission.

6. Policies for the provision of services will have regard to the Economic, Social and Environmental policies of the States as set out in their Strategic and Corporate Plan.

7. GEL shall comply with best practice on corporate governance, financial management and controls.

These provisions and policies have a parallel in posts as well as electricity. The States have given formal guidance to T&R as shareholder of GPL.<sup>10</sup> It is understood that Treasury has two observers attending board meetings of GPL. I have not examined how T&R has exercised its responsibilities in this sector.

### **2.3 Overlap and inconsistency in regulatory activities in practice**

T&R (on behalf of the States) and the OUR thus each have responsibilities with respect to monitoring and regulating the performance of commercialised States-owned entities. In particular, both organisations have responsibilities with respect to pricing (to balance the interests of shareholder and customers), operational efficiency and longer term capital expenditure. Both have to look to public, social and environmental considerations as well. And quite apart from these formal duties, T&R on behalf of the States has a clear interest in similar considerations as OUR - for example, in efficiency and price restraint by utilities in order to foster a healthy economy in Guernsey.

Both organisations have exercised these responsibilities, and their interests clearly overlap. To illustrate, the contents page of GEL's Five Year Plan 2005- 10, drawn up for discussion with its shareholder T&R, listed the following wide variety of topics:

security and reliability of supply, protecting the local environment, marine current turbines, the nature of commercialisation, laws and regulations, stakeholders, financial strategy, electricity market exposure, non-core business activities, plans and projects, customers and markets, regulation and the shareholder, technology, people, the long term vision, corporate governance, service standards, and financial results.

All these topics are also covered by OUR's regulatory duties and actions, and have featured in its statements and decisions on the electricity sector.

The extent to which this overlap leads to consistent or inconsistent decisions will therefore depend to a significant extent on the way in which these responsibilities are exercised. In the case of GEL, the OUR and T&R seem to have exercised their

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<sup>10</sup> The States of Guernsey, Billet d'Etat XXVIII 26 September 2001, States Advisory and Finance Committee - the future provision of Telecoms and Postal Services, p. 1241.

responsibilities in ways that have sometimes been mutually inconsistent in major respects.

Attitudes to pricing policy provide a clear and repeated illustration of this. In September 2002 GEL's Strategic Five Year Plan put to T&R envisaged a possible price increase in October 2003 to meet increases in costs. T&R did not object to this. But in March 2003 OUR imposed a price freeze on GEL until the end of 2004.<sup>11</sup>

During 2005, GEL put to T&R a range of possible rates of return and corresponding price increases to meet the increasingly severe cost pressures on the company. T&R indicated that in present circumstances a 1% return on the book value of the company's assets would more appropriately balance the interests of the shareholders and customers than a higher return. This would imply a path of price increases as subsequently proposed by GEL.

In September 2005 OUR took a different position.<sup>12</sup> It rejected a return of 1% on assets as being too low, and instead said that a return of 4.8% was appropriate. However, it also rejected the book value of the company's assets as the appropriate base, and determined instead that the assets had zero regulatory value because they did not belong to the company. Combining these two elements, OUR initially proposed a decrease in prices (in real terms) rather than an increase. Later, in December 2005, it determined that there should be an interim real price increase but significantly less than accepted by T&R.<sup>13</sup>

There have been similar differences with respect to other matters. For example, in considering GEL's Five Year Plan, T&R was able to consider whether the proposed operating expenditures were consistent with delivering improved efficiency in core activities. It was able to consider whether the five year capital expenditure programme was consistent with the generation self-sufficiency obligation and the Economic, Social and Environmental policies of the States. It saw no reason to object to the Five Year Plans, though it could have done so if it considered this appropriate. In contrast, OUR rejected various aspects of GEL's proposed operating costs and efficiency improvements and its proposed capital expenditure programme.

At this stage, this is not to take a view on whether T&R or the OUR were right or wrong in their judgements and decisions. It simply establishes that there has been duplication/overlap and inconsistency between the two bodies with respect to some major decisions in the electricity sector.

In the telecommunications sector there is no such overlap and inconsistency of actions since the company was privatised and the States are no longer the shareholder in this sector. In the postal sector it is not apparent that OUR has generally taken decisions that conflict with the views of T&R. A later section looks in more detail at regulation of GPL.

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<sup>11</sup> Price Regulation of Electricity Services: Report on the Consultation Paper and Decision Notice, OUR 03/07, March 2003.

<sup>12</sup> Review of Guernsey Electricity Limited's Price Control: Draft Decision, OUR 05/23, September 2005.

<sup>13</sup> Price Control on Guernsey Electricity Limited: Decision Notice, OUR 05/31, December 2005.

### **3 OUR's implementation of electricity regulation**

#### **3.1 GEL's concerns about electricity regulation in Guernsey**

GEL has several concerns about the way that regulation has developed in the electricity sector in Guernsey. These include the unduly detailed and onerous nature of the regulatory requirements imposed on the company, the associated costs of regulation and the time that it takes, the uncertainty and undue restrictions resulting from certain regulatory decisions, and the blurring of responsibilities for actions within the sector.

GEL has put to me the following examples to illustrate its concerns:

- GEL has to prepare one set of business plans for its shareholder T&R, and another set for the regulator OUR. The company's underlying assumptions are the same, but the required format and timescale are different. The views that OUR and T&R have given about prices, operational expenditures and capital investment have been different and often inconsistent. This duplication and inconsistency have increased GEL's costs and workload, introduced uncertainty and blurred responsibilities.
- The OUR required GEL to introduce separate businesses for its core activities of generation, conveyance and supply, and for its non-core activities, and to allocate its staff and assets to these separate businesses. This was required even though the company is relatively small, and some staff and assets are used in two or more businesses. Moreover there is agreed to be little prospect of competition, which would be an important reason for requiring separate accounts.
- The OUR required GEL to produce separate regulatory accounts. These were required even for the year ending 31 March 2002 when the company had been trading for only two months. These accounts were not needed or used for management purposes and it is not apparent that they have subsequently been used for regulatory purposes.
- The OUR required GEL to produce a Statement of Opportunity setting out how electricity was supplied in Guernsey. This Statement was intended to allow potential competitors to assess the market. This was a costly exercise. In the event the Statement was of little relevance to conditions in Guernsey. Moreover, the OUR initially required this Statement to be updated every three months, which added further unnecessary cost. The OUR subsequently agreed that the Statement could be updated and published annually, and is presently considering whether it could be provided on demand within a reasonable timeframe.

- In 2002 the OUR produced a 15 year Excel business model of GEL's business and required GEL to provide data to populate it. This required an extreme level of detail e.g. the names and salary levels of each member of staff who would be employed (or redundant) in each of the next 15 years. The OUR later initiated an extension of the 15 year model to 25 years with the same level of detail. The OUR model comprised 18 workbooks containing 194 worksheets and is estimated to contain some 2 to 3 million cells, of which about 600,000 (over half a million) were required to be populated by GEL. The file size was a total of some 154 MB, which is approximately 12 times larger than GEL's customer details file required to serve its entire customer base of over 28,000 customers. The purpose of the model was said to be to allow the OUR to understand the company's financial position for many years ahead. However, this model did not correspond to the company's own business planning and could not be prepared without numerous artificial assumptions. The company was never comfortable with the model and regarded the data provision as unduly time-consuming.
- The long term nature of the OUR's model inevitably required GEL to make major assumptions on the likely future pattern of generation investment, long-term capital expenditure planning, the development of 'green energy', and the future path of tariffs. OUR required these assumptions even though they lay well beyond GEL's own business plans, and even though GEL considered it premature to commit to such assumptions given the uncertainty of other relevant parameters. The OUR subsequently decided that it would not accept this assumed future investment path, since it did not have the status of being backed by States policy. Initially the OUR decided to establish a working party to recommend a policy to the States, without consultation with GEL. Later it dropped this proposal.
- The Board of Industry (subsequently the Commerce and Employment Department) and the OUR engaged consultants Mott MacDonald to carry out a review of the generation/import options available to GEL, and used regulatory powers to require GEL to cooperate. The consultants were apparently required or encouraged to use the OUR's new model mentioned above, even though they had access to a widely used and thoroughly tested model (ASPLAN). This report took over eighteen months to prepare. The conclusions and recommendations are based upon electricity and oil prices that are not just already out of date, but which did not consider a wide enough uncertainty range to encompass what has already happened in the way of escalating fuel prices.
- This project also served to blur the lines of responsibility for ensuring the adequacy of plant and network in Guernsey. Prior to commercialisation, GEL had a clear mandate to this effect. That would have remained the case, but the project left it wholly unclear as to who was supposed to be planning the future of GEL's plant and network: GEL, the OUR or the States?

- OUR announced on 7 March 2003 that it was freezing GEL's prices until 31 December 2004. The company had not applied for any tariff increase or suggested that it would do so in the immediate future. This limited GEL's ability to respond to changing market conditions.
- When it made this announcement, the OUR indicated that it would re-examine these tariffs for changes to have effect from 1 January 2005. During 2004 GEL became uncomfortable that the OUR was not actually proceeding with this process. This was a matter of concern because by that time there was a need for price rises as a result of the upward movement in world energy prices. In addition, GEL needed to renegotiate an existing fixed-price import contract with EdF with effect from 1<sup>st</sup> December 2005, which would necessitate further price increases. Accordingly, GEL had to stimulate OUR's work in this area. In the event, OUR did not allow revised prices until January 2006, one year later than it originally committed to.
- In the course of GEL's recent price control review, OUR made many assumptions that GEL regarded as unreasonable. Of particular concern was the unjustified assumption that the fixed assets and cash balances of the company did not actually belong to GEL (and hence to the States) but to the customers of the business. This and other assumptions implied real price reductions instead of price increases, which was inappropriate and unreasonable in circumstances of increases in fuel costs and prices worldwide.
- In its final determination, OUR decided to suspend its previous proposal for a three year price control, and to implement instead a limited price increase valid for fifteen months while the issue of the opening asset value was considered further.<sup>14</sup> OUR's final determination thus failed to resolve many of the issues that it had raised in the price control review, and introduced unnecessary uncertainty as to the level and basis for prices, and the conduct of regulation, in the period thereafter. It also means that GEL will be forced to make losses of about £1 million and £1.5 million in 2005/6 and 2006/7, respectively.

### **3.2 Evaluation of GEL's concerns about electricity regulation**

Are GEL's concerns about regulation broadly what one might expect in a newly-regulated environment? Or, as Europe Economics has suggested, do its concerns go beyond this? The next step is to consider in more detail the way in which the OUR has exercised its responsibilities, with primary reference to the electricity sector and GEL. Is there reason to be concerned at the specific nature of those decisions?

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<sup>14</sup> "He [the DG] proposes to establish an expert panel to examine all of the relevant evidence available and for its consideration of the issues identified by this current price control to further inform the OUR's future price control." *Price Control on Guernsey Electricity Limited: Decision Notice*, Office of Utility Regulation, Document No: OUR 05/31, December 2005, p. 30.

In some respects the decisions and processes of the OUR may seem similar to the decisions and policies adopted in the regulation of the UK electricity sector, and indeed regulation in other sectors and countries. In some cases, however, there is a question whether such decisions and policies are appropriate in Guernsey, which is of the order of one thousand times smaller than the UK. In other cases there is a question whether the decisions and processes would be reasonable in any size of country. I take in turn the examples cited by GEL.

- Separate businesses and accounts and regulatory accounts: in the UK the separation of generation, distribution and supply businesses together with separate accounting was fundamental to the operation of the regulatory regime. Important reasons were to promote competition, to facilitate the setting of separate price controls, and to avoid cross-subsidy. However, in Guernsey competition has been ruled out in certain respects and in other respects is at present considered unlikely. So there is a question whether the degree of separation and separate accounting and the costs involved were proportionate to the circumstances in Guernsey.
- Statement of Opportunity: in the UK, the National Grid's Seven Year Statement was invaluable for new entrant generators in the UK. However, economic conditions make such entry unlikely in Guernsey, hence it is not obvious that the Statement of Opportunity is relevant there. It is not clear that the time, cost and effort required to establish the Statement is reasonable. Even if the Statement is required to be provided, there seems no reason for the OUR to require GEL to update it every quarter. As noted, OUR has now reconsidered this requirement.
- Business Plans: it is normal to request a regulated company to provide its business plan as a basis for discussing price controls. It is also normal to discuss with the company beforehand what kind of data can realistically be provided. Here, the OUR seems to have adopted a more onerous approach than applied in the UK. In my own experience, for example, regulators in the UK and elsewhere do not insist on the provision of detailed data down to the level of individual employees. Nor do they find it necessary or reasonable for price control purposes to ask for detailed data much beyond about 5 years ahead, let alone 15 or 25 years. Where longer-term calculations are needed to evaluate certain capital expenditures, this can be done without such detailed and extensive modelling as the OUR required.
- Generation planning and imports: nowadays, it is not envisaged that regulation will extend to long-term planning, and in practice electricity regulators do not typically become involved in the detailed planning of generation strategies. Where appropriate this is left to the competitive market; in other circumstances this could be a matter for the government as the entity responsible for energy policy, or for a government-owned electricity

company. It is therefore not surprising that OUR's unduly detailed intervention here has blurred lines of responsibility for ensuring adequate electricity capacity in Guernsey.

- Price freezes and short-term price controls: regulators may implement price controls for a variety of durations depending on the circumstances. For example, it would be normal to distinguish between the different businesses of a regulated company and to consider a short-term control for the possibly volatile supply business activities, while providing a long term control for the usually stable distribution business activities. Sometimes temporary price freezes or short-term controls might be appropriate, but they are typically a last resort. It would not be normal for a price freeze to be imposed without a substantial justification of the need for it. It would not be normal for a short term price control to be imposed at the last minute after a consultation process aimed at a long term control, particularly when the issue that prompted this change of tack (the claimed uncertainty about ownership of assets) was one raised by the regulatory body itself rather than an unexpected exogenous event.
- Ownership of assets: suddenly and without prior discussion, OUR assumed that GEL's assets actually belong to its customers, and not to the States, so that for regulatory purposes its initial asset value is zero. This is a radically different approach to the valuation of initial asset value compared to what other regulators have done. There seems no basis for OUR's assumption, nor any evidence that it took the obvious precaution of checking this assumption with the States before or after making it. Nor is there any basis in the OUR's claim that actions of the UK regulator PostComm provide a precedent, since the circumstances are quite different. It is difficult to see that OUR's action here constitutes reasonable conduct, and it has imposed considerable cost and uncertainty on the company.

I am aware that the OUR has not yet had the opportunity to comment on this analysis of the above issues. However, most of these examples (and certainly the most serious one) are based on OUR's account as documented in the public record.

I conclude that the various examples noted above do indeed give reason to believe that the OUR adopted an unduly heavy-handed policy of regulation in the electricity sector. Some of its actions – for example, with respect to separate businesses and accounting and the Statement of Opportunity - might be reasonable elsewhere, but seem inappropriate for a country of the size and nature of Guernsey. Others of its actions – for example, the inappropriate long-term generation planning, the price freeze and the sudden short-term price control – are not normal and it is difficult to see the justification for them here. Yet other actions – for example the required detail and duration of the business plans and particularly the assumption the company does not own its assets - would be unreasonable whatever the size and nature of the sector being regulated.

### 3.3 Regulation of Guernsey Posts Ltd

There is a similar overlap of responsibilities between OUR and T&R with respect to the postal sector as there is with the electricity sector. An obvious question is whether the problems that have occurred in the electricity sector have also occurred in the postal sector, and if not why not. I am not in a position to examine the actions of T&R or the relationship between organisations within this sector. Nevertheless, the following brief summary and evaluation of OUR's main decisions with respect to the price control on GPL, based entirely on the OUR's published reports, suggests that there may have been fewer problems in the postal sector because OUR may have treated the two organisations differently.

On 3 November 2003 GPL requested an increase in postal rates as from 1 June 2004. The requested increases were 27 per cent for inland letters and nearly 20 per cent for overseas and other services. In support, GPL submitted a six year business plan. OUR considered that this did not cover a long enough period but was prepared to accept it. OUR carried out modelling exercises, sought more information, and engaged independent consultants. In March 2004 OUR decided to allow a price increase of 18 per cent for inland letters and accepted GPL's other proposed increases.<sup>15</sup> These would apply for 21 months (1 June 2004 to 31 March 2006), during which OUR would examine further the relevant cost and other factors.

OUR said that it evaluated GPL's Net Present Value (NPV) of revenues against its net cash outlays over this period, following Postcomm's practice in the UK, and also evaluated the proposals against an allowed rate of return on GPL's regulatory asset value. It took GPL's opening asset value as the regulatory asset base. It said that the allowed price increases covered the allowed rate of return, by implication whichever method of calculation was used (and drew the parallel with Postcomm's approach in the UK).

In early September 2005 GPL requested a tariff increase for one year from 1 April 2006 to 31 March 2007, which would be the start of a process of rebalancing over the period to 2009. This included an increase of 11.5 per cent in inland letter rates, and increases for other services ranging from about 5 per cent to about 20 per cent. GPL evidently presented relevant cost information to the end of the 2007/8 financial year, which appears to be for three years ahead. OUR looked at GPL's projected operating and capital costs.<sup>16</sup> It explained that its policy would be to set allowed tariff increases in line with an allowed return on GPL's regulatory asset base.

There is no indication that OUR took GPL's initial asset value to be anything other than the initial book value that it had assumed in the previous price control determination. OUR concluded that on balance the requested tariff increases were reasonably in line with these costs, and it allowed in full the proposed tariff increases for regular letter and parcel services. (It deferred consideration of requested increases in bulk mailing charges,

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<sup>15</sup> *Guernsey Post's Proposed Tariff Changes*, OUR 04/02, March 2004.

<sup>16</sup> *Guernsey Post's Proposed Tariff Changes: consultation paper*, OUR 05/22, September 2005, *Guernsey Post's Tariff Changes*, OUR 05/30, December 2005.

observing that GPL was still in contract discussions on this matter and that circumstances had changed since the original application.)

It seems that OUR's decisions have necessitated some additional work and costs by the postal company GPL. For example, OUR held that GPL's six year forward plan was not a sufficient basis for approving its tariffs and has required further information. In some respects, too, OUR's decisions have introduced uncertainties analogous to those in the electricity sector. For example, OUR initially allowed postal tariff increases for a matter of months only, pending further information and further study of various aspects of the business.

However, in other key respects OUR does not seem to have taken such questionable and unreasonable decisions in posts as it has in electricity. For example

- a. OUR largely accepted GPL's 2003 application for 27% and 20% price increases (to the extent of 18% and 20%) but in contrast froze GEL's prices in May 2003 even without the company making an application to increase them. This meant that GEL was unable to increase prices in late 2003 and 2004 at a time when (in the company's view) exogenous cost increases made a tariff increase increasingly appropriate.
- b. OUR accepted a 6 year business plan from GPL despite arguing that a longer period plan was necessary, but insisted on a 15 year business plan from GEL and then a 25 year business plan.
- c. OUR accepted GPL's 2005 application for 11.5% and other price increases but rejected GEL's proposed four year path of tariff increases starting at 9.8 per cent in 2005, which had been accepted by T&R on the basis of a 1 per cent return on investment. OUR initially proposed an increase of 2.9 percent for GEL (which in real terms represented a price reduction of 0.9 per cent). In the event, the OUR allowed a tariff increase of 5.5 per cent from 1 January 2006 and a subsequent increase of RPI+1.7 per cent from 1 April 2006, where these increases were determined on a basis that even OUR accepted was ad hoc.
- d. Even though OUR did not use the regulatory value method to set GPL's prices, it apparently accepted the book value of GPL's assets as the initial regulatory value, presumably not doubting that the company owned the assets. In contrast, OUR set the regulatory asset value of GEL's initial assets to zero on the basis that the company did not own the assets.
- e. Whereas OUR calculated GPL's allowed prices based on the net cashflow method and also on the regulatory asset method, and indicated that the allowed prices covered both methods of calculation, OUR apparently did not calculate GEL's allowed prices on both these methods and consequently did not ensure that the allowed price increase covered both methods of calculation: in fact it fell far short of the price implied by the regulatory asset method.

This brief account suggests that OUR has treated GEL differently from GPL. It would appear that OUR has largely accepted the approach, calculations and price increases proposed by GPL. OUR's stated reasons for its actions in the postal sector do not seem inconsistent with normal regulatory practice. In contrast, OUR has largely rejected the approach, calculations and price increases proposed by GEL. In important respects OUR's stated reasons for doing so are inconsistent with normal regulatory practice. In the light of OUR's actions, it is not surprising that more serious problems have been experienced in electricity than in posts.

## 4 The costs of regulation

### 4.1 Costs and staffing of OUR

This section shows the costs of OUR since its inception. The cost of regulation is only one aspect of concern, of course, but it is a relatively tangible and measurable one. Subsequent sections look at the additional regulatory costs incurred by GEL, and contrast the actual costs of regulation in Guernsey with the costs that were envisaged at the time when regulation was first proposed, and with the costs of regulation in the UK.

Table 1 shows the income and costs of the OUR since its inception in autumn 2001.

Table 1 Extracts from OUR Income and Expenditure Accounts (£000)

Calendar year	2001 (Oct-Dec)	2002	2003	2004
<b>INCOME</b>				
Post Office revenue	30	120	120	120
Telecoms revenue	75	447	494	553
Electricity revenue	-	165	180	180
Grant – Board of Industry	62	287	-	-
OUR Conference revenue	-	-	-	12
Bank Interest	0	1	8	4
<b>Total Income</b>	<b>167</b>	<b>1021</b>	<b>802</b>	<b>865</b>
<b>EXPENDITURE</b>				
Salaries and staff costs	81	271	316	350
Consultancy fees	-	507	189	253
Legal fees	-	57	314	91
OUR conference costs	-	-	-	12
Utility Appeals Tribunal	-	-	-	51
General Overheads	19	69	74	77
Finance costs	-	0	3	0
Depreciation	3	12	12	12
<b>Total Expenditure</b>	<b>102</b>	<b>915</b>	<b>905</b>	<b>892</b>
<b>Surplus/(Deficit)</b>	<b>65</b>	<b>105</b>	<b>(103)</b>	<b>(23)</b>

Source: OUR Annual Reports

On average, the OUR costs about £900,000 per year. The electricity industry (GEL) has paid a licence fee of £180,000 per year since 2003, equal to about one fifth of the OUR's

total income.<sup>17</sup> OUR has four professional staff plus the Director General.<sup>18</sup> Pro rata, therefore, there is one full time equivalent professional member of staff for the electricity sector. OUR also hires professional consultancy and legal advice, the costs of which to date have exceeded salaries and staff costs by more than one third. The exceptional legal costs in 2003 were primarily as a result of the first case taken against a decision of the OUR which was heard by the Utility Appeals Tribunal. Excluding these exceptional legal fees, consultancy and legal costs would be of the same order again as internal salary and staff costs.<sup>19</sup>

## 4.2 GEL's costs of regulation

The costs and licence fee charged by the OUR are only one element of GEL's total regulatory costs. It has to pay for additional costs of auditing the regulatory accounts and for outside consultancy advice. In addition, there are costs of its own internal staff time devoted to regulatory issues, over and above what would be required as a consequence of commercialisation. Table 2 shows that, in aggregate, GEL's total regulatory costs over the last three years have been about double its licence fees.

Table 2 GEL's costs of regulation

Financial year	2002/3	2003/4	2004/5
Regulatory costs (£'000)			
- Licence fee	180	180	180
- Audit fee (regulatory accounts)	6	6	6
- Consultancy fees and other costs	11	2	178
Total external costs	197	188	364
Internal costs	111	130	152
Total regulatory costs	308	318	516
Number of customers	27,844	28,201	28,255
Units sold (GWh)	296	306	317
Sales of electricity (£m)	23.8	24.5	25.3

Source: GEL *Regulatory Accounts, Notes to the Financial Statements*. These regulatory costs are part of the Finance and Administration expenses in the published accounts. Also Key Statistics.<sup>20</sup>

<sup>17</sup> *License fees for Telecommunications, Post and Electricity Licences in Guernsey*, Information Note, OUR 04/08, June 2004.

<sup>18</sup> Whether this is the final number envisaged is unknown. A press report says that "Under States Guidelines, the OUR can employ up to seven staff." (*Guernsey Press*, 26 October 2004)

<sup>19</sup> It is possible that additional consultancy costs associated with regulation, such as the cost of the Mott MacDonald consultancy report, were funded separately by one of the States departments hence are not included in the OUR's costs set out in its accounts.

<sup>20</sup> Note: the electricity licence fee has been £15,000 per month starting February 2002, hence the total was £165,000 in OUR's calendar year 2002 but £180,000 in GEL's financial year 2002/3.

Dividing GEL's licence fee by its number of customers in the relevant year (and adjusting to a full year equivalent in 2002) shows that the cost of the OUR licence fee per GEL customer was £6.46 in 2002, £6.38 in 2003 and £6.37 per customer in 2004. The average is £6.40.

GEL's total costs of regulation including the licence fee amounted to £11.06 per customer in 2002/3, £11.28 in 2003/4 and £18.26 in 2004/5.

On average to date, the total cost of regulation in Guernsey has been £13.53 per electricity customer per year. Of this, £6.40 has been calculated as the cost of the OUR, leaving £7.13 for GEL's cost of responding to this.

### **4.3 Comparison of OUR costs and Board of Industry proposals**

How should these costs and the staffing be evaluated? When the OUR was set up, reference was made to its costs not exceeding 1 per cent of licensees' turnover. As far as electricity is concerned, the regulatory costs have been within this. The cost of GEL's licence has been £180,000 per year, whereas 1 per cent of its turnover would be about £250,000 per year.

However, OUR's costs and staffing are clearly higher than the Board of Industry envisaged and proposed in 1999. It spoke then of the total cost of regulation being about £350,000 per year. In practice the total cost has actually been about £900,000.

The OUR's costs of electricity regulation have been about one fifth of the total costs of the OUR. If the electricity licence fee had been one fifth of a total regulatory cost of £350,000 it would have amounted to £70,000 per year. In practice the electricity licence fee has been £180,000.

The Board of Industry also referred to total cost being just 0.56% of total turnover in the three Boards. Electricity turnover in 2004/5 was £25,284,000, so 0.56% of that would be £141,600 per year. Again, the actual licence fee of £180,000 is in excess of this.

The implication of the Board of Industry assumptions is that average cost per electricity customer might now be £2.50 or £5.05 per year, depending on whether the benchmark is the £350,000 total budget or 0.56% of total turnover. In fact the cost per electricity customer is now £6.37 per year.

### **4.4 The costs of UK electricity regulation**

How do the costs of electricity regulation compare to those in other countries? The DG of OUR has said that "benchmarked against other sector specific regulators in the UK, the OUR compares very favourably with those agencies".<sup>21</sup> In 2004/5 the electricity and gas regulatory body Ofgem had a staff of 306 and a total cost of £ 35.9m. Table 3 gives some details.

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<sup>21</sup> OUR *Annual Report* 2005, p. 6

Table 3 Ofgem's income, costs of objectives and staffing

Year	2002/3	2003/4	2004/5
<b>INCOME</b>			
Licence fees £m	46.3	45.0	45.4
Less to DTI for Energywatch	(13.1)	(12.4)	(13.3)
Net fee income	33.2	32.6	32.1
After other adjustments			
Operating income	38.3	36.7	35.8
<b>COSTS (by Ofgem Objective)</b>			
Creating and sustaining competition	22.0	18.8	18.0
Regulating network monopolies	11.8	11.1	11.2
Security of supply	*	2.6	1.6
Voice in Europe	*	1.0	1.4
Protect the environment	2.9	2.5	2.9
Fuel poverty	0.6	0.7	0.8
Total costs	38.3	36.7	35.9
Allocated to electricity 56.4%		20.7	20.2
Ofgem staff	312	309	306
Allocated to electricity 56.4%		174	173

Source: Ofgem *Resource Accounts 2004-05* pp. 4, 21, 26; 2003-04 pp. 22, 28, 33

\* Objectives varied over time, and later accounts restated amounts from earlier years.

To be comparable with OUR, Ofgem costs must be adjusted for the costs of energywatch. The latter organisation is the primary vehicle for consumer representation and customer complaints. In Guernsey, the comparable organisation appears to be the Trading Standards Service of the Department of Commerce and Employment (formerly the Board of Industry). This is the organisation to which both OUR and GEL refer customers with complaints.<sup>22</sup> It is therefore appropriate to exclude the costs of energywatch in this comparison.

Again for comparability, Ofgem's costs must be adjusted to reflect the costs of regulating electricity only, since gas is not regulated in Guernsey. There are some 28m electricity customers in the UK and some 22m gas customers. Ofgem allocates 56.4% of its costs to electricity licensees and 43.6% to gas licensees.<sup>23</sup> This gives an attributed cost of UK electricity regulation of £20.7m in 2003/4 and £20.2m in 2004/5. Dividing by 28m

<sup>22</sup> "Customers who are unable to resolve a complaint they have with their utility provider directly with the company, can contact Trading Standards Service who will act impartially and attempt to find a fair outcome for all the parties involved." OUR *Annual Report 2005*, p. 35. See also section on Customer Complaint Handling Process on GEL website.

<sup>23</sup> *Licence fee cost recovery principles*, Ofgem, February 2002, Appendix 2.

customers, the average cost of electricity regulation was £0.72 per electricity customer in 2004/5.

The corresponding numbers of staff would be 174 and 173 in the two successive years. Ofgem does not give figures for professional staff. It seems that the mean or median proportion in developed countries would be a little over 60 per cent of total staff.<sup>24</sup> This implies a professional staff of about 105 in the UK.

#### **4.5 Comparison of costs of regulation in Guernsey and UK**

GEL's customer base of about 28,000 is about one tenth of one percent of the UK's. So a pro-rata cost of UK regulation in a country the size of Guernsey would be about £20,000 annual cost with 0.1 staff. In Guernsey, the OUR's licence fee to cover the cost of electricity regulation is £180,000 and the OUR's equivalent professional staff as calculated above is 1 for electricity. Both these figures are about ten times the level observed in the UK.

Further examination of Ofgem's accounts shows that half of its costs and nearly half its staff are associated with the objective of creating and sustaining competition. In practice this has negligible relevance in Guernsey. The same applies to Ofgem's objective of providing a leading voice in Europe. The objective of helping to protect the environment is relevant in Guernsey, but it does not involve comparable complexity and costs as it does with the taxation and regulatory schemes in the UK.

To adjust for these three differences, suppose those three items are reduced by 90 per cent of their UK level, that is by  $0.9 \times (18.0 + 1.4 + 2.9) = £20\text{m}$  in 2004/5. This gives an adjusted total UK regulatory cost of £15.8m. Multiplying by 56.4% yields an attributed cost of £8.9m for electricity. The pro-rata cost for Guernsey would be £8900 annual cost, one twentieth of GEL's present licence fee.

On a similar basis, reducing staff numbers by 169 (90 per cent of the staff associated with the objectives less relevant to Guernsey) gives an adjusted staff level of 137, or an estimated 84 professional staff. Multiplying by 56.4% yields an estimated 47 professional staff in electricity regulation doing comparable tasks as in Guernsey. The pro-rata professional staffing level for Guernsey's electricity regulation would be 0.047 professional staff. Again this is one twentieth of OUR's present attributed staffing level.

Admittedly, in place of competition in generation and supply, OUR needs to monitor these activities more closely and set price controls on them. This takes time and resources. A more moderate conclusion would therefore be that, on a pro rata basis, OUR's costs are somewhere between ten and twenty times those of Ofgem.

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<sup>24</sup> "Modelling the costs of energy regulation: Evidence of human resource constraints in developing countries", Preetum Domah, Michael Pollitt and Jon Stern, DAE Working Paper WP 0229, CMI Working Paper 11, University of Cambridge, October 2002, Table 2.

#### 4.6 Comparison of costs of price control reviews

Is the picture any different for the specific activity of setting a price control? Consider the setting of that component of the price control that relates to the distribution network, which applies in both countries. Ofgem has recorded its costs of the most recent Distribution Price Control Review, including both internal staff and external consultants, as being £3.350 m in 2003/4 and £2.354 m in 2004/5.<sup>25</sup> This is an average of £2.852 m per year for two years. On a pro rata basis, this would correspond to an average of £2852 per year in Guernsey, again for two years.

OUR has not published costs of individual activities. The price control review has been by far its major project - almost its only project - in the electricity sector over the past two years. (In addition, work and decisions on this project evidently started in the previous year and will continue into this year.) The distribution network component must have been a significant part – say one third - of that price control work.<sup>26</sup> So OUR's costs associated with the distribution network element of its recent price control review accounted for about one third of the OUR licence fee for the last two years, namely about £60,000 per year.

Thus, the distribution part of OUR's electricity price control review probably cost of the order of £60,000 per year for each of two years, whereas on a pro rata basis the cost of the UK's distribution price control was under £3000 per year. In other words, the cost of the distribution price control review in Guernsey seems once again to have been about twenty times the comparable cost in the UK.

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<sup>25</sup> Ofgem *Resource Accounts 2003-04* p. 4, 2004-05 p. 4.

<sup>26</sup> This component would include, for example, analysis of the initial value of assets, determination of the cost of capital, assessment of network operating costs and scope for efficiency improvements, consideration of related capital expenditure projects, and so on. Other (non-distribution) components would include generation planning, the importation of electricity and retail supply.

## PART THREE PROPOSED SOLUTIONS TO THE PROBLEMS

### **5 Removing the overlap of regulation**

#### **5.1 Alternative possibilities for removing the duplication/overlap in regulation**

The NAO has found a lack of clarity on objectives, roles and responsibilities in the electricity sector in Guernsey. Chapter 2 has established in some detail and with respect to some major decisions that there is presently overlap and inconsistency between the OUR as formal utility regulator and the Treasury and Resources Department as representative of the States as shareholder. The main features of the overlap are that T&R and the OUR are each required to satisfy themselves as to the key features of the performance and activities of commercialised entities. Specifically, both organisations are responsible for satisfying themselves on pricing policy, operational costs and efficiency, and longer term capital investment plans of GEL (and GPL). This not only involves duplication of effort, it also opens up the real possibility of inconsistency and conflict. In practice, the outcome seems to have differed between posts and electricity. With respect to posts, there has been relatively little inconsistency between the decisions and views of the OUR and those of GPL and, by implication, with those of its shareholder T&R. With respect to electricity, this is not the case.

An obvious question is whether it is possible to remove the overlap in governance by removing the role of one of the two authorities in question. Is it possible to remove or reduce the States' role as shareholder? It would seem infeasible or at least inappropriate to pretend that the States are not the shareholder, or to prevent them from exercising their duties as a shareholder. Some might argue that the States could or should act purely commercially, abandon its policy of balancing commercial returns against the interests of consumers and the community, and leave all such considerations to the OUR. But this is not the position that the States have taken to date. Moreover, in a small island community like Guernsey, it is unrealistic to suppose that the States could or would ignore the wide variety of social and other non-commercial considerations attached to utility pricing and investment.

However, it would not be difficult to refocus the role of the OUR on specified companies and not on others. The Regulation of Utilities Law 2001 (s 22) provides that "utilities services means postal services, telecommunications services and electricity services, and such other services as the States may by Ordinance direct". It would be simple to give the States the option to exclude any of these specified utility services, for a specified or unspecified period of time. In practice, it would only consider doing so in case of commercialised entities that remained in States ownership – or at least while that utility was still majority-owned or controlled by the States of Guernsey. OUR would thus continue to regulate the telecommunications sector. Whether the OUR should cease to regulate the postal sector is for consideration by others: the argument here concerns OUR's regulation of the electricity sector.

To the extent that ‘regulation’ was required for electricity, it would in effect be the responsibility of T&R department, which for the most part would operate essentially as it does at present. A few additional arrangements might usefully complement this arrangement. The remainder of this chapter outlines how T&R could do this, considers some possible objections to this proposal, and looks at international experience in other small islands.

## **5.2 T&R and the functions of regulation**

In practice, the activities carried out by regulators can be grouped into about half a dozen categories. An examination of these categories in the case of electricity shows that, in the absence of regulation by OUR, all OUR’s present responsibilities could in practice be covered by T&R without any significant increase in the volume of T&R’s activities.

### **1. Strategic issues**

Energy policy issues such as renewable energy, environmental emission controls and diversity of supply are clearly important. But they are presently the responsibility of the States rather than the OUR, and would remain so. Where a licensee is in private ownership the States may find it convenient to give effect to their decisions by placing a direction on the OUR, which in turn presently has power to impose directions on the licensees. But this is unnecessary where a licensee remains in States ownership. As noted earlier, it is not normal or helpful for a regulator to engage in long-term planning of the electricity system, an activity for which regulatory bodies are typically not qualified.

### **2. Setting, monitoring and enforcing price controls**

The OUR has set price controls covering most aspects of GEL’s business. These have involved reviews of most of GEL’s business activities including the distribution network, generation and retail supply. T&R too reviews GEL’s activities and prices and indicates its preferences. T&R could therefore continue as at present to require a commercialised entity to propose a Five Year Plan, renewed and updated annually. This would include, importantly, the planned investment programme, business plan and operating expenses, the pricing policy and all strategic risks facing the company. Where appropriate T&R would indicate any desired changes to the Plan – for example, to reflect a more challenging efficiency target or a different balance of shareholder and customer interest compared to what GEL had proposed.

It might be said that T&R’s reviews have hitherto not involved scrutiny of fine detail. From time to time, therefore, T&R might wish to take advice from technical, economic and financial consultants. Approving medium-term price controls could be an area where such advice would be appropriate.

There is scope for enhancing the present role of T&R to accommodate some of the practices of modern regulation. For example, a public consultation procedure on the price control review could be envisaged. GEL might be required to publish its draft Plan (at

least the non-confidential elements thereof) for public comment. T&R would take these into account. T&R might be required to issue a draft response for public comment before finalising and publishing its acceptance of the final Plan. Monitoring and enforcement of the price controls would be consistent with T&R's present role as shareholder.

### 3. Quality of service

OUR presently sets standards for quality of service. It would be relatively straightforward to use UK standards as the basis for Guernsey, unless there were good reason not to, as I understand is indeed the case at present. If desired, T&R could invite views of the OUR on specified issues – for example, on matters particularly relating to consumers, although it is not clear that T&R needs any outside assistance in taking a view on appropriate service standards for Guernsey. It would be for T&R to specify the context and scope of OUR's advice and to decide how to take the OUR's views into account. Since quality of service has been addressed already, however, it seems unlikely to be a major issue in the years ahead. .

### 4. Consumer complaints

Trading Standards Service (TSS) of the Department of Commerce and Employment presently deals with customer complaints if the customer has not already agreed the matter with GEL. That would continue. If TSS fails to resolve a complaint, present provisions are that a case may be referred to the User Council and then to OUR. If desired, T&R could be given the ability to refer the case to the OUR, which at present can if necessary issue an order on the company, but this seems unnecessary since T&R could settle the complaint itself as shareholder. In fact, there have been very few customer complaints, and to date TSS has been used only once in the last four years.

### 5. Other matters

Other regulatory tasks presently discharged by the OUR include representation, interviews, media appearances etc. These would be a matter for T&R department, which already as shareholder has to present and account for its decisions on commercialised entities.

At present the OUR has to spend time and costs dealing with appeals against its decisions. These can be expensive: it is said that the telecommunications appeal cost about £2 m. If regulation via OUR did not apply to the States-owned commercialised sectors then there would be no need to incur the time and costs of appeals against OUR decisions.

To summarise, T&R could discharge all OUR's present regulatory responsibilities with respect to electricity, with little additional workload. It could call on technical and other consultancy advice as appropriate. It could commit to a consultation process comparable to that of the OUR. It could even ask OUR's advice on certain issues if it wished to do so. But there would be no real need for OUR as far as electricity regulation was concerned.

### **5.3 Possible concerns about removing OUR regulation**

There might be concern that removing OUR regulation from the electricity sector, and relying wholly on T&R to regulate GEL, would have several disadvantages. Surely independent regulation is a step forward, and transferring regulation to T&R would be a backward step? However, consideration of experience and circumstances in Guernsey suggests that such a fear is not justified.

Let us first be clear that the proposal is not that GEL should be de-commercialised and taken back into full States operation and control, with a political board running the business, as was the case before commercialisation. Commercialisation itself has been a success, and the proposed arrangements would build upon this. Electricity would continue to be provided by GEL as a limited liability company with an independent Board of Directors. Arrangements would continue essentially as at present, except that the present role of OUR as regulator would be removed and T&R would take on any necessary regulatory responsibilities.

Consequently, this does not mean that GEL would no longer be regulated. Nor would GEL be free to take all its own decisions, responsible to nobody. GEL would henceforth be regulated by T&R.

Would T&R, on behalf of the States as shareholder, be reluctant for political reasons to accept or encourage more efficient management and reductions in staffing? This argument does not carry weight in Guernsey. GEL has already achieved notable efficiencies in manpower and other areas since commercialisation. T&R has every reason to welcome reductions in costs and the reductions in utility prices that they make possible.

Would the States refuse price increases or hold prices below cost, again for political reasons? Experience again shows that this is not the case. T&R did not oppose the need for a price increase in October 2003 and it accepted the need for GEL significantly to increase its prices beginning in 2005. Nor can it be said that customers would be unprotected because T&R would agree to unreasonable increases in GEL's tariffs. On the contrary, T&R opted for GEL to earn only a 1 per cent return on assets, far below the commercial rate. And as a States-owned company in a small island community, GEL itself is not likely to want to charge excessive prices.

In fact, T&R's record on electricity pricing is more defensible than OUR's. OUR froze electricity prices without justification in March 2003, proposed a real price reduction rather than a real price increase when international fuel prices were rising sharply, and eventually conceded a lower price increase than T&R had accepted was appropriate to reflect rising costs. At the same time, it can hardly be said that customers would be better protected by OUR when it proposed that GEL set charges to earn a return on assets higher than T&R preferred.

Would regulation by T&R mean more government intervention in investment and operating decisions? On the contrary, it is arguable that OUR's interventions have increased the politicisation of decision-making on operational decisions such as purchasing of electricity and on long-term planning of generation adequacy, whereas one of the arguments for commercialisation was to reduce such interference.

Would T&R lack the necessary expertise to evaluate GEL's capital expenditure plans? There is no reason why it should, since it could hire technical and economic consultancy advice as OUR and C&E have done.

The NAO has expressed various concerns about previous arrangements between T&R and GEL – for example, with respect to clarity of roles, adequacy of dividend targets in stretching the company, communications between the two parties, energy strategy and non-core activities. I understand that T&R and GEL have already resolved some of these, for example those involving communications. To the extent that problems still remain, they need to be and can be resolved whatever the role for regulation. Transferring regulation from OUR to T&R would not exacerbate such problems. In fact, it might facilitate clarification of roles and responsibilities if OUR were removed from the picture.

Another concern might be that removing OUR regulation from the States-owned commercialised entities would preclude or make more difficult the introduction of private capital if the States subsequently decided that this was appropriate. However, this should not present a problem. The proposed regulation by T&R is consistent with private shareholders having a minority or controlling stake in a commercialised entity in which the States have a majority shareholding. If the States decided to sell majority ownership and control of the company to private investors, then the company could revert to regulation by the OUR as in the telecommunications sector at present. At that point T&R, in consultation with OUR, could put in place price control and other arrangements to facilitate a natural transition to continuing regulation by OUR. Some arrangement of this kind would in any case have to be made in the event of private capital being introduced. The clarification of GEL's asset valuation and associated issues, proposed as part of the completion of the recent price control review, would probably go a long way to facilitating any transfer of regulation back to OUR if the States were to envisage private capital.

Would the benefits of independent regulation be lost? As suggested above, it is not at all clear what benefits OUR has in fact provided. Moreover, independent regulation also has costs and these costs may outweigh any benefits. Regulation is costly to provide, and also imposes costs on regulated companies in terms of resources, diverted management time, and additional uncertainty. It can reduce initiative and responsiveness to change, and blur responsibilities. More staff can tend to make more work for regulation. It can divert skilled resources from more valuable and productive use elsewhere in the economy. There are increasing concerns about excessive regulation, not only in Guernsey. For example, in the UK the NAO found that most of the UK distribution companies considered that most of the price control information requested by Ofgem was

unnecessary.<sup>27</sup> Hence the Better Regulation Task Force principles that require, amongst other things, that regulation be proportionate and introduced only where necessary. These possibilities are explored in the next chapter. For the present, the main point is that independent regulation also has disadvantages, and is not necessarily the most sensible approach in all circumstances.

#### **5.4 Evidence from overseas including other small island countries**

Independent regulation is accepted as appropriate for privatised utilities. In general it has proved successful with the privatised utilities in the UK. It has also proved a useful component in the privatisation and reform of the utility sectors in several larger developed countries such as Australia and Scandinavia. But it has proved rather costly in smaller countries, since there seems to be a minimum scale of operation of an independent regulatory body. (See Appendix Two) International evidence on the impact of regulation is also somewhat qualified.<sup>28</sup> Is independent regulation therefore appropriate and proportionate for government-owned utilities in a small country? In general, other small countries have not been convinced. Instead, they have found other solutions.

About a dozen countries seem broadly comparable with Guernsey with respect to population, per capita income, number of electricity customers and size of electricity system. About half of these are embedded in larger countries, and often take their electricity supply from outside, hence have no real role for regulation.<sup>29</sup> Five small countries are also islands comparable to Guernsey (see Table 4).

The electricity systems in these islands have various different modes of ownership: public, municipal, private and mixed. They are 'regulated' in a variety of ways. There is the Jersey Competition Regulatory Authority (JCRA); the government as owner in the Isle of Man; the Price Control Commission in Bermuda; and government regulation via licence in the Cayman Islands (though separate but light-touch regulation is to be introduced there as part of a more general commercialisation process).

The Faroe Islands are a little different in that they comprise 17 separate inhabited islands, but since 1977 a single company SEV has been supplying all the islands. It is run and presumably 'regulated' by representatives of the municipalities. "The board of SEV

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<sup>27</sup> Asked what proportion of the requested information was necessary, 1 distribution company said 51 to 75%, 5 said 26 to 50% and 4 said 25% or less. National Audit Office, *Pipes and Wires*, Fig 33, p. 40.

<sup>28</sup> For example, one recent survey concludes that "regulation often has many undesirable consequences". J Luis Guash and Robert W Hahn, "The costs and benefits of regulation: implications for developing countries", *The World Bank Research Observer*, vol. 14 No. 1, February 1999, pp. 137-158. Another recent survey concludes that "Thus far, for electricity, there are some preliminary indications of a positive effect of regulation but nothing conclusive." Jon Stern and John Cubbin, "Regulatory Effectiveness: the impact of regulation and regulatory governance arrangements on electricity industry outcomes", World Bank Policy Research Working Paper 3536, March 2005, p. 44.

<sup>29</sup> Otherwise-comparable small countries that are not islands are Liechtenstein (population 33,717, GDP \$25,000), Monaco (32,409, \$27,000), San Marino (28,880, \$34,600), Andorra (70,549, \$26,800) and Gibraltar (27,884, \$27,900).

consists of seven members from all islands elected by the 78 agents located around the country. The board hires a director and the administrative staff.”<sup>30</sup>

None of these countries has an independent Utility Regulatory Authority per se. Yet as far as one can gather, the electricity systems in these islands are as modern as in Guernsey and operating just as satisfactorily. There seems to be no indication of problematic relationships between these electricity organisations and whatever part of government is responsible for supervising them.<sup>31</sup> These supervisory bodies are generally engaged in supervising numerous entities, rather than focused on one or a few utility sectors. This suggests that relatively few resources are devoted to the regulation of electricity in particular. Moreover, the apparent lack of any need to provide details (at least on the web) of the operation, staffing and costs of utility regulation is in itself an interesting point. Utility regulation in all these small islands seems to be accomplished in a low-key yet effective way. It provides reassurance to customers on prices and quality of service, and achieves good service and new investment, but does not seem to be costly or burdensome. It suggests that there are other ways of achieving satisfactory regulation that could be of relevance in Guernsey too.

Table 4 Electricity systems in comparable small island countries

Country	Population	GDP per capita	Electricity Sector				
			Customers	Production	Consumption	Capacity including imports	Ownership
		\$US 2003		GWh 2002	GWh 2002	MW	
Guernsey	65,228	40,000	28,255	54+264	296	116+60	Public
Jersey	90,812	40,000	44,348	(France)	630	208+145	62% Public 48% Private
Isle of Man	75,049	28,500	>40,000	132+274	n.a.	177 + 45	Public
Bermuda	65,365	36,000	33,239	643	598	180	Private
Faroe Isles	46,962	22,000	n.a.	220	205	n.a.	Municipal
Cayman Isles	44,270	32,300	21,000	411	382	123	Private

N.a.: not available

<sup>30</sup> <http://www.randburg.com/fa/sev.html>, 20 January 2006.

<sup>31</sup> The Cayman Island electricity company refers to extensive discussions in agreeing its new licence but the issues seem to have been resolved satisfactorily.

## **6 Modifying the framework of regulation**

### **6.1 Modifications to OUR's statutory obligations**

Europe Economics (EE) was asked to examine the ethos of regulatory legislation in Guernsey. It focused on four main issues:

- a) the structure of regulatory bodies, and specifically whether there should be a move from an individual regulator to a committee-based body;
- b) clarity, hierarchy and content of regulatory duties;
- c) powers of governments to give directions; and
- d) the impact and efficiency of the appeal process.

I have considered how the EE's recommendations on each of these issues might help to resolve the regulatory problems identified above, and then made some additional proposals.

### **6.2 Structure of regulatory body**

In general I agree with the pros and cons identified by EE, and with the recommendation to stay with a single Director General rather than to introduce a committee structure. However, in the present context I would put more weight on the role of a committee structure in moderating extreme positions taken by an individual regulator that might be unreasonable or inappropriate. Such a safeguard needs to be given particular weight in present circumstances. For example, it seems unlikely that the OUR could have imposed such burdensome requirements on GEL, or assumed that the company did not own its assets, if the regulator had first to persuade a local board of the wisdom of these actions.

To avoid the more bureaucratic committee structure, I suggest that consideration be given to the following approach that I first used in the context of the price control review for the National Grid Company in the UK, and later extended to other price control reviews. I appointed a panel of three senior businessmen to advise me on what it was reasonable to put to and expect of the regulated companies (for example, in the way of efficiency improvements or other changes). The companies no doubt recognised this in the arguments they put forward. At the same time, the companies found the approach reassuring because they knew that practical businessmen like themselves were involved in the regulatory decision-making process at the highest level (although of course responsibility for the regulatory decisions rested firmly with the regulator). A third benefit was that the meetings between company and regulator, which were attended by the business advisors, were more constructive than they otherwise might have been. The approach proved very successful, including in the views of the companies, and was repeated until the structure of regulation was itself changed. It seems to me that this approach could be beneficial in Guernsey too.

### 6.3 Regulatory duties

EE suggests that the lack of hierarchy of OUR's duties and their commonality across all three regulated sectors is likely to have made decision-making more difficult than necessary, increased regulatory risk and may have contributed to some of the conflict between the OUR, utilities and consumers. It recommends differentiating between primary and secondary duties and between each of the three regulated sectors.

Although there are clearly differences between the three sectors, I should be surprised if the OUR was not able to take account of this in its decision-making. So I am not convinced that the present duties are likely to have caused the problems mentioned. If a Direction does require the OUR to give particular priority or weight to a particular duty, it will be important to ensure that this does not simply mean an additional burden of regulation with respect to that duty, without recognising the need to reduce the burden of regulation with respect to other duties. It might therefore be helpful for any such Direction to provide that any priority should be without prejudice to the Better Regulation duties discussed below. Indeed, in present circumstances there would be merit in a Direction making the Better Regulation duties a priority for the OUR and the States with respect to all the sectors presently regulated.

I strongly agree with EE's recommendation that the OUR should be given an explicit duty, applicable to all three sectors, to have regard to the costs of compliance and to adopt regulatory methods appropriate to the size of Guernsey. In understanding the present situation, it is fair to say that there has been some lack of clarity in the general framework, and probably (as the NAO and EE reports suggest) some conflicts of personalities. Nevertheless, the bottom line is that the actual regulatory process and decisions have generally been 'over the top'. Getting a more appropriate regulatory approach is therefore the key to solving all the problems. I am pleased to note that the OUR itself is now looking at ways in which it can improve its procedures.

The proposed new duty will certainly help here, but is open to the question: what exactly does it mean to regulate in a way proportionate to Guernsey? I would therefore urge that the new duty includes, in addition, an explicit statement of the principles of Better Regulation that are now incorporated within the regulatory duties in the UK. Specifically, they require that "any person exercising a regulatory function must have regard to the principles that

- b) regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent;
- c) regulatory activities should be targeted only at cases in which action is needed."

Even these useful additional principles do not quite capture the importance of the point that, in the present context of Guernsey, 'proportionate' should mean a reduction in the scale and intrusiveness and cost of regulation. To this end, it would be helpful to supplement the above clauses by two additional clauses:

- d) regulatory activities should promote and not discourage flexibility, initiative, innovation and responsiveness to customer preferences within the regulated sector; and
- e) possibilities for reducing the scope, intensity, intrusiveness and cost of regulatory activities should be actively pursued.

Incidentally, I assume that this additional duty, like the present ones, will apply equally to the States as to the Director General. This of course would be desirable.

#### **6.4 Powers of government to give directions**

EE notes that the scope for the States to give directions to OUR is narrower in Guernsey than in the UK or elsewhere and suggests that there should be scope to give directions to change the priority that OUR should afford to each of its duties. It warns against creating too much regulatory uncertainty or enabling the States to intervene in operational decisions by the regulator, and suggests allowing changes to the priority of the regulatory duties only every five or ten years

I appreciate that it may be convenient for the States to be able to give general directions to the OUR. However, I too place weight on EE's concerns about regulatory uncertainty and the dangers of intervention in regulatory decisions. It is not clear that limiting changes to once every five or ten years is consistent with responding to whatever circumstances might indicate a reordering of duties. I am therefore not inclined to see government powers of directions as a solution to the present problems of regulation, though they might have a useful role to play.

#### **6.5 The appeal process**

At present, licensees aggrieved by a decision of the OUR can appeal to the Utility Appeals Tribunal (UAT). The Department of Commerce and Employment has suggested that it would be more efficient and cost effective for appeals to be dealt with by the Royal Court. EE concludes that there would be greater advantage in improving the operation of the UAT than in substituting the Royal Court, for example by limiting the time available to the UAT to resolve cases. I agree with this. A legal route is likely to be more expensive and may not focus adequately on the economic as opposed to legal issues involved. It may be helpful to set out my views at greater length.

There has been understandable concern at the cost and time taken by the present utility appeals process, particularly in view of the experience of Cable and Wireless in 2002. The intention of the OUR to publish draft decisions for comment before a final decision will help to resolve issues that might otherwise have gone to appeal. Use of a mediation process could be helpful in some circumstances, although it is not necessarily suitable for all types of regulatory dispute. Moreover, the accepted view in the UK (I understand in Guernsey too) is that it is inappropriate for the regulator to negotiate with licensees, as opposed to hearing what they have to say and then making a decision. Increasing the time for lodging an appeal from 14 to 28 days will allow a more considered response, though

whether it will reduce the number of appeals is not obvious. I am therefore not optimistic that the above procedures, whilst probably useful, will really address the issue of a satisfactory appeal process.

Consider now the possibility of referring all appeals to the Royal Court, possibly with technical or other assessors. I would not wish to rule out the possibility of recourse to the Royal Court for primarily legal issues, including judicial review. However, I am concerned that if this were the only route for appeal it would lead to an excessive and often inappropriate emphasis on legal issues. This would be even more costly and time-consuming than the present process, which alternatively could be improved, as the EE report explains.

In my experience, and consistent with a point made by EE, the issues most likely to arise in utility regulation appeals are generally not legal ones but rather are matters requiring economic and business judgement. A common question would be: is this price control proposal a reasonable one to impose on the company, and if not what is? A legal approach would ask whether due process has been followed, whether relevant information has been overlooked, whether anything is inconsistent with the facts in the case, whether it is possible that a reasonable regulator could have come to the decision in question based on the evidence before him or her, and so on. Although such questions may sometimes be relevant, the more likely and relevant set of questions concerns the substance and magnitude of the regulator's judgements. For example, would this or that assumed efficiency improvement be more appropriate in the future circumstances of the licensee, how should the weighted average cost of capital be calculated in the licensee's particular circumstances, are particular items of capital expenditure justified in view of future possible demand and supply scenarios and if so how soon, and so on. Experts can often shed light on these questions, but there are generally no right or wrong answers - these are questions where even experts may legitimately differ. What is required above all is a judgement whether, all things considered, the regulator has 'got it about right' or has been a little too severe (or too lenient), and if so a judgement on what would be 'about right'.

I would therefore suggest that it would be premature to remove the possibility of appeals to the Utility Appeals Tribunal in the majority of cases. Steps can be taken to avoid the problems that have previously been experienced. For example, the EE report proposes giving the Tribunal only a limited time (3 months) in which to complete its work. This would be sensible, and consistent with the approximately three-month period provided for appeals against Code modifications in the UK energy sector. In the case of modification references to the UK Competition Commission, it is up to the Director General to specify the time in which the report is to be completed. The parties then can and do organise their material and processes to meet this timetable.

There is no reason why legal issues should dominate Tribunal appeals, or why the parties should think that advocates are the most effective presenters of their case. If there is a concern that members of the Tribunal are not sufficiently familiar with the conditions and approach appropriate to Guernsey, then it is open to the States to appoint appropriate

people to the Tribunal. It is certainly not the case that the UK Competition Commission limits its membership to technical experts and specialists in utility regulation: on the contrary, part of its strength has always been the diversity of its membership, not least the participation of the non-specialist business person.

To summarise, I strongly agree with the conclusion of EE, which I am told is also the view of the three regulated utilities, that it would be better to improve the operation of the Utility Appeals Tribunal by making it more cost-effective, than to refer all appeals to the Royal Courts.

I would make one further suggestion. At present the regulator has the power to impose any modification to the license that he or she considers necessary or expedient. In the absence of appeal by the licensee, the modification stands. This puts the regulator in a stronger position, and the licensee in a weaker one, than in the UK. There, the regulator may propose a change to a licence, but if the licensee declines to accept, then in the absence of appeal by the regulator, the modification does not stand. This puts an additional pressure on the regulator to ensure that its proposals are reasonable. In present circumstances, it would seem appropriate to consider adopting the UK practice in this matter.

## **6.6 A possible Competition Commission**

It is understood that the Department of Commerce and Employment is “carrying out an investigation into whether the island needs a competition law”. (*Guernsey Press* 15 Nov 2005) If a new Competition Authority were set up to enforce such a law, would it be sensible for the OUR and utility regulation (or at least electricity regulation) to be part of it, and if so in what way?

There are two possibilities here. One is that regulation by a Competition Authority should replace regulation by the OUR, at least with respect to States-owned entities. The other is that utility regulation should continue as now, but that a combined Competition and Regulatory Authority should be responsible for both sets of activities.

Electricity is in fact regulated in the first way in Jersey. Jersey Electricity has been a Public Company since 1924 and is listed on the main London Stock Exchange. The Jersey Government owns 62% of the ordinary share capital of the Company whilst the remainder is owned by a diversity of institutional and private investors. The States of Jersey set up the Jersey Competition Regulatory Authority (JCRA) in 2001 as an independent body with responsibility for promoting competition and consumer interests through economic regulation and competition law. In the field of economic regulation, its responsibility currently covers the telecommunications and postal sectors. It is also responsible for administering and enforcing the Competition (Jersey) Law 2005. Although there is no electricity sector-specific regulation, the JCRA can still act if Jersey Electricity abuses its monopoly position. To date the JCRA has not needed to intervene in the electricity sector.

Replacing sector-specific electricity regulation by a Competition Authority would avoid the costs of a regulatory office and reduce regulatory uncertainty since there would be less of a role for regulation. It would therefore reduce the costs of compliance by the company, and increase the company's flexibility and responsiveness to new situations.

If there were sufficiently serious concerns about the actions of the electricity company, then the Competition Authority could investigate. It would have resources to do so, though initially it would have little accumulated expertise in the electricity sector. If it did find abuse of a monopoly position it would have to consider how to deal with this. Whether a one-off remedy would suffice is unclear. If the monopoly position is permanent then a permanent remedy may be called for. There may be advantage in a price control framework as a means of clarifying what prices it would be reasonable or unreasonable for the company to charge. Any such price controls would need to be monitored and updated from time to time. The Competition Authority would need to allocate staff and resources to do this, including perhaps by means of consultancy advice.

All this might suggest that the situation would tend to become the same as under regulation. Against this, however, a States-owned body would be unlikely to want to act anti-competitively, at least with respect to seeking excessive prices and profits. It is also argued in this report that T&R could adequately regulate States-owned entities. In special circumstances there might need to be a Competition Authority investigation from time to time to reassure those concerned (including customers and companies, politicians and commentators). Even a States-owned company might welcome some external guidance. However, this would not be the normal situation, and there would be advantage in waiting to see whether price controls or some other form of regulation are required, rather than presuming that they are from the start. Thus, replacing the OUR by a Competition Authority, at least for States-owned entities, would have merit in the context of Guernsey.

Combining the OUR with a Competition Authority would not have the above advantages but it would have at least two other related advantages compared to the present situation. First, the authority would have a broader range of staff and responsibilities. This would increase flexibility of regulatory resource use and increase the range of expertise available with respect to each aspect, including electricity regulation. This is particularly relevant if a rigorous slimming down of the present regulatory body is envisaged. Importantly, where appropriate and on the most critical issues, it would enable the person primarily responsible for electricity regulation to discuss the matter with a wider range of colleagues to inform the decision-making process. In some measure, then, this would provide some of the advantages of a regulatory committee over an individual Director General, without the additional cost and bureaucracy that a regulatory committee would entail.

Second, a combined Regulation and Competition Authority provides a wider context against which to assess the need for action in any particular sector. Specifically, an organisation responsible for the health of a large proportion of the market sector in Guernsey might be less inclined to see any problems in the electricity sector as overwhelmingly serious, needing detailed and continuous intervention. It might be more

inclined to see them as presenting issues from time to time that need to be dealt with expeditiously along with many other issues in the more or less competitive market as a whole. There will be many other issues to deal with: the fortunes and reputation of the Authority will not depend so heavily on electricity regulation as the OUR does. This would seem more consistent with the view of regulation set out by the States in 1999.

## **7. Reducing the cost of regulation**

### **7.1 Improved budgetary control**

Although the costs of the OUR, at about £900,000 per year, have remained within 1 per cent of the aggregate turnover of the licensed companies, as mentioned in the Advisory and Finance Committee letter of 2001, this is rather higher than the States' 1999 estimate of £350,000. On average, as shown in a previous chapter, the OUR's electricity regulation costs the Guernsey electricity customer £6.40 per year. Per capita, this is ten to twenty times the cost of electricity regulation in the UK. There is no reason to expect the per capita benefits of regulation to be any higher in Guernsey than in the UK. The Committee was therefore right to say that regulation should also deliver value for money, and should in due course be reviewed. In my view, regulation is not presently delivering benefits to justify this level of expenditure and involvement, and indeed cannot be expected to do so.

How is this best accomplished? One of the States' first general Directions could usefully require the OUR significantly to reduce its direct costs of operation, in parallel with the proposed new duty to regulate proportionate to the circumstances of Guernsey.

Is a regulatory body likely to respond significantly to this? There is room for doubt here. The statutory duties on a regulator are quite broad and serious. The regulator is appointed to protect the interests of consumers in respect of prices, quality and variety of service; to secure as far as practicable that the provision of services meets reasonable demands; to ensure that these activities are carried out so as best to serve the economic and social development and well-being of Guernsey; and many more. These are far-reaching objectives. The regulator is provided with equally far-reaching functions and powers to enable the fulfilment of these objectives. It is perhaps not surprising that a regulator might feel the need to investigate all these issues in some depth, and that a considerable staff and minimum scale of activity is required in order to discharge these duties, and to convince others that they are being properly discharged.

It is therefore important to consider what additional steps can be taken to ensure that the costs (and the scale) of regulation are indeed reduced to a more appropriate level. In this context I am concerned to learn that there is no direct budget limit on the OUR, so that it can incur whatever costs it chooses to, and simply charge these to the licensees. I appreciate that it may not be appropriate to have the OUR subject to an annual vote on its allowed budget. However, is there no other way by which the States can exercise responsibility or express their concern on this matter? In the UK, the Treasury has responsibility for approving the budget of Ofgem. Should not Treasury and Resources Department, or Commerce and Employment Department as sponsor Department of the OUR, be expected to set and enforce an appropriate budget for utility regulation?

## 7.2 The feasibility of a smaller budget for regulation

What size of budget is appropriate for utility regulation in Guernsey? Various different benchmarks might be considered. A pro rata calculation based on UK experience might be unduly severe. For present purposes it seems sensible to work with the estimate suggested by the Board of Industry in 1999, namely £350,000 and one full time professional staff (the DG) to regulate the three sectors. This would imply a licence fee of £70,000 for electricity with one fifth of a professional staff member's time. This involves somewhat more than the pro rata cost in the UK. However, it reflects the considered original opinion of the Board of Industry in 1999, informed by its advisers (KPMG), as to what kind of regulation would be appropriate for Guernsey.

How would the regulatory budget be made up? On the basis of the OUR accounts for 2004 (total cost about £900,000 for five staff and three sectors), assume that staffing costs are reduced to about one fifth and other costs to about one half, so as to give a total cost of £350,000. The revised provision for electricity regulation is then assumed to be one fifth of the budget of the whole regulatory body. The provisions for the other sectors have also been reduced pro rata.

Table 4 Possible smaller regulatory budget (£'000)

	Total body	Electricity
<b>INCOME</b>		
Post Office revenue	70	
Telecoms revenue	210	
Electricity revenue	70	70
<b>Total Income</b>	<b>350</b>	<b>70</b>
<b>EXPENDITURE</b>		
Salaries and staff costs	70	14
Consultancy fees	140	28
Legal fees	50	10
General Overheads	50	10
Other	40	8
<b>Total Expenditure</b>	<b>350</b>	<b>70</b>

The main tasks of electricity regulation, in Guernsey as elsewhere, have been set out in an earlier section. This showed how T&R could discharge these tasks. Appendix One contains a more detailed exposition of how a smaller regulatory agency could discharge them, including by the use of consultancy advice. (This calculation is of potential relevance to the T&R solution too.) The conclusion is that it would indeed be possible for a regulatory body to carry out the statutory functions of electricity regulation within a reduced budget equal to the level initially envisaged by the States.

## PART FOUR SUMMARY AND RECOMMENDATIONS FOR POLICY

### 8.1 Introduction and concerns

Guernsey Electricity has asked me, as former UK electricity regulator, to examine electricity regulation in Guernsey and to consider possible modifications.

I have looked at three potential causes of concern;

- The confusion and overlap in roles and responsibilities between the States and the OUR with respect to States-owned commercialised entities
- The actions of the OUR with particular regard to electricity regulation, and
- The costs of regulation, both in total and for the electricity sector in particular.

There is substance in all these concerns:

- Some actions of T&R on behalf of the States and the OUR as regulator seem to overlap and to have been mutually inconsistent.
- The OUR's actions have in some cases been heavy handed, inappropriate in Guernsey, unduly onerous and unreasonable in any country.
- The cost of regulation is greater than initially expected in 1999 and ten to twenty times the cost per capita in the UK.

This Report has examined three ways of addressing these concerns.

### 8.2 Analysis of measures to address these concerns

- 1) Transferring regulation of one or both of the States-owned commercialised entities (GEL and GPL) from OUR to T&R Department would resolve all three problems at a stroke (at least for the electricity sector).
  - This is not claimed to be the most appropriate method of regulation for privately owned enterprises, or in larger countries. But there is reason to believe that it would be a more satisfactory outcome for a States-owned company in a small island economy, and in the particular circumstances of Guernsey.
  - There must also be some doubt whether in practice other solutions would effectively address the above three concerns. The OUR may continue to exercise an inappropriately intrusive role in the business decisions of States-owned utilities, and the States cannot be expected to withdraw from active involvement. This would lead in practice to a continued overlap and confusion over responsibilities as well as excessive regulatory cost.
  - Given the size, nature and present circumstances of Guernsey, transferring regulation of States-owned entities to T&R seems more likely to produce a stable, non-bureaucratic and low cost yet effective system of regulation.
- 2) Modifying the regulatory framework would address the problems of unreasonable regulatory actions. The principle proposals are
  - That the OUR appoint a panel of senior business persons to advise it on price control reviews and other important interactions with licensees;

- That the OUR should be given a new duty, which could usefully be made a priority, to implement the principles of Better Regulation, and specifically
  - To regulate in a way proportionate to the size and circumstances of Guernsey and to have regard to the principles that
    - a. regulatory activities should be carried out in a way which is transparent, accountable, proportionate and consistent;
    - b. regulatory activities should be targeted only at cases in which action is needed.”
    - c. regulatory activities should promote and not discourage flexibility, initiative, innovation and responsiveness to customer preferences within the regulated sector; and
    - d. possibilities for reducing the scope, intensity, intrusiveness and cost of regulatory activities should be actively pursued;
  - That the role of the Utility Appeals Tribunal be retained but that it be given a limited time (say 3 months) in which to determine an appeal; and
  - That if a determination of the OUR is not accepted by the licensee then it should not be implemented, hence it would be a matter for the OUR, and not the licensee, to appeal the matter to the Tribunal.
- 3) Reducing OUR’s budget would address concerns about the cost of regulation and, indirectly, about its heavy-handed and onerous nature.
- If the States were given the power to give general Directions, one of its first general Directions could usefully require the OUR significantly to reduce its direct costs of operation;
  - In the surprising absence of any control on the OUR budget, Treasury and Resources Department, or Commerce and Employment Department as sponsor Department of the OUR, should consider setting and enforcing an appropriate budget for utility regulation;
  - It would be feasible to carry out the statutory functions of electricity regulation within a reduced budget consistent with the level (total £350,000) initially envisaged by the States in 1999. This would imply a budget of about £70,000 per year for electricity regulation instead of £180,000.

### **8.3 Recommendations**

Transferring regulation of States-owned commercialised entities from OUR to T&R could be expected to work well. It would solve all three problems, at least with respect to electricity, and is therefore recommended. This would not preclude the implementation of other measures, such as those suggested above, to deal with any problems of regulation in other sectors. Alternatively, if regulation is not transferred from OUR to T&R, application of these other measures would be helpful in resolving the problems of electricity regulation in Guernsey.

## APPENDIX ONE

### **A.1 Allocation of regulatory time and resources within a reduced budget**

Section 5.2 outlines the main regulatory tasks presently undertaken by OUR with respect to electricity, and shows how T&R could deal with them relatively straightforwardly. Alternatively, section 7.2 suggests that an independent regulator might undertake the same five tasks within a lower budget than the present one.

How much time might each of these tasks require? Some would be relatively constant from year to year, others would vary considerably depending, in particular, on whether a price control is in course of being set. With a professional staff person devoting one fifth of his or her time to deal with them, total  $1/5 \times 250 = 50$  working days per year, the average number of days per year on each task might be allocated as follows.

1. Strategic issues: 5 days per year on average, more in years when relevant policy is being formulated or revised, less in other years.
2. Price controls
  - a) Distribution network price control: 60 days in a year when the price control is being reviewed (perhaps spread over parts of two years in practice), 4 days in the other four years, average 15 days per year.
  - b) Generation and supply: assume the same as for the distribution network control (although there might alternatively be two shorter price control periods per five years), average 15 days per year.
3. Quality of service: 2 ½ days per year on average, more in price control years when standards might be reviewed, less in other years.
4. Consumer complaints: 2 ½ days per year on average.
5. Other matters: 10 days per year on average.

What would be the cost of each of these activities in terms of other resources? The main item apart from salary and staffing costs is consultancy fees. These are budgeted to total £28,000 per year, or £140,000 over five years. The main use of these would be in connection with the price control reviews. Possible allocations would be as follows:

- Technical report on the distribution network and limited financial advice, both including discussion with the regulator as required: £50,000 once per five years.
- Technical reports on generation and economic reports on purchasing and supply, including discussion with the regulator as required: £50,000 once per five years or about half that twice per five years.
- Ad hoc advice as needed on implementation of price control and on other issues, average £8000 per year for five years, total £40,000.

The regulator would have the ability to vire between these categories and (within approved guidelines) within other categories of expenditure.

This is of course a much-reduced kind of regulation compared to present practice. It is designed to enable one staff member to monitor and where necessary guide or restrain the company, but as one of several regulatory tasks covering other sectors too. It is not intended to be detailed and intrusive. It is intended to reflect the kind of regulation originally envisaged in Guernsey at the time of commercialisation.

## APPENDIX TWO

### A.2 International comparisons

Have other countries actually created independent utility regulation authorities on a small scale? One study looks at a sample of 60 energy regulatory bodies in developed and developing countries (or states and provinces therein).<sup>32</sup> Their size ranged from 5 to 946 total staff, of which from 2 to 600 were professional. Among developed countries, the median regulatory office has 51 staff, of which 31.5 are professional, in order to deal with 3 sectors. The authors conclude that “there is a very substantial ‘fixed cost’ element in electricity regulation. ... [E]ven for small countries with limited electricity systems, our estimates suggest that the number of regulatory staff required is around 30 including 15 professional staff”.

This conclusion seems on the high side for smaller developed countries. For the nine developed countries in their sample with fewer than 1 million electricity customers, the number of professional regulatory staff ranged from 2 to 24, regulating 1 to 6 sectors. The median size was 10 professional staff to regulate 3 sectors. The two smallest of these nine sample countries had around 100,000 electricity customers each. These were Barbados (2 professional staff to regulate the electricity sector alone) and the Bahamas (5 professional staff to regulate 3 sectors). This suggests that it is possible to regulate 3 sectors in some of the smaller developed countries with about 5 professional staff rather than 15.

Guernsey has about one quarter as many electricity customers as the two smallest countries mentioned, yet it has a comparable size of professional staff. Since the per capita costs of regulation are much higher in smaller countries, this raises the question whether the benefits of regulation outweigh the costs of regulation in small countries in general, and in Guernsey in particular. The potential benefits of regulation cannot be assumed to be any greater in a smaller country than a larger one.<sup>33</sup> Some have suggested that developing countries, in particular, might have to forego the benefits of privatisation or commercialisation that is thought to necessitate regulation.<sup>34</sup> This does not seem a

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<sup>32</sup> “Modelling the costs of energy regulation: Evidence of human resource constraints in developing countries”, Preetum Domah, Michael Pollitt and Jon Stern, DAE Working Paper WP 0229, CMI Working Paper 11, University of Cambridge, October 2002.

<sup>33</sup> A variety of factors are likely to impact on the potential benefits of regulation, including the nature of the previous or alternative regime, the actual and potential extent of competition, the stability of the general economic framework, and so on. But it seems unlikely that electricity utilities in smaller countries would be able to make larger percentage reductions in their operating or capital costs in each sector their businesses than utilities in larger countries. If anything, indeed, the assumptions made by UK regulators might suggest the opposite. OUR’s Table 4 shows that regulators have assumed less scope for efficiency improvements in Northern Ireland distribution and Scottish Transmission than in comparable organisations in England and Wales.

<sup>34</sup> Domah, Pollitt and Stern 2002, op.cit. note that developing countries may not be able to afford the costs of regulation, or will not have sufficient qualified people to run the regulatory offices. Stern 2000 expresses concern that this might necessitate deferring policies of reform such as commercialisation, privatisation and competition. In a developed country such as Guernsey, inability to attract qualified staff does not seem to be such a problem.

critical factor in Guernsey. However, discussion in the text shows that other developed small island countries have avoided this problem by adopting other forms of regulation, rather than by creating a separate regulatory body for government-owned enterprises.