REGULATORY POLICY INSTITUTE

Review of Guernsey's utility regulatory regime

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Summary

i. This report constitutes our assessment of Guernsey's utility regulatory system as applied to the regulation of electricity, post and telecoms, and it includes recommendations for change to improve the framework and conduct of regulation. Although initially triggered by issues noted in the April 2010 Requête, the scope of the Review has broadened to take account of other structural, policy and institutional factors. We consider this broadening desirable, as any assessment of the effectiveness of a regulatory regime requires an examination not just of the regulator, but also of the broader policy and institutional structure of government within which regulation operates.

ii. We have taken it as axiomatic in conducting the Review that Guernsey folk are much the same in their nature as folk everywhere else, and that any general differences in conduct and performance are to be ascribed to differences in context (those things that make Guernsey different). Among the factors that we considered particularly relevant were: the small size of the relevant markets; the structure of government in Guernsey; public ownership of Guernsey Post and Guernsey Electricity; corporate governance in the commercialised public sector; prospects for cooperation with Jersey; and Guernsey's save-to-spend policy.

iii. Although Guernsey's system of utility regulation is broadly similar to that developed in the United Kingdom, the system of formal regulation is operated at a scale much smaller than is typically observed in other jurisdictions. We examine, as a preliminary exercise, the question of whether the size of the economy is such that regulatory success is unlikely. We conclude that regulation can work in a small economy such as Guernsey, but that, precisely because of its size, issues such as the scope and proportionality of regulatory activity are of critical importance. In this respect, we suggest that regulatory arrangements be built around a regulatory style that we have termed 'doing a limited number of biggish things well', but which might alternatively be called an approach based on 'limited regulation'.

iv. We then consider issues surrounding the appropriate objectives for the regulatory system in Guernsey, which brings us to questions of competition and public monopoly. On competition, we conclude (contrary to the view put to us by some

parties) that the scope for competition on the Island – and in the regulated sectors, including electricity – is greater than is generally assumed. While Guernsey's size means the intensity of competition may not be as vigorous as in larger economies, the possibility of challenge through competitive entry can still be a powerful inducement to better performance in many sectors and industries (including the regulated sectors).

v. On questions of monopoly we note that where utilities remain in full public ownership (such as is the case for Guernsey Electricity and Guernsey Post) this tends, on average, to dull the managerial incentives for improving performance over time and requires a very activist shareholder to counteract the effect of this. In this respect, we find significant limitations in relation to the current governance arrangements for the publicly owned electricity and post monopolies in Guernsey. In particular, we note that the States guidance (to the shareholder) envisages a broad shareholder role which involves the resolution of trade-offs between price levels and financial returns; which is <u>not</u> the approach envisaged under the standard 'independent regulation' way of doing things. In addition, we consider there to be a serious design issue with the application of price-cap regulation to these publicly owned monopolies. In particular, we question whether fixing prices will create the same desirable incentives for cost reduction in the commercialised entities as it does in private companies. We conclude that there may be more effective means of achieving the relevant public policy objectives (than simple price-cap regulation of public enterprises).

vi. Turning to the specific sectors, our assessment is that the regulatory system has worked effectively in telecoms, and has been particularly effective in allowing for new entry, and in creating a general environment of trust and professionalism. Our recommendations in this area are that the current regulatory structure is maintained, and the approach be tilted further towards the gradual withdrawal of formal price controls as competition develops. We also consider there to be considerable merit in proposals to allow for greater harmonisation with the regulatory framework in Jersey. An important implication of our assessment is that there is an on-going role for the Office of Utility Regulation (OUR) in the telecoms sector, and that, in consequence, the OUR's role in regulating postal services and in electricity should be considered on an incremental basis.

vii. In post, it is our assessment that the regulatory system has not performed effectively. We conjecture that this is the result of a combination of factors including the application of the standard price control approach, the weaknesses of the broader governance and oversight arrangements, and the absence of any second-opinion expert review panel ('an adjudication panel') which could deal with issues as and when they arise. Our major specific recommendation in post is that issues surrounding the USO be addressed as a priority.

viii. Our assessment in electricity is that the regulatory system has failed in some key respects, including in relation to fairly standard regulatory matters such as the treatment of the issue of cost-pass through in the price control. In our view, an appropriately designed and constituted adjudication panel might have been able to deal with these issues swiftly and decisively. However, there are also deeper issues in electricity relating to the ownership and governance arrangements. For this reason we consider that the approach of sticking with the current regulatory model may not resolve the underlying problems, and that more radical change may be necessary. In this respect, we canvassed a number of possibilities including: the full or partial privatisation of GE; a more active shareholder function; a shift toward a more 'adjudicative' (as opposed to 'activist') role for regulation in price setting arrangements; and the possibility of moving toward a 'regulation by exception' arrangement. Each of these proposals has merits as well as drawbacks associated with them. That said, our own conclusion is that a more adjudicative approach to regulation is most likely to provide a good fit with the Guernsey system of government. Separately, we suggest that the States give serious consideration to the adoption of a clear and stable formal energy policy in order to avoid the instability caused by potentially significant changes in policy preferences, which has the potential to have a negative effect on the effectiveness of regulation going forward.

ix. Finally, in addition to the specific recommendations in each of the sectors, we set out more general recommendations to improve the regulatory system in Guernsey. Among these are:

- That an adjudication panel be established, to be called (and remunerated) on an 'as needed' basis, to provide an authoritative second opinion on disputed matters and adjudicate on disagreements between the regulated companies and the OUR.

- The States consider again the suitability of the current governance arrangements for the commercialised utilities, particularly the role of the non-executive directors and T&R as shareholder. In particular, we consider there to be merit in the proposal for the creation a 'shareholder resource', preferably in cooperation with Jersey, responsible for engaging with the utilities on financial matters and holding them to account in terms of its performance against its plans and shareholder objectives.

- That a formal institutional mechanism or process be developed to enhance the accountability of the OUR, and permit a review of its activities on a regular basis.

- That, as already contemplated, competition laws should be established in Guernsey, but that further thought be given to the issue of appropriately adjusting 'standard' thresholds relating to market shares, so that those thresholds better reflect the realities of competition in a small market.

"Mankind are so much the same, in all times and places, that history informs us of nothing new or strange in this particular. Its chief use is only to discover the constant and universal principles of human nature, by showing men in all varieties of circumstances and situations, and furnishing us with materials from which we may form our observations and become acquainted with the regular springs of human action and behaviour. These records of wars, intrigues, factions, and revolutions, are so many collections of experiments, by which the politician or moral philosopher fixes the principles of his science, in the same manner as the physician or natural philosopher becomes acquainted with the nature of plants, minerals, and other external objects, by the experiments which he forms concerning them."

David Hume, *An Enquiry Concerning Human Understanding*, 1748.

1. Introduction

1.1 Terms of reference

We have been appointed by the Commerce and Employment Department (C&E) in the States of Guernsey to undertake a review of Guernsey's utility regulatory regime.

The objectives of the study/exercise are those set out in the C&E's invitation to tender (ITT):

- To review the States of Guernsey's existing objectives for the regulation of electricity, post and telecoms, with particular reference to the liberalisation of the post and electricity markets;

- To assess the effectiveness, and appropriateness, of Guernsey's regulatory regime in delivering these objectives;

- In light of these findings to identify and assess options capable of achieving the States objectives; and

- To provide evidence based recommendations for the C&E to take to the States of Deliberation which will ensure that Guernsey has a form of regulation that meets the present and future needs of the States of Guernsey, consumers and the Guernsey economy.

The objectives of the review described in the terms of reference are rather broader than the issues that were the principal focus of the April 2010 Requête, which has triggered the subsequent process. We consider this broadening of the scope of the review to be desirable, and note that it might, in fact, have been impossible to undertake a satisfactory assessment on a narrowly defined basis. This is because the effective functioning of a regulatory system depends upon the interactions among a number of 'structural' factors, including the legal, public policy and institutional frameworks in which regulation occurs/operates. Without studying these interactions, it may be impossible to diagnose the sources of any problems that are discovered, and hence impossible sensibly to discuss remedial actions.

1.2 Attributes of good regulatory frameworks

A number of general principles or attributes have been linked to good regulatory frameworks in work undertaken or sponsored by bodies such as the World Bank and the OECD, aimed at examining whether a particular jurisdiction's infrastructure regulatory regime is *designed* in a way that is likely to foster good decisions and outcomes.[1]

Among the most important of the attributes identified in such work as being significant for good regulatory practice are the following:

- ***The independent regulator as benchmark:*** There is widespread agreement that infrastructure regulators should be independent from the regulated entities and, as far as possible, from government influence. Regulatory independence is conducive to greater neutrality and objectivity in regulatory decision making, which tends to contribute to greater confidence and greater market participation by all those who might have dealings with the utilities concerned. One argument is that the establishment of an independent regulator helps improve a potential trade off between market and government 'failures'; the central market failure problem being monopoly, and the central government policy failure being opportunism, or unstable/volatile political objectives. In short, establishment of an independent regulator is seen as a commitment by the government that decisions on allowed prices will be determined chiefly by economic, rather than by political, factors.

[1] See, for example, the World Bank's *Handbook for Evaluating Infrastructure Regulatory Systems* (2006), as well as material presented in the Bank's working paper *Regulatory Effectiveness and the Empirical Impact of Variations in Regulatory Governance* (2005).

- ***Clarity in the framework of roles, objectives and responsibilities:*** Alongside the need for regulatory independence is a need for clarity in the framework of regulatory roles, objectives and responsibilities. It is typically the case that regulated utilities will have dealings with more than one branch of government, and clarity is important at an institutional level in order to help avoid unnecessary conflicts and duplication of functions among the various parties. In addition, clarity on these points helps avoid policy confusions that might send uncertain signals to capital markets and other stakeholders.

- ***Completeness in rules and targeting:*** In addition to being clear, good regulatory governance arrangements should be 'complete' insofar as those subject to regulation are made aware of the principles, guidelines, and objectives that will be pursued in carrying out regulatory activities, and are also made aware of expectations concerning their own responsibilities, as well as the potential consequences of failing to discharge those responsibilities.

- ***Stakeholder participation:*** Participation and consultation are generally seen as conducive to good, analytic decision making, as well as providing information on issues such as the acceptability of different policies to the various stakeholder groups. In addition, consultation and participation serve to promote confidence in the regulatory system and ensure its legitimacy. Formal rights of participation are, however, generally considered insufficient of themselves. In practice, participation must be *meaningful.* In this respect, there needs to be ample opportunity for all affected parties who wish to participate to do so, at a time and in a form that allow regulators to take submissions properly into account before rendering a decision in regulatory proceedings.

- ***Transparency:*** Transparency implies openness of the regulatory process and regulatory decisions to stakeholders, so that both the process of decision making and the substantive evidence, reasoning and judgments are visible and comprehensible. Transparent processes and decisions serve to increase confidence in the regulatory system, and to impose organisational and intellectual disciplines on regulators that potentially contribute to the making of better decisions. Proxies for transparency in regulatory processes include: public hearings, a public record of submissions, public access to decisions, and an annual report of activities including a

financial audit. In relation to the substance of regulatory decisions, any key principles and methodologies on which major regulatory decisions are made should be clearly set out in advance in appropriate documents. Various institutional safeguards aimed at achieving transparency in regulatory decisions have been suggested. These include: making all documents and information used for decision available for public inspection; ensuring the procedures by which, and criteria upon which, decisions are made are known in advance and made publicly available; establishing criteria relating to how written decisions are presented including requirements for: a clear statement of the decision, a description and analysis of all evidence taken into consideration, a summary of the views offered by participants to the proceedings, and finally, a discussion of the underlying rationale for the decision.

- ***Predictability and consistency:*** A good regulatory system should provide reasonable, although not absolute, certainty as to the principles and rules that will be followed within the overall regulatory framework. In this respect, good decision-making draws an acceptable balance between predictability and consistency on one hand, and flexibility and discretion on the other.[2] As economic regulation can involve interventions that affect existing property rights, it is important that the uncertainty attached to regulatory decision making is limited as far as is possible without overly fettering the regulator's discretion to make the most appropriate decision.

- ***Proportionality:*** Regulatory interventions should be proportionate to the problem that the regulator is addressing. In particular, it can be argued that, as a general matter of principle, intervention should be the minimum necessary to remedy the problem identified, and should be undertaken only if the likely benefits outweigh the expected economic and social costs. Any enforcement action should be in proportion to the risk, with penalties proportionate to the harm done. Similarly, compliance obligations should be affordable to those regulated.

- ***Accountability:*** Independence does not imply that the regulator is not accountable. It follows that, in order to ensure that the regulator is accountable for her/his conduct, and for how he/she implements policies, there should be procedures in

[2] Guidance on regulatory uncertainty is itself not always clear. What matters to investors, for example, is not that policy is set in stone and unchangeable. In fact, that would tend to lead to poor regulation, which could damage utility performance in the longer run. Rather, what matters is that capital markets (say) can predict how regulatory decisions will respond to changing circumstances (e.g. how the Bank of England's Monetary Policy Committee might react to changing information about inflation, unemployment, the sterling exchange rate, etc.)

place to scrutinise the regulator's performance in light of the relevant objectives. Such procedures commonly include publication of decisions, and the ability to appeal the regulator's decision in some cases. Consultative bodies of consumers, industry representatives and/or others are ways of seeking to ensure meaningful public participation, which enhances the accountability of the regulator.

- ***Appeals:*** It is generally recommended that all regulatory decisions should be subject to *final* right of appeal to an impartial or independent, legally designated court or tribunal, in which the following issues can be addressed: has the regulator acted beyond its legal authority?; has the regulator followed appropriate procedural requirements?; has the regulator acted arbitrarily, unreasonably or disproportionately?; and how did the regulator approach the evidence and submissions before it? The ability to appeal decisions is an important guarantor of both transparency and accountability, and this arguably helps improve the quality of regulatory decisions (i.e. by acting as a form of regulatory quality control). In addition, the prospect of an appeal helps keep regulators 'on their toes', both in relation to the processes followed and the substantive decisions made. Alongside any formal appeals mechanisms it is sometimes suggested that other non-traditional, means of challenging regulatory decisions, such as the use of an Ombudsman or specialist tribunals or panels, can be effective.

We mention these attributes here, not because they provide a checklist or scorecard by which we can assess Guernsey's regulatory regime, but rather to highlight the point that for regulation to work effectively it is often the case that a number of 'pieces of the puzzle' must be present and connected. In particular, when assessing the effectiveness of a regulatory regime, it is necessary to look beyond the activities of the regulator: consideration must also be given to the broader institutional structure of government within which regulation operates.

1.3 Do these general factors apply to the context of Guernsey?

We take it as axiomatic that Guernsey folk are much the same in their nature as folk everywhere else, and that any general differences in conduct and performance are to be ascribed to differences in context (those things that make Guernsey different). In this, we simply follow the founding fathers of political economy (see the David Hume quotation at the beginning of this review), and the generally accepted legal wisdom that: *"Context is everything: circumstances alter cases."*

Among the factors that we consider particularly relevant to the Guernsey context, and therefore which we consider and discuss throughout the review, are the following:

- The small size of the relevant markets.
- The structure of government in Guernsey.
- Public ownership of Guernsey Post and Guernsey Electricity.
- Corporate governance in the commercialised public sector.
- Prospects for cooperation with Jersey.
- Guernsey's save-to-spend policy.

Before examining each of these factors in detail, however, this report considers (in sections 2 to 4) three sets of preliminary issues:

- First, we examine the question of whether the size of the relevant markets in Guernsey is so small that, even if all other factors were favourable, independent regulation could never realistically be expected to succeed. We consider this question before any others because, if small market size alone were likely to preclude success, there would be little point in further assessment. As our subsequent discussions indicate, we did not reach such a conclusion, but we nevertheless set out our reasoning on the issue, because the asking and answering of this relatively simple question points to some of the characteristics of regulatory arrangements that, in our view, are necessary for the achievement of successful outcomes in Guernsey.

- The second preliminary exercise relates to the characteristics of competition. We found in our consultations for this Review that there are some fairly widespread misunderstandings about the nature of competition and its likely effects in sectors such as telecoms, postal services and electricity. This is unsurprising, since words like 'monopoly' have subtly different meanings when used in different contexts, some of which are more technical than others. The word can be, and is, used to describe: supply by a single seller (from the original Greek), supply by a single seller that faces no competitive threats (i.e. cannot be displaced), and supply by an enterprise with a large market share and an ability to have a significant influence on market prices. Though the label applied may be the same, each of these 'monopolies' is different from the others, and can be expected to exhibit different

behavioural patterns. Accordingly, we have sought to clarify some of the relevant economic concepts, and reasoning, relevant to the assessment of competition, in the hope that this may help facilitate a better public discourse, not only on the regulatory issues covered in this Review, but also in relation to the possible future development of competition law on the island.

- Our third preliminary exercise relates to the implications of public ownership for the conduct of independent regulation. We single this issue out because of its particular significance for the matters that we have been asked to consider; and because that significance has already been identified in an earlier document produced by Professor Stephen Littlechild for Guernsey Electricity. Accordingly, we judged that it would be helpful to set out the general challenges posed for independent regulation by public ownership, ahead of looking at how the issues crystallize in the specific Guernsey context.

The later sections of the Review (sections 5 to 7) comprise evaluations of the current regulatory framework, and its performance, in the three sectors currently subject to sectoral regulation – telecoms, postal services, and electricity – together, in section 8, with suggestions and recommendations on reforms that might help improve policy effectiveness in relation to regulation and competition on Guernsey.

1.4 Approach to the review and the materials examined

An important aspect of this Review was an extensive consultation process, the purpose of which was to build up our understanding of the specific issues, and the specific contexts, of utility regulation on Guernsey. As part of this process we met with the following parties and representatives:

- A large number of States' Members, including the signatories to the Requête as well as other Members.
- Commerce and Employment Board Members and Department staff.
- Treasury and Resources Board Members and Department staff.
- The States Chief Minister.
- The States Chief Economist.
- The Office of Utility Regulation.
- The Jersey Competition and Regulatory Authority.
- Cable & Wireless Guernsey.

- Guernsey Electricity.
- Guernsey Post.
- Guernsey Gas.
- ClearMobitel.
- Airtel Vodafone.
- Hub Europe.
- Citipost DSA.
- The Bulk Mailers Association.
- Representatives of the Communications Workers Union.
- Consumer representatives, including Postwatch.
- The Guernsey Reform Group.

In some cases, we met with relevant bodies and organisations on more than one occasion, and also talked with past, as well as current, employees. In order to facilitate open discussion, all of the meetings were conducted on a confidential basis. We have, therefore, not attributed any statements in what follows to any particular individual or organisation. Generally speaking, the consultation meetings were highly informative, and we are grateful for the atmosphere of openness and frankness in which the great majority of the meetings were conducted.

Our assessment of the performance of the regulatory system across the individual sectors (electricity, post, telecoms) draws upon the general themes of these discussions and the other materials we have examined. However, in reviewing the performance of the regulatory system, we have also focussed our attention and analysis on the examination of a small number of important 'episodes' or specific issues (such as the reserved area dispute in post, or the cost-pass through issue in electricity) that we consider likely to be particularly informative about the operation of regulation in the sector concerned. We consider there to be a number of advantages in adopting this approach. As a matter of methodology, this type of forensic analysis of specific, but important, issues/episodes can be revealing in terms of providing deeper insights into how such problems arise in the first place, and how they are then dealt with/addressed within the broader regulatory and institutional system.[3] In addition, by applying this approach across the sectors we are able to look for any patterns

[3] The approach of tracking back from very specific problems/issues to the root causes, is not dissimilar (albeit in a very different context) to that entertainingly described by The Times columnist Matthew Parris in an article concerned, in his own terminology as 'Keyhole Diagnostics'.
< http://www.timesonline.co.uk/tol/comment/columnists/matthew_parris/article5679226.ece>

or recurring issues across the different sectors which can help to identify underlying issues and problems beyond that of the specific issue/episode examined.

Alongside the consultations and meetings, we collected and assessed a wide range of materials and evidence in the course of this Review, including the following:

- The April 2010 Requête, and related correspondence between the Commerce and Employment Department and Treasury and Resources Department;
- Past reviews and materials, including earlier studies by the National Audit Office (NAO) and Europe Economics, a Report by Professor Stephen Littlechild for Guernsey Electricity in 2006, a Report on electricity issues for the Office of Utility Regulation by Sir Ian Byatt, Chris Bolt and Professor David Newbery in 2006, a provisional Report on utility regulation by Guernsey's Chief Economist;
- Written submissions, documents and letters on specific regulatory issues/matters provided by companies, consumer representatives, Deputies and individuals;
- Various presentations made by regulated companies and individuals;
- Publicly available documents relating to previous regulatory decisions, including not only those of the Office of Utility Regulation but also those published by other States' departments;
- Documents relating to company and financial performance for the regulated companies in Guernsey;
- Material and reports published by the OUR since its inception in 2001;
- The Regulation of Utilities (Bailiwick of Guernsey) Law 2001, The Post Office (Bailiwick of Guernsey) Law 2001, The Electricity (Guernsey) Law 2001; The Telecommunications (Bailiwick of Guernsey) Law, 2001, and related directions in accordance with these pieces of legislation.

We have also had regard to more general materials on regulation, including material produced by other regulatory agencies, regulated companies in other jurisdictions, and material on approaches to regulatory assessments produced by bodies such the World Bank and the OECD.

2. Regulation in a small economy

The system of utility regulation adopted in Guernsey is broadly similar to that developed in the United Kingdom in the 1980s and 1990s. It is most similar to that currently operating in Northern Ireland, in that a single regulatory office is responsible for unrelated sectors.[4] While this approach of combining the regulation of different sectors (post, electricity and telecoms) into a single regulatory office differs from that used in the UK (excluding Northern Ireland), it is not uncommon; and similar institutional structures can be found in countries such as the Netherlands, New Zealand, Germany and Australia.[5]

On the other hand, there can be no doubt that the States are operating a system of formal regulation at a scale much lower than is typically observed in other jurisdictions that followed broadly similar paths. This raises the immediate question: is the size of the economy simply so small that success is unlikely? Using an analogy from the theory of evolution (a not uncommon source of analogies in economics): *is this type of animal destined for extinction in this type of environment?*

As an initial approach to this question, we have considered the proportionality between the costs and potential benefits of the current regulatory arrangements in Guernsey. We use *potential* benefits because, even if actual benefits were found to be below costs, if it were possible to improve performance by incremental reforms without abandoning the main features of the system, it would be sensible to consider those reforms first, before considering the 'extinction option'.

Put another way, we have looked first at the question: *can it work?* This is to be distinguished from the questions: *has it worked?,* or *Is it working?*

2.1 Costs

The costs with which we are concerned can be divided into:

- The costs of the Office of Utility Regulation (OUR).

[4] In Northern Ireland the Utility Regulator is responsible for electricity, gas, water (telecoms is regulated by Ofcom). In Guernsey, the OUR is responsible for telecoms, electricity and post.

[5] In the Netherlands, rail and energy are combined with competition regulation as separate chambers of the NMa. In Australia, competition and regulation of all telecoms, post, energy are generally combined within a single authority. In Germany, post, rail, energy and telecoms are regulated by the Federal Network Agency.

- The compliance costs incurred as a result of OUR activity.

In each case, we are concerned only with the costs that are borne by Guernsey residents (the significance of this point is explained below).

OUR costs

Table 1 below presents estimates of the costs of the OUR in Guernsey and of regulatory agencies in other jurisdictions. It shows that in 2008 the total OUR costs were just over £758,100, and that this represents a cost of £126,353 per employee, or £12.28 per resident of Guernsey. Two interesting observations can be made from this table. First, the cost per employee for the OUR is broadly similar, if not slightly lower, than the costs per employee at comparable agencies in Jersey, Ireland and the UK (although not Germany). Second, the estimates are consistent with the existence of significant 'scale economies' in regulation; with the exception of the Jersey comparison, as the population gets larger the cost of regulation per capita falls.

Table 1: Cost of regulatory agencies in other jurisdictions - 2008 (£)

	FTE Staff	Budget (£)	Cost per staff member (£)	Cost per capita (£)
Guernsey				
OUR Guernsey (post, telecoms, electricity)	6	758,118	126,353	12.28
Jersey				
JCRA (competition and telecoms)	9	1,154,220	128,247	12.57
Ireland				
CER (energy)	68	8,610,785	126,629	1.95
Comreg (post and telecoms)	113	17,878,181	158,214	4.04
	181	*26,488,966*	*146,348*	*5.99*
United Kingdom (excluding N.I for energy)				
Ofgem (energy)	302	39,907,000	132,142	0.67
Ofcom (telecoms)	810	138,611,000	171,125	2.34
Postcomm (post)	66	9,159,000	139,619	0.15
	1178	*187,677,000*	*159,372*	*3.17*
Germany				
Federal Network Agency (post, telecoms, rail, energy)	2500	123,269,629	49,308	1.50

Source: Annual reports and resource statements

In reviewing these costs, it is important to recall that not all of them are necessarily borne by Guernsey residents.[6] This is because the OUR derives its incomes from licence fees and, while the licence fees levied on Guernsey Post and Guernsey Electricity can be expected to be recovered by those state-owned enterprises from residents, either as customers or as taxpayers, this is not necessarily the case in relation to the telecoms companies.

In telecoms there are private shareholders (and a non-Guernsey, public owner in the case of Jersey Telecom), and there is an element of competition among providers. In such circumstances, there is no guarantee that the companies can recover 100% of license costs, and it might well be that, in effect, (non-Guernsey) shareholders bear some of the burden of the licence fees.[7] In this context, it is relevant to note that more than 60% of the licence fees received by the OUR are derived from the telecoms sector (table 2).

A detailed consideration of the size of this effect is beyond the scope of this Report, but we think that, as a rough approximation, the cost-to-Guernsey of the OUR may be a little lower than the OUR accounts would suggest.

Table 2: Licence fees (£)

	2002	2003	2004	2005	2006	2007	2008
Guernsey Electricity	165,000	180,000	180,000	180,000	180,000	120,000	80,000
Guernsey Post	120,000	120,000	120,000	180,000	180,000	120,000	80,000
Telecoms companies	447,381	493,886	552,671	589,850	863,745	495,935	369,837
Total	**732,381**	**793,886**	**852,671**	**949850**	**1,223,745**	**735,935**	**529,837**
Telcoms as a % of total	*61%*	*62%*	*65%*	*62%*	*71%*	*67%*	*70%*

Source: Annual reports

[6] Although the OUR is financed by licence fees, to the extent to which those licence fees are not fully translated into higher prices, shareholder returns will be lower. In the case of electricity and post this can potentially have a negative effect on Guernsey taxpayers. Where the consequences of regulatory decisions may have effects via impacts on prices (consumer impacts) or via impacts on profitability (which affect the fiscal position, and hence taxpayers), we refer simply to effects on 'Guernsey residents', to encompass both.

[7] This is an example of the general issue of the *incidence* of a tax. For example, corporation tax is levied on company profits, but that doesn't mean that it is borne by shareholders: most of it might be passed on to customers in the form of higher prices.

Compliance costs

As is widely recognised in the Guernsey debates on regulation, the direct costs of a regulatory agency such as the OUR is only one side of the costs associated with regulation. Compliance costs – by which we mean the resource costs (including costs of staff time) incurred by regulated companies in responding to the activities of the OUR – are also a highly relevant factor in any assessment of the costs and benefits of a regulatory regime.

Compliance costs depend heavily on the style of regulation, as well as on the relative efficiency of the business being regulated. Regulators require information on which to base assessments, but, for the most part, this should be similar to management information already available for the running of an efficient business. There are some additional requirements – for example, the need, under regulation, to keep track of the regulatory asset base or to prepare regulatory accounts – but, on the whole, once systems have been set up, these should be fairly straightforward accounting exercises. In practice, compliance costs may often be greater than the minimum required, and when this occurs it is to be counted as a regulatory inefficiency. Such 'excess' costs are not relevant for the exercise here – *can it work?* – but will be considered later when we ask *has it worked?*

During the course of our Review, a range of estimates of compliance costs associated with the regulatory regime were suggested to us. These included estimates up to an annual cost of £1 million for some companies.[8] We note that in 2005 the NAO recorded annual estimates of compliance costs (excluding licence fees) of £40,000 for Guernsey Post and £500,000 for Guernsey Electricity (although it expressed caution when interpreting the latter number).[9] We asked parties if they could provide us with any further evidence in relation to these estimates, which some did, but, in the time available, we were unable to verify these amounts.[10] We do think, however, that the relatively low figure recorded by the NAO for Guernsey Post indicates the sort of compliance cost level that is achievable when things are working well.

[8] In its 2010 Annual Report, Guernsey Post stated that *"[T]he costs of dealing with the regulator this year was close to £1m*". < http://www.guernseypost.com/index.php/download_file/-/view/441>

[9] National Audit Office *Review of Commercialisation and Regulation in the States of Guernsey* September 2005, paras [2.39] for Guernsey Post; and [3.51] for Guernsey Electricity.

[10] Part of the difficulty associated with verifying these estimates is in distinguishing information reporting that is directly caused by regulation, from that which would be required for other purposes.

Overall costs of efficient regulation

Given that some regulatory costs are likely be borne by telecoms shareholders, but that there will always be some level of compliance costs even when the informational demands of regulation are light, we are of the view that the overall costs-to-Guernsey of efficient regulation at around the current scale and scope of such activity should be fairly close to the actual outlays on the OUR, that is around £750,000 - £800,000 per annum. As indicated above, this implies a cost-per-resident of around £12.15 - £12.96 per head per annum.

2.2 Potential benefits of independent regulation

The costs of regulation need to be set against the potential benefits of the type of regulatory arrangements established on Guernsey. Again we stress *potential* benefits, since the focus for the moment is on the question *can it work?*

One way of approaching this question is to ask how big the reductions in costs of the utilities (ie: the efficiency benefits) attributable to regulatory activity would need to be to offset the costs of regulation. That is, what would the cost-savings associated with higher productivity or efficiency improvements in the utilities need to be to offset the costs associated with the regulatory regime.

There are a number of points to bear in mind in undertaking this mini-exercise:

- In telecoms, a large part of the benefits of regulation may come from product and service innovations (e.g. increases in broadband speed), not reduced costs. The existence of benefits attributable to regulation in telecoms is, from experience in other jurisdictions, most likely to occur via effects on new entry. Regulatory agencies around the world have tended to be helpful in removing barriers to entry, facilitating innovations from new entrants, and stimulating incumbents to greater innovative efforts in response to the new competition. Guernsey appears to be no different in this regard.[11]

[11] While it may be argued that there are limited prospects for another major operator in Guernsey, the point is a more general one (discussed in the following section) which is that one of the benefits of competition, and of effective competition policy, is that it generates continuing incentives for all involved, including incumbents and other operators alike, to improve their performance so as to reduce the risk of being *displaced* by another operator. That is, a new entrant may seek to take over from an incumbent supplier, not to co-exist with the incumbent.

- If we separate out telecoms from post and electricity for the purposes of the proportionality tests, and if it is found that an independent regulator passes these tests for telecoms (even if telecoms were to become the only sector regulated by the OUR), then the relevant costs to be taken into account for the assessment of postal and electricity regulation will be *incremental* regulatory costs: given the existence of a regulator responsible for telecoms, the question of interest is whether or not there can potentially be a case for adding postal and electricity regulation to telecoms regulation.

- Large slices of costs in the postal and electricity sectors will be 'non-controllable', and it is appropriate to exclude these for the purposes of the calculations. For example, if utility costs were £50m and regulation cost £1m, it might be said that a 2% reduction in utility costs is required to offset the regulatory burden. However, if only 50% of the costs are controllable by management of these firms, the relevant threshold for cost performance reduction is 4%. In postal services, management has very limited influence on Royal Mail costs; and in electricity, management has only limited control over fuel costs and wholesale energy prices (i.e. the price of wholesale power imported via the interconnectors to France).

Particularly given the scope for efficiency gains suggested by experience in other jurisdictions when utilities are privatised or commercialised, and then regulated, we think that it is not at all infeasible that the levels of cost reduction (to recover the applicable licence fees) detailed in table 3 below could be achieved. Further, if efficient compliance costs are broadly similar in scale to the licence fees – so that the total cost of regulation is double the applicable licence fee – we think the required levels of cost reduction attributable to regulation would still be within a range that an effective regulator could achieve.

There is then a further question of whether, once any obvious cost improvements have been made, there is a continuing case for independent regulation. That is, might it be that the current arrangements are desirable on a transitional, but not a permanent, basis?

Such might be the case if efficiencies, once driven out the system, stayed out. However, particularly in a changing economic environments where 'efficiency frontiers' are liable to

change, constant attention is likely to be required to maintain performance at close to best practice levels. The search for efficiency is, therefore, typically never-ending.

Table 3: GE and GP licence fees as a % of costs and revenue - 2007 and 2008 (£)

	Guernsey Electricity		Guernsey Post*	
	2007	**2008**	**2007**	**2008**
Licence fee (£)	120,000	80,000	120,000	80,000
Controllable costs (£)	20,611,000	21,735,000	12,041,000	12,403,000
Licence fee as % of controllable costs	**0.58%**	**0.37%**	**1.00%**	**0.65%**
Turnover (£)	33,070,000	38,661,000	31,209,000	36,982,000
Licence fee as % of turnover	**0.36%**	**0.21%**	**0.38%**	**0.22%**

* Guernsey Post's controllable costs are based on those listed at note 2 of the 2008 financial statements and include: Staff costs, Auditors' renumeration, loss on disposal of fixed assets and depreciation.

Source: Annual reports

2.3 Implications and conclusions

Our first, broad conclusion is that, *notwithstanding the small size of the Guernsey economy and the existence of economies of scale in regulatory activity, the underlying parameters do not imply that successful, independent regulation cannot work.*

However, perhaps a more interesting implication that flows from these basic assessments concerns the *nature* of proportionate regulation in Guernsey. Since the per capita cost of regulation is almost four times greater than in the UK then, at least when considering expansions or contractions in regulatory activity, and holding all other things equal, the regulatory performance standard required to justify incremental expenditure will, in per capita terms, likely be several times higher than in the UK.

In our view, this suggests that:

- It would be unreasonable for a Guernsey regulator to try to cover a similar range of issues at similar levels of detail to, say, a regulator such as Ofgem. More marginal, less productive, activities should rationally be shed.

- The appropriate regulatory style might be characterised as: seeking to do a limited number of biggish things well.

In later sections of this report, when we turn to assessing how regulation has been implemented across the different sectors, we will refer to the second of these points as the 'LNBTW' test/criterion.

The relevant intuition for this test/criterion is already to be found in Guernsey political discourse, in the form of the notion of light handed or light touch regulation. We are not particularly attracted by this term (light touch regulation), because it can be misleading, and strongly prefer the notion of 'limited regulation'.

The reasoning here can be explained by a political analogy. Guernsey may be proud of the fact that it has smaller, more limited government than in neighbouring European jurisdictions, but it would not, we think, refer to this as light-touch government. 'Light touch government' might give the impression that everything that government did was done in a similar laid back way; and might communicate to a violent criminal in London that, if caught in the act in St Peter Port, the hand of the law would be much lighter than in London. We hope that would be a misapprehension.

The point is simply that, on some (big) issues, a regulator may need to be tough, even while pursuing a highly limited and very focused agenda. The idea of doing a limited number of biggish things well seems to us to better capture what is required to translate the potential for worthwhile regulation into an actuality.

To summarise, and in response to the question posed at the start of this section (C*an regulation work in a small economy such as Guernsey*?) our assessment is positive one. However, we would qualify that statement by noting that, precisely because of the small size of the economy, issues such as the scale and proportionality of the regulatory framework, and the regulator's application of that framework, become critically important. For this reason, *we suggest that the regulatory arrangements should be built around the notion of 'limited regulation'.*

3. The scope for competition

During the course of our discussions on Guernsey, it was put to us by several parties that there was:

- No scope for competition in the electricity sector.

- Relatively limited scope for competition more generally on the island, as compared with larger economies.

We believe that the first of these views is wrong (for the reasons discussed in section 7 below), and that the second, whilst correct in thinking that small market size can have a dampening effect on the strength of competition, may be based on an exaggerated view of the quantitative significance of the effect. That is, competition can still be vigorous in a small market, whilst not being quite as vigorous as it might be if there were more at stake (i.e. more business to win).

These things matter – i.e. it is important for policy makers to have clear sight of what competition can and can't do – because prospects for competition should affect the conduct of regulatory policies: price regulation, for example, is generally introduced where competition is inevitably absent. Further, if Guernsey is to follow Jersey (and most of the rest of the world) in introducing competition law, it will be important that such law is enforced in a proportionate way that is sensitive to the island's contexts.[12] Failures of understanding about the nature of competition at the outset would greatly increase the risks of disproportionate enforcement.

3.1 What is competition?

The technical definition in economics (and economic policy) of the process of competition is no different from the dictionary definition: *competition is rivalry*. In the situations of interest, the relevant rivalry is generally that for the business of the customer/consumer; but, in thinking about competition, sporting analogies can sometimes be helpful (provided that the right analogy is used!).

[12] In this respect, we note the States Resolution of 10 July 2009 (and the earlier report of Commerce and Employment of 29 May 2009) in relation to proposals for mergers and acquisitions regulation, as well as the July 2006 States Resolution in relation to the development of enabling legislation incorporating measures to address anti-competitive arrangements and abuses of a dominant position.

The standard reasoning as to why competition is important is that it provides consumers with choice. If a consumer is dissatisfied with the price or the quality/performance of a particular or product, they can switch to other suppliers.

Over the long haul, however, it is the contribution of competition to rising living standards that is the primary benefit. This comes about because competitive processes are, by a long mile, much better at discovery and innovation that any other system of economic organisation known to man.

The incentive effects of competition include both carrots and sticks, but it is the sticks that are perhaps the more distinctive properties. It is often said that 'necessity is the mother of invention', and competition creates the necessities. If rivals are introducing new, superior technologies and products, then it becomes necessary for business survival to do likewise. Crucially, the pressure of necessity is universal, as Adam Smith put it:

> *Monopoly, besides, is a great enemy to good management, which can never be universally established but in consequence of that free and universal competition which forces everybody to have recourse to it for the sake of self-defence.*[13]

Competition is likely to have its greatest payoffs where economic conditions are dynamic; where the world is changing; where conditions are uncertain, and there is more to be learned/discovered; where adaptation to new circumstances is required. As we understand it, commercialisation and privatisation began in Guernsey because of these types of perceptions in relation to the telecoms sector. In this sense, the policy developments made obvious sense in the light of the underlying economics.

In contrast, and as noted, there does not appear to be a similar recognition of the role of competition in electricity, even though the sector is, at the global level, in the early stages of what is likely to be a protracted and uncertain technological revolution, on account of pressing environmental issues. We will return to this point later.

[13] A Smith *The Wealth of Nations* in W Letwin (ed) (Everyman's Library London 1975) page 91.

3.2 Assessing competition

In a broad sense, the intensity of competition in a market is a measure of how sensitive an enterprise or business's prospects are to its performance, *relative to rivals*, in serving customers. In competitive markets, prospects and returns are highly geared to relative performance; in less competitive markets the gearing is weaker.

Competition and regulatory agencies have developed a number of techniques and measures to assess the strength of competition, and it is perhaps unfortunate that the easiest to understand and measure, namely market shares, tends to be given undue prominence. Specifically, high market shares are often interpreted, uncritically, as a sign of lack of competitive pressures. They may be, but they may not be. Indeed, particularly in small markets, they are frequently *not* an indicator of absence of competition – a point that generally gets lost in economics textbooks, but that is highly relevant in the Guernsey context.

The critical issue is related to the ability of others to challenge the existing suppliers, including challenges by potential rivals who are not yet established in the market. This ability to challenge by potential entrants is measured by the height of 'barriers to entry' into the market, which many economic theorists would put at the top of their list of indicators of strengths/weaknesses in competitive pressures (but which, unfortunately, being harder to measure than market shares, is an indicator not typically favoured by those wanting simple results).

We will refer to a market in which there are low or modest barriers to entry as an 'open market', and distinguish it from a closed market where entry barriers are insuperable. Consider, for example, 'the only shop in the village'. The shop has 100% of the local market, but it is unlikely to be free of competitive pressures – it may, in fact, be on the margin of existence. It can lose business by customers 'shopping in different markets', eg. in a supermarket relatively distant from the local market; and, if it is inefficient, charges high prices, and offers poor service, it may be vulnerable to someone setting up in competition. One possible result of such a development is a price war, with the inefficient shop closing-down after a time. Even though this returns the village to having a single shop, competition has potentially achieved a lot:

- A less efficient enterprise has been displaced by a more efficient enterprise, capable of better serving customers.

- Much more important, the process of competition generates continuing incentives for all involved, incumbents and potential entrants alike, to improve their performance (the threat of displacement is ever present, even though actual competitors are not).

For an analogy, consider Tiger Woods, who is ranked number one in the world golf listings. There can only be one number one, and Mr Woods has, at the time of writing this review, 100% of that slot. He may not have by the time of the reading of this review. There is constant challenge here, and if it were the case that Mr Mickelson took over the berth and held it for a while, no-one would claim that, because there is still only one number one, that there is no competitive pressure. Quite obviously, the competitive pressures at the top of the tree are persistent and strong, and serve the customers (golf fans) well.

All of these points suggest to us that while it is obviously the case that, in relation to the supply of some products or services, and given Guernsey's size, the intensity of competition may not be as vigorous as it would be in larger economies, it is nevertheless the case that possibility of challenge through competitive entry can be still be a powerful inducement to better performance in many sectors and industries.

We hope that these points will be recalled when the States come to implement a mergers policy for Guernsey; since there is an obvious risk that market share thresholds, developed for larger economies and markets, may be mechanistically and inappropriately 'copied in' from larger jurisdictions. We have seen copies of the May 2009 Commerce and Employment report, and Dr Michal Gal's recommendations in her February 2008 report, and are not convinced that the proposals as they stand obviate the risk of setting inappropriate thresholds.

4. Public ownership

Another theme that emerged from our consultations was the suggestion that many of the perceived problems associated with the regulatory regime could be traced back to the fact that Guernsey Post and Guernsey Electricity remain in public ownership.

In section 8 we explore this issue in greater depth in the context of discussing possible ways forward. However, we think it is useful, at this early stage, to outline some of the more general challenges posed for independent regulation in circumstances where utilities are in public ownership.

4.1 'Closed monopoly' in general

The public ownership of utilities has, in many jurisdictions, typically been associated with statutory monopoly. That is, legislation has prevented entry and challenge to incumbents from competitors, and thereby created a closed market with only one supplier for a particular product or service.

This can be contrasted with an open market, where even sole suppliers can be under strong competitive pressures, including from the threat of entry (see discussion above). In a closed market, there are no immediate rivals and competitive pressures are therefore necessarily weak.

Closed, *privately owned* monopolies, if unregulated, can be expected to exhibit two tendencies *on average*:

- For any given level of costs, they will tend to set high prices, in order to increase profits.

- 'Sleepiness', meaning that they are likely to have higher costs and be less active in product and process innovation, etc. Although they have carrots – financial returns are likely to be higher if performance is better – they do not face the existential threat of being driven out of business or of being severely reduced in their circumstances in the event that performance is poor. There is no *necessity* for managerial performance, particularly in relation to innovation, to be good.

We emphasise 'on average' because there tends to be a greater variance in the performances of closed monopolies than of competitive enterprises. Good performance is not a necessity for survival of closed monopolies, so there can be a tail end of very poorly performing enterprises that are able, because of the lack of alternatives for consumers, to continue operations for many years. On the other hand, in some cases, the remaining incentives are sufficient to induce very good performance indeed, and closed monopolies can in some cases even outshine comparable, competitive brethren (e.g. because they can avoid some of the distractions that competition may bring).

We can summarise these points by saying that, for suppliers in competitive markets, good performance is a matter of necessity, whereas, for closed monopolies, it is a matter of choice.

4.2 Publicly owned monopolies

Managerial incentives in publicly owned monopolies tend to be weaker than in private monopolies, because not only are the existential sticks missing, but the carrots tend also to be weaker: profit seeking is typically not the driving motivation of the owner, and indeed the owners' objectives may be fuzzy/unclear and unstable over time (being influenced by the shifting sands of the relevant politics).

Sir Peter Parker (as he then was), a distinguished and highly experienced industrialist said, of becoming Chairman of British Rail, that it was the first job he had taken on in his lifetime in which he did not know, from one year to the next, what might be counted as 'success'. (We note in passing that fuzziness and instabilities in political preferences also have implications for the corporate governance of publicly owned enterprises – a point that will be developed later – but here we focus on the direct effects on managerial incentives).

There are two consequences of the dulled managerial incentives:

- Publicly owned monopolies do not typically set prices that are high in relation to existing costs. The more frequent tendency is for prices to be set such that profit margins for the enterprise as a whole are lower than normal (although, on a disaggregated basis, some margins may be very high, and some highly negative, reflecting the fact that pricing often reflects political preferences for cross-subsidisation – see our later discussion of the universal service obligation in postal services).

- Publicly owned monopolies tend, on average, to be even 'sleepier' than their privately owned counterparts. That is, they tend not to be active in identifying and driving out cost inefficiencies, and at the same time, are typically less active in innovative activity because the incentives to undertake such actions are generally weak.

Again we stress 'on average'. Weak incentives can give public sector management discretion to pursue different types of business *strategies*, and, in some cases, the discretion has been used to deliver excellent performance. The risks of 'strategic car crashes' and of excessively high costs are, however, much less closely contained, and it is the eventuation of some of those risks that is the chief cause of the low average performance of public enterprise.

4.3 Implications of public ownership for the regulatory model

This brings us to the implications for Guernsey's regulatory model of the fact that two of the utilities in Guernsey remain in public ownership. As has been pointed out by a number of participants in the Guernsey debate, RPI-X(+Y) price control was designed for the regulation of private monopolies, not public monopolies.[14]

The RPI-X(+Y) approach is intended to work as follows:[15]

- Like all forms of price control, a central aim is to prevent prices being raised to excessively high levels in relation to costs. In this way, consumers can be said to be protected against the exploitation of market power.

[14] In very general terms, this form of price control involves the regulator setting a maximum allowable average price (or revenue) path for a set of relevant services for a specified period, which to some degree is independent of the actual costs associated with the provision of those services.

In standard RPI-X approaches, for example, prices are indexed to movements in *non-controllable* changes in the rate of inflation (RPI) and an assumed rate of productive efficiency growth (X). In other implementations, such as that adopted in some sectors in Guernsey, elements of costs deemed to be beyond the influence of the supplier (ie: non-controllable, such as fuel cost changes) can also be incorporated into price changes through a +Y factor, where Y in the change in these costs over the relevant period..

[15] These are the positive aspects of the approach. Like all forms of price controls, the RPI-X(+Y) approach also has disadvantages and limitations. To give an example, in the simple approach there are only weak incentives to improve product quality, if such improvement would cost money: it would not be possible to reflect the increased quality in higher prices. Indeed the incentives are to degrade quality if that would save costs.

- By predetermining prices for a period of several years (i.e. putting the average price level beyond the control of the regulated company), any reduction in operating costs accrues as increased profit to the firm. Assuming that there are profit-seeking pressures on managers from shareholders, managers will have reasonably strong incentives to seek reductions in operating expenditure.

As discussed, however, public monopoly does not usually tend to lead to high margins on average (so the problem-to-be-corrected identified in the first bullet point is unlikely to be a major problem to begin with). And, while excessive cost is a potentially serious issue, it is far from immediately obvious that fixing prices is a good way to encourage cost reduction for a publicly owned monopoly. The thing that links them (i.e.: that links prices to cost reductions) in the case of private monopoly – the profit seeking pressures emanating from shareholders – is typically not there in the case of public monopoly.

It is, of course, possible to go some way, within a public ownership structure, to require those in government responsible for supervising the financial performance of the relevant enterprises to behave 'more like' private shareholders or investors. This, in effect, is the approach taken by State Aid policy in the European Union, which is motivated by a desire to ensure that public investment in enterprises is not used by Member States to distort competition in the internal market. It is not, however, the approach that has been taken in Guernsey.

The States Trading Ordinance 2001 specifies that the States may give guidance as to how the shareholder role is to be exercised, but the legislation states that such guidance can be "only of a general nature", and the relevant committee simply has to "have regard to" the guidance, which means that there is no requirement that guidance should always be followed. More importantly, in relation to the crucial issues of prices and costs, the guidance issued by the States in connection with Guernsey Electricity, first to the Advisory and Finance Committee, and later to Treasury and Resources, says that:

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

1) *deliver improved efficiency in fulfilling the requirements of the Public Supply Obligation imposed under the regulatory regime whilst drawing a balance between seeking a commercial return on the resources employed and the effect on the community of any increase in charges which may result; and*

2) *achieve as soon as is practicable an appropriate commercial return on the resources employed in the provision of other services."*

The guidance concerning Guernsey Post has been identical, save that the reference to the 'Public Supply Obligation' is replaced by a reference to the 'Universal Service Obligation'.

The key point is that the guidance explicitly envisages a shareholder role that includes the resolution of trade-offs between consumer interests in lower price levels and the potential fiscal burdens that might be caused by prices that are below commercial levels. Whilst this is the traditional approach taken toward publicly owned enterprises, it is <u>not</u> the approach envisaged under the 'independent regulation' way of doing things. The latter works on the basis that shareholders and managers seek higher financial returns, and that the regulator seeks to establish incentives that channel that drive toward cost reduction and performance improvement, rather than toward excessive prices, by setting price caps. The independent regulation 'model' therefore envisages the trade-off between the benefits of lower prices to consumers and the disbenefits of lower financial returns being settled via the interaction between regulator and enterprise management (acting for a financially motivated shareholder), not via a political judgment of the shareholder.

In effect, given the guidance, Guernsey has been operating with two, different, incompatible regulatory philosophies. In this light, it is not surprising that there has been some unnecessary confusion and conflict at times, at least in postal services and electricity. Indeed, it might even be argued that it is a credit to the pragmatism of those involved that things have not been significantly worse.

In the Guernsey context, any leverage that a regulator might seek to exert in relation to promoting cost reductions by means of fixing prices is further eroded by the States' 'save to spend' policy. Whilst we understand that this policy is not a completely rigid constraint on the financial freedom of commercialised public enterprises, in that borrowing is potentially permitted where it can be shown to lead to a future income stream that is more than capable of remunerating such external capital, the fact is that both Guernsey Post (GP) and Guernsey Electricity (GE) have, over time, built up significant financial reserves, so as to be able to finance investment when the appropriate time comes for major, new capital expenditures.

The availability for such financial reserves to managements means that, in the event that revenues do fall short of costs in a particular year, it is unlikely that this will lead to any very

immediate, strong pressures to improve performance. Not only is there no equivalent to the threat of bankruptcy that faces privately owned companies when performance deteriorates, but also there is a source of finance that can be automatically drawn upon to cover the losses. At worst, there will be need for some explanation to Treasury and Resources (T&R) that funds for future investment are a bit lower than projected; but since the consequences of any shortfall might not be felt for many years, it is unlikely that T&R would regard this as a major matter, requiring urgent attention.

Since recourse to save-to-spend reserves by enterprise managements could be impeded by a more activist, shareholder approach to financial matters – for example, by T&R insisting on ring-fencing of the funds, or by requiring that the funds are paid over to T&R for safe keeping – the underlying issues here are just another aspect of the current shape of the shareholder role in the Guernsey arrangements; and, as indicated by the guidance cited above, that role is not currently in tune with the role envisaged for independent regulation.

We conclude, therefore, that there is a serious design issue in relation to the application of price-cap regulation to publicly owned monopolies in Guernsey. Although there is no shortage of examples of such regulation being used in other jurisdictions – postal services and rail networks in the UK, water supply in Scotland, electricity transmission and distribution networks in Australia and New Zealand, airport regulation in the Republic of Ireland – we conjecture that what success there has been is associated with a very narrow shareholder role that focuses on achieving higher financial returns, and that avoids shareholder involvement with other aspects of public policy. Since it is usually harder to motivate public officials to take such a narrow, financial approach, than it is to motivate private investors who have more direct stakes in the financial outcomes, *prima facie* it is possible that there will exist more effective means of achieving the relevant public policy objectives (than price-cap regulation of public enterprises). We will return to this point later.

5. The position in relation to telecoms

In the following three sections we turn our attention to examining the three sectors that are subject of this review: telecoms, post and electricity. We consider telecoms first, because the issues that arise in that sector are distinct from those in post and electricity, for the following reasons among others:

- The incumbent telephone operator, Cable and Wireless Guernsey (CWG) is privately owned, and so the points identified above about the application of the RPI-X price control to public monopolies do not apply. Rather, the fixing of prices by a regulator should be expected to encourage managers, via shareholder influence, to seek to reduce costs to increase profitability.

- There is competition in the provision of telecommunications services, particularly for mobile services, with both large and small operators working on the island.

- As a consequence of competition it appears that the scope of formal price control is dwindling, and that the OUR is clearly moving in the direction of shifting the emphasis toward an *ex post* regulatory framework. In this respect, there appears to be a fairly clear role for a regulator in terms of interconnection rate determinations, and in access adjudications more generally.

- There are no issues related to the States' policy of 'save to spend' in the telecoms sector.

5.1 Assessment of current arrangements

In discussions held with various stakeholders, the overarching impression of the regulation, and performance, of the telecoms sector was generally positive. Although there were one or two recurring concerns raised by some parties regarding specific issues – such as that broadband prices appear to be higher than they should be; and historical issues such as the underlying motivations for, and financial benefits from, the initial privatisation of Guernsey Telecom – the general perception was that regulation 'worked' in relation to telecoms.

Among the reasons put to us for why this may be the case was the following:

- The fact that CWG was a private concern;

- The effect of new entrants on the behaviour and conduct of CWG, which, together with regulation, acted as a 'dual pressure' on CWG;

- The specific characteristics of the sector, particularly rapid technological change which is seen to lend itself more readily to new entry and the development of competition via product and process innovation, and the fact that (unlike say the postal sector) telecoms tends to be capital rather than labour intensive.

Alongside these factors, it was put to us on more than one occasion that the generally positive performance of telecoms could, in part, be attributed to the regulatory framework and to the conduct of regulation in the sector. Indeed, almost all of the parties we spoke to who worked in the sector made favourable comparisons between the OUR's approach to regulation and the approaches to be found in other, small jurisdictions, including Jersey. Specifically, it was noted that entry into the market in Guernsey was relatively unproblematic, as compared to other jurisdictions. Moreover, it was put to us that there have been significant efficiency savings following the privatisation of CWG, and that staff numbers had reduced by over a third without any perceived reduction in quality of service.

Terms such as 'competent', 'diligent' and 'constructive' were used when describing the OUR, and almost all of the respondents we spoke to involved in telecoms did not wish to see the regulatory function withdrawn from this area. Indeed, the opposite view attracted much more support: a number of respondents argued for an expansion of the regulatory remit and powers, and, in particular, some parties argued that there was a pressing requirement for competition law in the sector. There was also a perception by those close to the sector that the relationship between OUR and CWG had matured in recent years, and that the environment now was one in which the different parties (OUR, CWG and entrants) can work together in reasonably constructive ways, notwithstanding the tensions that naturally exist among competing enterprises.

Despite this generally positive perception of the regulatory arrangements in the telecoms sector, it was also put to us that there were still areas of activity that offered scope for improvement. Specifically, some respondents voiced concern about the current approach to

the development of next-generation networks on the island, and in particular, the role of the regulator in facilitating that process. In addition, it was suggested that there are some unresolved issues relating to the Universal Services Obligation (although this was suggested to be more of a public policy issue than a matter for the OUR).

Other points of criticism put to us during the course of our discussions about the OUR's approach and processes, included the following:

- decisions in some key areas were too slow;
- it was sometimes difficult to know when the OUR would reach a decision or issue guidance;
- there was a tendency for the OUR to use external consultants, who did not fully appreciate the Guernsey context;
- models used in financial determinations were not as transparent and clear as they could be;
- parties were not given sufficient time to respond to information requests; and
- there has been a tendency, particularly in the past, for the OUR sometimes to use public relations announcements to argue their case against particular companies.

We are not in a position to assess the merits of these claims on a point by point basis; and we note them in passing chiefly insofar as they reflect views of some of those who are close to the operation of the regulatory system in telecoms. Having had the pleasure/pain of listening to extensive commentaries on regulatory performance in other jurisdictions, however, we did not come away from the meetings with any impression that the regulatory performance weaknesses mentioned were in any sense out of the ordinary. Regulated companies views of regulation are not dissimilar to farmers' views of the weather, and sailors' views of the sea: there is an ever-present recognition that livings have to be made in environments that are not the best of all possible worlds. If anything surprised us in the discussions relating to telecoms, it was the general tendency, on a balance of effects basis, to view the OUR in a favourable light.

The doing a limited number of biggish things well ('LNBTW') test

It is our general assessment that the regulatory framework in the telecoms sector, and the application of that framework by the OUR, pass the LNBTW test. There are a number of factors underlying this conclusion, but in particular, we find that the most important tasks of a regulator in this sector – setting CWG's price control; determining fixed interconnection and access rates and mobile termination rates – appear to be performed to a good standard. Moreover, the regulatory framework appears to have adapted well to the introduction of new competition in the market. Finally, we note, as a general observation that the conduct of regulation in the telecoms sector appears to operate in a constructive environment, for which credit is appropriately due to all participants.

Nevertheless, as in other jurisdictions, a number of important challenges lie ahead for the States and for the regulatory framework in telecoms. Most important among these will be the development of an appropriate policy and regulatory approach with respect to the roll-out of new technologies and next-generation network infrastructure. In this respect we note that the most important 'big thing' for the regulatory framework will be to ensure that the access arrangements are such as to keep markets open to new participants and new ideas (ie: to keep entry barriers down).

5.2 Alternatives to the current arrangements

We have considered possible alternatives to the current regulatory arrangements and whether these may improve the effectiveness of the performance of the telecoms sector in Guernsey. The key point here is that, under alternative proposals, the basic, 'big thing' functions would still have to be addressed, even if the current independent regulatory structure were abolished. Moreover, no alternative way of performing the functions appears to offer material benefits relative to current arrangements. We therefore see no immediate benefits, and some costs, from abolition of the OUR.

There are, however, two adaptations to the current structure which open up possibilities for reducing the regulatory burden in the sector, to a modest extent. First, there could be an acceleration of the current trend toward deregulation of prices. In common with other jurisdictions, the scope of *ex ante* price capping has been reduced over time; and the transition to *ex post* supervision of prices, where the regulator only intervenes in price setting (and other non-price matters) if a complaint is made by a customer or a competitor, could be completed, particularly if Guernsey were to introduce competition law. A

framework of competition law would provide a formal mechanism by which parties could seek to persuade the regulator to investigate particular issues as and when they arise. Such a shift to a competition-law focus over a transitional period could also be consistent with movements toward closer harmonisation with Jersey on regulatory and competition matters (see further below).

While such a possibility appears, in principle, to have merit, we would caution that telecoms disputes, and in particular competition law matters in this sector, can very quickly become litigious areas. We note, for example, that a very large proportion of cases heard before the UK Competition Appeal Tribunal involve issues relating to telecommunications.

It goes without saying that increased litigation in an economy as small as Guernsey's could be very bad news for residents, and that there are therefore potentially high payoffs from developing arrangements for market supervision that minimise recourse to the courts. We therefore strongly recommend the introduction of 'fast-track' arrangements for obtaining second opinions in the event of disputes between companies and regulators. We will consider this later in discussion of appeals procedures in postal services and electricity, but note here that (a) similar reasoning seems to have led, in Guernsey, to the establishment of an appeals tribunal as part of the initial regulatory and commercialisation policy, and (b) the approach appears to have fallen out of favour with the States, possibly influenced by an early and costly conflict between CWG and the OUR. As already indicated, however, subsequent regulatory relationships have been much more satisfactory, and the initial dispute may simply have been the result of early adjustments to a new regime, rather of defects to the regulatory model itself.

The second alternative to the current structure that we have considered is the possibility of closer ties and greater cooperation with the Jersey Competition and Regulation Authority (JCRA). There appears to be widespread recognition in Guernsey of the benefits of closer co-operation with Jersey, and of a pan-island regulatory approach in the sector. This is not just a question of reducing costs, though that is clearly a factor, but also reflects the fact that the regulators in the two islands are, for the most part, dealing with the same companies, who operate on both islands, which face similar issues. There is therefore likely to be considerable benefits in greater coordination of approaches.

At the same time, it is recognised that the underlying regulatory architecture in the two islands is different: the Guernsey approach is based on the Regulation Law with no

competition law in place, while the Jersey approach is based principally on competition law. Deeper cooperation between the two regulators will, to be effective, likely require significant convergence of (currently) divergent policies, and is therefore likely to involve much more than simply sharing administrative resources.

5.3 Conclusions and implications

On the basis of the above assessment, we conclude that the current regulatory structure and arrangements for the regulation of telecoms in Guernsey should be maintained, but that the regulatory framework should be adapted as and when necessary to facilitate greater co-ordination with Jersey.

We endorse the current OUR approach, which contemplates the gradual withdrawal of formal price controls as competition develops further, and a transition in the regulatory approach toward monitoring and *ex post* interventions where necessary. In our view, the transition could be accelerated in the event that the States decide to introduce a competition law. Such a law could also accelerate the development of cooperation with Jersey, although the States will need to think carefully about the precise content of such a competition law, since there will be aspects of it – such as the way in which market shares are interpreted for enforcement purposes – which will need to be fine tuned to reflect the small size of the economy, at least if disproportionate enforcement is to be avoided.

In the interim we consider that the primary aims of the regulatory framework in telecoms should be to focus on keeping entry open to new competitors, which is of particular importance given the rate of innovation and technological change in the sector, and on ensuring that a low-cost dispute resolution process is established. Finally, subject to the provisos made, we see considerable merit in exploring the potential for the fuller harmonisation of the regulatory functions with Jersey.

Implications for post and electricity

Our conclusions in relation to telecoms have immediate and important implications for evaluation of the future role of the OUR in the postal and electricity sectors. Specifically, given our conclusion that the OUR has positive, on-going functions to perform in regulating the telecoms sector, any on-going role for the OUR in regulating electricity and post should properly be considered on an incremental basis.

This means that it is not appropriate to argue that if, say, supervision of GP and GE were taken back within government in some way or another, the OUR could be closed and considerable cost savings made. If the OUR is retained as the telecoms regulator, the savings available would only arise from the cost reductions achievable by shedding the OUR's functions in postal services and electricity. As Table 1 indicates, the bulk of OUR's revenues, and, by implication, its costs, are associated with telecoms regulation. The cost savings achievable from shedding postal and electricity responsibilities probably therefore amount to no more than about £100,000 for each sector. These are not trivial sums in a small community, but neither could they be classified as major savings.

Even modestly successful regulatory arrangements should be able to contribute value added that could justify such expenditures, and so the central questions in postal services and electricity are to do with whether the framework is fit for purpose, and whether, in fact, independent regulation adds any value at all, in a context of public ownership.

6. Post

In reviewing the postal services sector, we have identified a number of major issues surrounding the operation and regulation of Guernsey Post (GP) over the recent past, including:

- Declining mail volumes, which have called into question the sustainability of the Universal Service Obligation (USO), at least at current service levels. This is a not a Guernsey specific issue, and we note the difficulties faced by Royal Mail in the UK, and the recent proposals in Jersey to substantially reduce the number of deliveries and collections each week.

- An attempted diversification by GP into banking which failed at considerable cost to Guernsey residents as owners and, to the extent that there is any subsequent effect on prices, as customers.

- A costly court case, resulting from an appeal by GP against an OUR decision to significantly reduce the scope of the reserved area (i.e. those GP services that are protected from competition from other postal operators). The issues at stake were closely related to the perceived threats to the existing level of local services (deliveries and collections) that might follow if new entrants took substantial business from GP and reduced GP's ability to finance loss-making local services.

- Competitive developments in the bulk mailing sector, including the entry of new competitive bulk mail providers, and the emergence of possible issues relating to the low value consignment relief exemption in the UK which could impact on the ability of new entrants to compete in the market.

- Changes in terms of trading between GP and Royal Mail, resulting in a re-alignment in tariffs for mail deliveries to the UK.

- The existence of a substantial GP pension fund deficit.

The issues related to the pension fund deficit (which are common to many postal operators) are beyond the scope of this report – although we note the extra financial pressure that it implies – but we consider each of the other issues in the discussion that follows.

The USO is necessarily a key plank of postal services policy, and it is the issue that can be expected to be of greatest concern to the people of Guernsey. Although the USO is set by the States not the regulator (the States give directions to the regulator on the relevant matters), it is nevertheless an issue that had a substantial influence on the recent dispute between GP and the OUR, which has cost Guernsey residents a significant sum in legal costs. For these reasons, we begin our review of postal services regulation in Guernsey with a brief discussion of the nature of universal service in the sector; and we state at the outset our general conclusion that, *if the universal service obligation can be put on a more sustainable basis for the future, postal services regulation will be greatly simplified, and will be unlikely to lead again to the kinds of problems that have been witnessed recently.*

6.1 The universal service obligation (USO)

Traditionally, local postal services have been provided by public or private-but-regulated monopolies on terms that involve heavy cross-subsidisation. There is generally a single price for letter collection and delivery (sometimes called a 'postalised' price), irrespective of the fact that delivery and collections costs may vary significantly with location. Some customers pay prices for services that are significantly in excess of the costs of providing the relevant services, and the resulting profits are used to supply other customers at prices that are significantly below the costs of providing the services. Directions of cross-subsidy flows include, for example:

- From services in densely populated areas to services to and from remote rural areas.
- From bulk mail customers to household-to-household letters.

For these arrangements to be viable, there must be sufficient net income from the profitable traffic to support the unprofitable services. The sources of net income (sometimes called economic rents) have traditionally been secured by granting post offices protected/closed monopoly positions. In the absence of competition, postal operators could charge prices for some services substantially above costs. In contrast, if unrestricted competition had been allowed, it would have driven prices towards costs, and the sources of net income would have tended to dry up. Moreover, new entrants could be expected to

target highly profitable services first, since, for these services, it would be possible to undercut the incumbent's prices by margins large enough to get customers to switch their business, yet still make a profit.

The world is changing, however, and this traditional type of arrangement is coming under pressure, more or less everywhere, from two types of developments:

- First, there has been an increasing tendency for governments, unimpressed by the efficiency performances of incumbent operators, to open up parts of the market to competition, in an attempt to introduce greater incentives for enhanced performance. Given the political popularity of universal postal services – like the sight of policemen/policewomen on the street, the regular postal round appears to have social value over and above the immediate service actually provided[16] – governments have typically been cautious about opening postal markets to competition. The aim has been to strike a balance; so as to achieve the greatest benefits from the stimulating effects of competition without fundamentally undermining the USO. In the dispute between GP and the OUR described above (now resolved), GP was of the view that the OUR had gone too far with market opening, whereas the OUR was of the view that GP's reserved area was greater than necessary for an efficient operator to be able to sustain the USO.

- Second, and far more threatening to incumbent postal operators than the controlled contraction of the protected/reserved areas, has been the loss of business to electronic communications systems. These substitutable methods of communicating mean that basic postal services (e.g. small letters) are no longer a monopoly, and that governments are increasingly incapable of protecting them from competition. GP is, in reality, *competing* with electronic communications and, in broad terms, is losing local business (at what currently is a relatively rapid rate). This is the existential threat that all competition brings, and it cannot be avoided. However, it does have very obvious implications for the universal service, and for public policy toward the USO.

[16] There are also narrower, economic arguments why the economic benefits of universal service might not be fully reflected in postal revenues from sales of stamps. For example, if a service is withdrawn, the loss to the average consumer is not the value of stamps that might be purchased in, say, a given year, but the amount that the consumer would have been willing to pay to send letters, which will typically be higher.

If the USO is to be maintained at some prescribed level that is loss making, what is required in these circumstances (of erosion of monopoly) is an alternative source of finance to cover the losses.[17] This could be general taxation, but more usually it is via the establishment of a universal service fund (USF), which derives income from a levy on postal services, whoever is the provider, outside the reserved area.

If the business of providers outside of the reserved area is subject to significant rates of erosion, for example because of competition from electronic mail, this may be no more than a temporary holding operation. However, bulk mail comprises substantial levels of delivery of physical objects (DVDs, small electronic components, etc.) for which electronic communication is not such a good substitute as it is for letters, bills, bank statements, etc. The funding source may therefore prove more durable, although this is a matter that obviously needs to be kept in under review.

What is wrong with the current USO arrangements?

As required by our terms of reference, we have considered in some detail the evidence that has been put before us in relation to regulatory problems of the recent past in the postal services sector; and we will discuss some of that material later in this section. It appears to us, however, that, notwithstanding the detail, there is a major policy problem that needs to be addressed, ahead of all other issues.

The problem is easily stated, and has at least three aspects:

- the current level of universal service in Guernsey is unsustainable under current funding arrangements because of falling volumes,[18]

- under potentially superior funding arrangements, retention the current level of universal service might still be the preferred option of Guernsey residents, and

[17] As just indicated, we do not take the view that all loss-making services should be closed down. Particularly where there is an element of collective choice, services may have social and symbolic functions beyond the immediate service that is paid for (e.g. the collection and delivery of a particular letter), and may yield economic benefits over and above what is measured by stamp purchases. It is a matter for the relevant communities to decide whether the service is worth the costs of subsidisation, most appropriately via the political system.

[18] We note that the OUR examined the issue in 2006, but volumes have fallen considerably since then and appear set to fall further.

- current regulatory arrangements are failing to give Guernsey residents and States Deputies clear sight of the costs of alternative levels of universal service provision, and hence impeding their ability to make informed decisions on the matter.

A way forward: a universal service fund

Given the above points, we suggest the following way forward, to put the universal service obligation on a more sustainable basis:

i. The OUR should be given a primary duty to assist in ensuring that States Deputies and the public are informed about the costs of providing different levels of universal local services on the island, so that the scope of the USO can be determined from time to time on an informed basis.

ii. GP should, as a matter or priority, prepare estimates of the efficient costs of providing universal service over a range of alternative standards: six days a week collections/deliveries: five days a week collections/deliveries (i.e. not Saturdays); three days a week collections/deliveries; etc.

iii. These costing estimates should be submitted to the OUR for review, and the OUR should set out its views, subject to a standard consultation exercise with all parties.

iv. GP should estimate the financial losses that it would incur in providing the different service levels for a predetermined time period, such as three years (which will require a pricing as well as a cost assessment); and hence indicate the funding requirement necessary to provide the different, defined service levels.

v. The OUR should set out its views on the same.

vi. If agreement between GP and OUR is reached, the amount of funding required to sustain the USO at varying levels is sent to the States of Deliberation, for decision by Deputies as to the level of service that should be provided, taking account of the costs and perceived broader social/community benefits.

vii. The OUR should then determine an *ad valorem* levy on relevant services estimated to be sufficient to raise the necessary level of funding, with an adjustment mechanism for forecasting errors, calculated, say, on a quarterly basis.

viii. If agreement is not reached between GP and the OUR on the funding levels, the issue would be resolved by resort to a specially convened expert adjudication panel (about which see further below).

ix. The written views of the expert panel on the requisite funding level would then go to State Deputies, who would make their decision on the service level and the associated funding level, before asking the OUR to determine an *ad valorem* levy at a rate that could be expected to provide the necessary finance.

Under these arrangements:

- The determination of the reserved area should not be particularly controversial, since its shrinkage would simply imply a wider base on which the USO levy would be applied (the problem at the moment is simply that a contraction of the reserved area necessarily eats into the funding base for the USO). Indeed the reserved area could, in principle, be abolished entirely, yet GP would still be able to sustain the level of service decided by the States.

- The substantive issues that are currently addressed via price controls would be addressed more directly and transparently, via the process set out above. Once the USO funding level has been determined, GP could be left free to set its own prices, constrained by (a) the competition from electronic media at the small letter end of the market, (b) other postal operators for bulk mail, (c) the knowledge that, if it collected significantly more revenue than projected at the USO determination, it could expect to receive lower funding levels when the USO and its funding is reset.

We think these measures would simultaneously:

- Address the issues likely to be of greatest concern to the Guernsey public (the provision of local postal services, and the costs thereof);

- Achieve this in a way that is least restrictive of competition; and

- Allow for a substantial measure of deregulation (the OUR would, under these recommendations, no longer actively fix GP's prices).

The last of these aspects may appear radical, but it does no more than recognise that postal services compete with electronic communications systems. We believe that the OUR recognises this reality and would, in any event, seek to move toward deregulation of prices in future years. Our proposals can, therefore, be seen as serving to accelerate, and better manage, an existing path of evolution for postal services on Guernsey.

6.2 Assessment of current arrangements

The operation of the regulatory framework in postal services was clearly recognised as an area of tension and dispute among the different parties we spoke to. Some parties were of the view that the regulatory approach in this area had been effective in reducing what were perceived to be excessive cost levels/overheads of Guernsey Post (GP), and that recent problems could be attributed to sustained efforts of the OUR to 'break the back' of GP's excessive costs, and to improve productivity.

Other, differing views were also put to us. Among these were that the regulatory framework was rigid and inflexible; that the regulatory burden on companies was significantly disproportionate and too intrusive; and that the regulatory approach was, at times, accusatorial and adversarial. There was also a perception by more than one party we spoke to that regulation had become a vehicle to advance the interests of the bulk mailers.

Among the mixture of points made, there were two specific claims made about the OUR's approach in postal services that attracted particular interest because they resonated with points made in our discussions in relation to telecoms and electricity. The first was that the approach of the OUR tended toward heavy-handedness and was disproportionate, particularly in relation to amounts and types of information requested; and that certain OUR staff had, in the past, sometimes been brusque and dogmatic about issues, which had, at least in part, contributed to the deterioration of the relationship between the OUR and GP. The second claim was that the OUR had, in the past, relied heavily on the use of external consultants to undertake the efficiency reviews, and that the selected consultants tended to bring with them a specific conception of 'efficiency' and how things should be done, and

that they worked to detailed 'models' that were not appropriately adjusted to the circumstances of GP.

There are two general issues here:

- It is an old saying in regulation that, notwithstanding the technical nature of many aspects of the tasks, "people matter". All regulatory agencies are, therefore, susceptible to variations in performance as personnel change. The OUR has a small staff, and is therefore more vulnerable to these effects than would be a larger regulatory agency. In a larger agency, it is only personnel changes at the top level of the organisation that are liable to have significant and immediate implications, but, in a small agency, replacement of more or less any member of staff can have such effects. From our own experience, whilst the quality of recruits to regulatory agencies is generally high, no organisation is fully protected against the occasional lazy person, or (and usually a bigger risk to effective regulation) the occasional zealot. Our proposals in relation to the establishment of an expert adjudication panel discussed below are designed to mitigate the effects of the occasional hiccup in this regard.

- Outside consultants often come with their own preferred approaches and 'technologies', which may have been developed for enterprises very different in size to GP (and GE and CWG). Consultants can sometimes work with old 'technologies'. In the economic field at least, there is often a tendency for consultants to develop a relatively standardised product, since this is easier to sell to multiple clients. Particularly when economic conditions are changing, this can lead to disjunctions between modelling and reality. Precisely because there are a number of features of the Guernsey circumstances that are distinctive, such 'standardised' approaches are best avoided. In future, we recommend that OUR thinks more carefully about its use of outside consultants, although we note that our proposals in relation to (a) deregulation of prices and (b) the establishment of an expert adjudication panel, should mitigate any tendency toward 'standardisation of assessment'.

Given the diversity of views expressed, we judged it unwise to rely too heavily on our general discussions with interested parties in seeking to gain an understanding of the relevant issues. We therefore examined two specific issues/episodes, which appeared

capable of providing deeper insights into the application of the broader regulatory and policy framework in post: the diversification episode, and the reserved area dispute.

The diversification episode

Almost without exception, a topic which arose at meetings we had on the island concerned the implications of the recent strategic initiatives of GP to diversify its activities into financial services, particularly the failed initiative to start a savings bank. Various costs associated with this initiative have been put to us, which are generally in the vicinity of £700,000 to £800,000. On all accounts, however, it is agreed that the diversification episode was a costly failure for GP, and the costs would inevitably fall, in one way or another, on Guernsey residents.

While this issue does not immediately relate to the regulatory framework, or the OUR, it does, we think, highlight broader questions about the adequacy and appropriateness of the current corporate governance arrangements of GP, and in particular: the role of T&R as shareholder; the functions and powers of non executives directors; and the interactions between management, the T&R as shareholder, and other departments of the States of Guernsey, notably C&E. These issues are important as they relate to Guernsey Electricity as well as GP.

We explored these matters in our discussions on Guernsey, and heard a number of views. These ranged from a perception that non-executive directors did an adequate job given their other time commitments and relatively low levels of remuneration, and that they were the best available on the island given the small pool of potential candidates, to the opposite view: that the non-executive directors were completely ineffectual; that there were 'Old Boys' influences at work in the appointment of non-executive directors; and that in practice it was 'remarkable how quickly non-executive directors went native'.

As regards the role of T&R as shareholder, again we heard different views. On the one hand, it was put to us by some that T&R's position as shareholder puts it between 'a rock and a hard place', and that it necessarily has to take a low-key role with respect to the boards of GE and GP, so as to not interfere, and to not be seen to interfere, too actively in the management of these commercialised enterprises. However, the alternative view was also suggested: that the management of the commercialised entities had, in the past, seen

T&R as a mechanism to voice their disapproval of the regulator, and maintain a campaign against the regulatory system.

Notwithstanding these points, the almost unanimous view of the people we spoke to was that the shareholder function was a fairly low priority for T&R, whose interests lay in broader concerns about the island's economy and taxation system. As one respondent succinctly put it, the main interest of T&R in the commercialised utilities was one of ensuring that the 'post was delivered and the lights were on', and that it was not particularly concerned with other aspects of GP's and GE's commercial operations, provided that they were not significantly loss making.

After consideration of the issues, our first conclusion is that, for reasons adumbrated in Section 4 of this Review, public ownership raises particular challenges for the co-ordination of the roles of shareholder and regulator. Traditionally, public ownership has been used as a form of regulation, with ownership and regulatory functions bundled together. Separation of the roles requires an appropriate division of labour between the two functions, and clarity as to what that division of labour, and associated division of responsibilities, should be. We do not think that existing arrangements on Guernsey exhibit such clarity. Without reform, there is no guarantee that episodes like the savings bank episode will not be repeated (and this applies to electricity as well as postal services). Indeed, given the observed, almost world-wide propensity of the managements of commercialised and privatised utilities to diversify, it might be said that such outcomes are positively likely to occur again in the future.

The reluctance of T&R to get heavily involved in supervising the business strategies of commercialised, public enterprises is fully understandable: it is not an area of public policy in which a Treasury or Finance department of government would normally have particular expertise, or seek to get involved. T&R truly does have bigger fish to fry, particularly in the current economic climate.

This, however, leaves some activities of the boards of public enterprises largely unsupervised, at least in circumstances where the roles of non-executive directors are not re-defined to encompass supervisory functions (such as might occur in two-tier board structures).

Lack of supervision of non-regulated activities is, in Guernsey's case, compounded by the point made earlier, that, under public ownership, the price-capping powers of a regulator are a much weaker instrument for influencing cost levels than they would be if enterprise managements were under stronger pressures from outside interest groups (shareholders, debt-holders) to increase profitability by reducing costs.

These points, then, serve to highlight the inadequacy of existing arrangements for performance of the shareholder's or investor's role in overseeing and influencing the Board. In a sense, commercialisation has been only half accomplished. The management of GP and GE have been afforded the freedoms usually enjoyed by commercial managements, but they have not been subject to the normal disciplines and constraints. One of those normal constraints is competition, for which regulation is a surrogate when competition is infeasible. The other is pressure from owners/investors to improve financial performance, and that external pressure is largely missing under full public ownership.

For the avoidance of doubt, whilst it is clearly the case that the missing pressure (in postal services and electricity, but not in telecoms) could be introduced via the introduction of private capital, we are not suggesting that privatisation, or allowing GP and GE access to debt markets, is the only way of completing the commercialisation process. We simply conclude that something is missing from the Guernsey model, and that, if the States do not act to fill the void, the kind of risk that is illustrated by the savings bank diversification plans of GP will likely continue to eventuate.

We also appreciate that, whilst the context is one in which political Deputies may be reluctant to be too involved in the oversight of the commercialised boards, it is nevertheless the case that, in normal circumstances, we would expect to see shareholders, and other investors, taking a more active and questioning role in matters of general business strategy. A considerable amount of analytic resources is typically deployed, on behalf of investors (whether directly, or indirectly), in understanding what the managements of publicly listed companies are up to, in order to be able to value the shares.

It appears to us that one implication of the inadequacies in current corporate governance arrangements is that the OUR has, in effect, been invited to 'step-in' and perform some of the oversight functions that would ordinarily have been performed by the non-executive directors of the board, or by the shareholder. Put differently, the 'gap' in oversight of the operations of the commercialised entities has effectively put the OUR in a position where it

represents the only form of external challenge to the management of the commercialised entities, rather than being only one of two, major sources of challenges to, and constraints on, enterprise managements.

Given the earlier criticisms of the OUR for being over-intrusive in its approach, we conjecture that one possible causal factor here may be the weakness of external shareholder pressures, and hence a tendency to substitute regulatory solutions for those absent pressures. That is, the OUR may have done too much because government has done too little.

Although this may be a situation that can have certain attractions – politicians can avoid difficult decisions to resolve awkward and unwanted trade-offs, and criticism can be offloaded on to a (conveniently unelected) regulator – it is not a situation that can be expected to work well for consumers and taxpayers over the longer term. Our general recommendation on these matters is therefore that policy should be rebalanced, toward stronger corporate governance focused on improving enterprise performance coupled with more limited regulation.

The reserved area dispute

As noted earlier, issues surrounding the scope of the reserved area were one of the triggers for the Requête, and were the central issue of dispute in the recent legal proceedings in the Royal Court. If the proposals discussed above relating to the introduction of a USO fund were adopted, we are of the view that this issue should not arise again.

Nevertheless we consider the reserved area dispute to be worth discussing here because it has led us to a more general conclusion: that, far from being simpler, regulation in a small governmental system is, in many ways, more complex than in a large system, most conspicuously because of the entanglement of other issues, and of personalities, with regulatory processes and decisions. The theme for this sub-section of the Review might, therefore, be said to be *"A prophet is not without honour, save in his own country, and in his own house."* (St Matthew, 13:57)

To repeat an earlier point, it is a standard view in the study of regulation that 'people matter'. Major regulatory reforms happen because of the personality and drive of a particular regulator; and dysfunctionalities can develop because of personality clashes

between individuals. Most importantly, issues can become entangled: information from other contexts can be wrongly imported into decision making where that information is not relevant at best, and misleading at worst.

On reflection, we think these general tendencies are rather more pronounced in small systems for reasons which now appear to us obvious, but which were less obvious before our discussions. The discussions were focused on technical matters, but we encountered a not inconsiderable amount of gossip as well.

On the technical side of the restricted area dispute, we found that there was a degree of 'suddeness' in the final decisions of the OUR on the reserved area issues, in the sense that earlier documents did not prepare the reader very well for what was to come. We also found that, particularly given the points above about competition from electronic mail, the OUR's information gathering was more intensive than we would have expected.

In relation to the latter (information gathering point), we conjecture that in this particular case:

- Personalities may have played a role.
- The use of an outside consultant resource may not have helped as it should.

In relation to the 'suddenness' of the decision eventually made, we conjecture that this may have been triggered by an element of frustration on the part of the OUR. As noted above, the regulatory model being applied was not designed for publicly owned enterprises: OUR was chiefly interested in squeezing inefficiencies out of GP, but the chief instrument available, price control, does not work directly on costs in a publicly owned monopoly. At the same time, GP's management appears to have formed an impression that the OUR could get nothing right, which is implausible in the light of telecoms experience, and hence indicative of other factors at work. The lack of GP's progress on certain matters seems to have caused the OUR to lose patience.

The inherent limitations of the standard regulatory model when applied to a public enterprise such as GP, subject to weak, external financial pressures, particularly when coupled with personality issues, appears to us have been a major contributing factor to the tensions surrounding the reserved area dispute. A further exacerbating factor may have

been the States' save-to-spend policy, which further reduced the leverage on cost cutting from price setting (see section 4 above).

Overall, we conclude that, on this occasion, the regulatory system cannot be said to have passed the LNBTW test; particularly when account is taken of the costs of the court case.

6.3 Alternatives to the current arrangements

The preceding discussion has highlighted an important possible alternative to the current regulatory arrangements – in the form of the establishment of a USO funding mechanism – which should allow for deregulation of prices, and, at the same time, help avoid costly and protracted disputes about the reserved area in the future. However, we have also outlined other weaknesses of the current regulatory framework, which include: the governance and oversight arrangements for the commercialised entities and the effects of dysfunctional relationships on the operation of the regulatory system. Unlike the USO funding proposal, the recommendations set out below are potentially relevant to the electricity sector, as well as to post.

Governance issues

We (like the National Audit Office, and others before) have considered some of the issues surrounding the governance arrangements for the commercialised utilities, particularly the role of the non-executive directors and the role of T&R as shareholder. As a general observation, we do not think there is an obvious 'off the shelf' alternative structure which could improve upon the current arrangements, although there may be ways of reforming the current structure to allow for greater scrutiny and oversight. This suggests that there may be value in considering some more radical options, as well as the more incremental recommendations set out below.

As regards the non-executive directors, we suggest that it may be important to focus not only on the process of appointment (to make sure that potential talent can be drawn from a bigger pool), but also on the criteria that are applied when considering the merits of different candidates. In terms of the appointments process, our understanding from discussions about the current arrangements is that potential appointees are proposed by the companies and that there is very little challenge to, or scrutiny of, the appointments that are proposed by the executive management. Slightly contrary to the view we cited

earlier, to the effect that non-executives quickly go native, this process may be biased toward appointments who are native to begin with.

In terms of the criteria applied when reviewing the suitability of potential applicants for non-executive director roles of the commercialised entities, we conjecture, from our discussions, that while some very able people have been appointed to the boards in this capacity, they have not necessarily been people with the right, or desirable, qualities to perform the role effectively. Ideally, the States should give general guidance on policy/strategic matters, and what is therefore more likely wanted in non-executive directors, are people who have Scrooge like characteristics when it comes to making use of other peoples' money, coupled with the inclinations of investigative journalists in relation to some of the things they might be told by executive management. These characteristics may not necessarily be highly correlated with past business success.

In relation to ways of enlivening the role of the shareholder, a number of alternative possibilities were put to us. One general alternative, which we discuss in detail below in relation to GE, is to privatise the commercialised entities. While we recognise that this is a possibility that has merit, we are not in a position to assess the feasibility, or likelihood, of this happening in relation to GP (or GE); this is firmly a matter for the States and we do not enter into a further discussion here.

Other alternatives put to us included the suggestion that the role of shareholder might be transferred to the Commerce and Employment department, or to another States department. This suggestion is not a new one, and we note that, in the original plans for commercialisation, there was a similar debate about whether the shareholder function should be performed by the Advisory and Finance Committee or the Board of Industry. The case for C&E to assume the role is now, as then, based on the argument that C&E would be able to afford the role greater attention, and that it is generally consistent with the broad skills and mandate of that department. While this alternative may have merit, we note that, under the current structure, T&R has expressed concern that its shareholder role is at risk of being politicised, and that it may consequently become too active in its dealings with the commercialised entities. General experience of regulation indicates that this is a serious risk – in the relevant literature it is referred to as 'regulatory capture' – and we do not see how shifting the shareholder function to another department would alleviate this concern.

More radically, it was put to us that the role of shareholder of the commercialised entities might be more effectively performed outside of the immediate political structure, particularly given that its focus should be on improving the *financial* performance of the relevant enterprise. We understand, for example, that the States of Jersey are in the process of considering the feasibility of a 'shareholder resource' in relation to its public enterprises, aimed at providing better definition of the role, and greater coherence in its execution. Specifically, it is our understanding that such an approach is intended to create a 'buffer' between the Ministers and the Boards of the utilities, and would involve the establishment of a dedicated, professional capability within the Treasury department, responsible for engaging with the each utility and holding it to account in terms of its performance against its plans and shareholder objectives. We have not been able to investigate this in great detail, but recommend that this option be examined further, particularly given that there appears to be general support on the island for greater harmonisation with Jersey (the two Islands might usefully share a common shareholder resource).

Mitigating the effects of dysfunctional relationships

A view that we share with the previous reviews of regulation in Guernsey, and one that featured in almost all of our discussions, is that relationships in the regulatory sphere in Guernsey can quickly become personal and fraught. Whilst many of the technical issues addressed by regulatory policy might be considered to be 'as dull as dishwater', personality issues are not: the local media have, in their own words, noted that regulatory 'spats' make for 'entertaining news copy'.[19] Unfortunately, too much news copy can undermine trust between the parties, reduce the scope for informal dialogue and communication, and potentially be of detriment to the broader regulatory framework (and the Guernsey consumer).

One suggestion put to us to assist in the mitigation of the effects of rogue personalities and dysfunctional relationships, which we have considered carefully, is that the OUR move to a Commission system, similar to that used in Jersey for its competition law authority, and used by many regulatory agencies elsewhere. We have experienced these alternative approaches in operation in the UK and in other jurisdictions, and are not convinced this would help. Commissions do tend to de-personalise things a little, but by no means completely. Commissions can also be less innovative, in classic committee ways, which can be a disadvantage in sectors subject to major change, where good regulation needs to adapt

[19] Guernsey Press 'Opinion' 5 April 2010.

quickly to changing technologies and market environments. Crucially, in a small system, it is likely to be more significantly more costly than feasible alternatives, at least if Commissioners are expected to do significant work rather than simply be ornaments.

The approach we would favour to deal with substantive matters of disagreement between the OUR and the companies it regulates would be to introduce a mechanism that provides for the taking of a second opinion on disputed matters into the institutional architecture. Specifically, our proposal is to constitute a small expert panel on standby, to be called (and remunerated) on an 'as needed' basis, to adjudicate on disagreements between the regulated companies and the OUR ('an adjudication panel'). The decisions/opinions of the panel would have no formal standing in law, but they would be written down and would gain authority from the standing and experience of their authors.[20] If, in the event, the OUR did not accept the recommendations of the Panel, it would be required to explain its reasoning for the rejection in writing. The expectation would be that decisions/opinions of the panel would be accepted by the Regulator, not least because they could used in court proceedings in the event of any formal appeal. Rejection of a panel's opinion coupled with a subsequent adverse decision from the Royal Court could be expected, with reasonably high probability, to be terminal for the career of a regulator, in the Channel Islands at least.

In relation to this proposal, we note the following:

- In our conversations on the island we found widespread support for the idea that a more informal (than recourse to the Royal Court), first instance, disputes resolution process should be put in place.

- Support was based on the reasoning that the ability to obtain an authoritative second opinion on disputed matters can provide for a quick, relatively inexpensive and focused way of resolving specific matters as and when they arise.

- A similar, though not identical, arrangement to what we have in mind was proposed by Ofgem in GB in 2000 in relation to proposals for reforms to the supervision arrangements for wholesale electricity markets, though they were not introduced at the time and were subsequently overtaken by developments, including wider reforms in competition law.

[20] Depending upon the preferred approach the States might also consider directing the OUR to have the 'utmost regard' to the views of the panel.

- The Aviation Appeals Panel (AAP) in the Republic of Ireland is another, similar but not identical, example of the approach. The AAP is constituted as and when needed to hear 'appeals' by interested parties against decisions of the airports regulator, whose major task is to set price caps for (the publicly owned) Dublin Airport. The AAP's decisions are not legally binding on the regulator, who is simply required to reconsider the relevant matters, but this can be enough to settle matters without recourse to the High Court in Dublin.

- The proposed arrangements are also not entirely dissimilar to an approach already employed successfully in Guernsey. In 2006, an Independent Expert Panel was appointed by the OUR to consider issues relating to the valuation of the initial assets of GE, a difficult and potentially highly contentious issue at the time. The Panel was characterised by the distinction and experience of its members – Sir Ian Byatt, Chris Bolt, and Professor David Newbery – and the (not unrelated) brevity and crispness of its reasoning and recommendations. This report was praised by most parties, including parties from different sides of the arguments, and appears to have produced generally acceptable outcomes..

6.4 Conclusions and implications

We have found that the current regulatory structure and arrangements for the postal sector have not performed effectively in the recent past; (more importantly) are not fully adapted to handle future challenges, particularly the erosion of the current sources of funding for the USO; and are in need of reform.

Looking forward, the priority is to address the issues surrounding the USO. The current objectives of the OUR are not structured so as to give this issue top priority, and, in any case, we are of the view that it is a matter chiefly for the States, not for devolved regulation, since it raises issues of, in effect, taxing some postal services (or, in the alternative, to raise general taxation) to subsidise other postal services. Tax and spend policies are matters for parliaments, not for regulators, although the latter may be afforded a role in implementation of decided policy.

We have outlined one possible method of approaching the issues, based upon funding the USO from a levy on all postal service providers, and not just GP; which, in our view, should be the preferred approach. It would likely have a number of immediate benefits, including:

- It should prevent issues like the reserved area dispute arising again in the future, at least with anything like the level of significance that the recently settled dispute acquired.

- Once the USO funding level has been determined, the role for the OUR could shift away from a determinative role in price setting (where things have not gone well) to tasks that are more to do with ensuring fair competition, advising on the USO, and dealing with implementation issues in regard to the USO. Specifically, GP's prices could be deregulated (although they would, of course, be subject to guidance from the shareholder).

Even allowing for the effects of such changes in the regulatory arrangements for postal services – which we consider would be significant – there will still remain issues regarding the adequacy of the governance and management oversight arrangements for GP. As explained, while some of these issues are not of direct relevance to the regulatory regime (such as implications of the diversification/savings bank episode), to the extent that the regulator is required to assume, by default, a role that should be performed either by the non-executive directors of GP, or by the shareholder, they can become relevant. We will pick up on these points in more detail in the next section in the context of GE.

7. Electricity

Despite the fact that the electricity sector has not been subject to the same level of market and technological change as the telecoms and postal sectors, we have found it to be the most difficult sector to assess in terms of the impacts of the regulatory regime, and also the most challenging in terms of proposing practical alternative ways forward.

There are, in our view, a number of reasons for why the issues in this sector are so difficult, but one factor that seems of particular relevance is that the disputes between the incumbent provider, GE, and and the regulator, have been sustained, at relatively high intensity over a long period. This is different from telecoms, where there was a major dispute following privatisation, but there has been a long, 'quieter' period since, and also from postal services, where, despite disagreements stretching some way back, things only came to the boil relatively recently.

Indeed, from the evidence we have seen, GE has questioned the legitimacy of the OUR more or less from the beginning, and, whatever the merits of the arguments on each side, it is somewhat extraordinary that one part of a system of government – and GE is a state-owned enterprise – can, for so long a period, openly challenge the legitimacy of another part of the system of government, without the matter being resolved by the government itself.

We suspect that the history has deeply affected the relationships between all parties, and, perhaps more importantly, has affected the implementation of regulation to such a degree that important issues have not, and are not being, addressed in cool-headed and informed ways. Whilst it appears, from the materials we have seen, that the relationship between the OUR and GE improved for a short period following the NAO Report, after the States instructed the parties to get along better, the wheels quickly came off again. We consider why this may have been the case in some detail below.

As a preliminary point, we state our view that GE's concerns about the regulatory arrangements were not, in our view, spurious. In this respect, we recognise, in particular, GE's reliance on views expressed in 2006 by Professor Stephen Littlechild (one of the original architects of the UK regulatory model) to the effect that the standard RPI-X regulatory arrangements are not well designed for public ownership, and are inappropriate in the small-island context of Guernsey. While we have discussed the small economy issue in Section 2 (and disagree with the general proportion that regulation cannot be made to work

in a small economy -- for example, because of our findings in relation to telecoms), our conclusion here follows from the reasoning set out in section 4 above: in particular, we think that the standard price control model lacks leverage in providing incentives for cost reduction in the public ownership context, and that the problem is exacerbated in the Guernsey context by the absence of a performance-focused exercise of the shareholder function, and by the softening of cost-reduction incentives caused by the 'save to spend' policy.

We note, however, that Professor Littlechild's main proposal was that the supervision and oversight of GE's activities be transferred from the OUR to T&R. For the reasons already discussed in the previous section in the context of GP, we consider there to be fundamental corporate governance issues that put serious question marks against such an alternative in the specific Guernsey context. In any event, it is our understanding that T&R made it clear that they did not want to assume such a role when the matter was considered in 2006/7, and that that view was widely supported among Deputies. In the course of our discussions we found no evidence to suggest that the policy position has materially changed since that time, and we have therefore not considered the proposal further.

This history appears, to us, to provide another illustration of the problematic shareholder role: the current position appears to be 'pass the parcel' on enterprise governance issues. As in relation to postal services, one of our general conclusions from the history of commercialisation in the electricity sector is that, to the extent that the OUR may have been over-active relative to the 'light handed' regulation anticipated by at least some Deputies at the time of the establishment of the OUR, one of the principal causes appears to be that other parts of government have been under-active in taking responsibilities. In the American idiom, the OUR has been left 'batting cleanup'. As stated earlier, the OUR might have done less, if others had done more.

That is, however, largely a matter of history now; and of more importance is the future. GE has continued to press for a change in the form of the supervision arrangements which has been rejected in the past, and which, from our discussions, does not attract significant support today. There is an element of Groundhog Day about this: and the position is surely unsustainable and a resolution of the issues is called for. This is perhaps the biggest single issue that we have encountered in the course of this Review.

7.1 General issues in the electricity sector

Before presenting our assessment of the performance of the regulatory regime, we outline some of the broader contextual issues that appear to be shaping the way in which regulation has operated, and which, we believe, are going to become more important in the future.

The States energy policy

It is not for an independent regulator, such as the OUR, to determine matters in relation to security of supply and the environment. These are clearly questions of energy policy, and responsibility appropriately lies with the States.

Nevertheless, it is our view that, while a clear demarcation in roles and responsibilities between the States and the regulator is appropriate, it is also the case that the regulatory framework, as applied to the energy sector in Guernsey, would benefit from a clear and stable articulation of a coherent energy policy for Guernsey. In this way, the more technical decisions could be better adjusted to contribute to public policy objectives in an efficient way.

There was considerable ambiguity evident in our discussions regarding the status of any energy policy in the States. Our understanding is that, while an Energy Policy Report was prepared in 2008 and tabled to the States of Deliberation, it was simply formally noted at that time, and it was said that further work identified in that report was to be pursued. No subsequent, major statement on the relevant matters has been drawn to our attention, and, in this sense, we have been unable to locate a formal energy policy for the States.

In our view, this is not a clear and stable framework within which regulatory policy can be expected to operate. It is beyond the scope of our remit to comment in-depth on the substance of any energy policy, but we note simply that the continuing lack of clarity can be expected to have a negative effect on the effectiveness of regulation going forward.

Indeed, the absence of a settled energy policy could fundamentally undermine both independent regulation of the sector and its efficient management. Major lessons of the UK experience with nationalised industries, and the subsequent experience of independent regulation, are that:

- Volatile and unstable political preferences made effective management of the industries extremely difficult to achieve (here we refer again to the statement of Sir Peter Parker noted in section 4 about what constitutes 'success' in such a context).

- Independent regulation was, among other things, intended to reduce the influence of these instabilities on commercial decisions, and it has generally succeeded where such 'de-politicisation' has proved feasible and durable.

The significance of these points in relation to electricity regulation cannot easily be understated. Today, energy policy is driven to a very large extent by environmental considerations. Hence, for so long as there is not a settled viewed on environmental matters within a jurisdiction, and for so long as policy tomorrow may be different from policy today, and different again from policy yesterday, instabilities in political preferences will continue to exist and, given the high significance attached to the environmental issues, can be expected to undermine independent regulation and good management alike (e.g. major investment projects will tend to become snagged up in what are really disputes about unsettled aspects of energy policy).

Competition

As noted in section 3, we were surprised at the extent to which those we spoke to viewed competition as largely inconsequential in the electricity sector, and as likely to remain so. We do not agree with this consensus for a number of reasons, including:

- There is latent competition in generation between on-island generation (GE generation) and generation in France (by EDF). If, as is the case in the UK, there were greater separation among the various activities that comprise GE – generation, distribution, supply, goods retailing, and systems operation – GE supply/distribution would need to purchase its power from one of the competing generators. This could be (the separated) GE generation on-island, EDF via the undersea cable, other continental generators, or other generators located on Jersey. It may even include small scale distributed generation on Guernsey.

- For the future there is the possibility of developing new generation technologies such as tidal/marine power.

- There is potential competition in reserve generating capacity. The current security of supply policy requires all imported electricity, and then some, to be backed up by Guernsey generating capacity. As Byatt, Newbery and Bolt noted in their expert report for OUR in 2006, this implies that electricity generation on Guernsey is very capital intensive – large amounts of capital are required to generate relatively small amounts of electricity – which contributes to higher costs.

  It is our understanding that some back-up capacity already exists on-island, for example, back-up capacity owned by CWG (for its servers), by the Princess Elizabeth hospital, etc. Since it exists for the same purposes as GE's back up plant (to operate in the event of a disruption to supplies from normal sources) this capacity should be remunerated on a broadly equivalent basis to GE's own reserve capacity, so that there can be at least some competition in this area. This would be likely to reduce costs, and could potentially lead to some innovative, alternative ways of achieving security of supply objectives.

- Finally, when a micro-generation unit is installed in a property, the owner effectively becomes a self-supplier, in competition with GE at the supply level. More generally, the development of load/demand management can serve to reduce demand for supply from GE, and also possibly contribute to that demand becoming more price-sensitive. Such developments have similar effects on GE to the effects of a competitor (who steals business, and makes business more sensitive to pricing).

For reasons explained earlier, we expect competition issues generally to become more important in the future, unless the development is prevented by inappropriate energy policy. Our view then is that energy policy and regulatory/competition policy should work together to promote the kinds of innovations and adaptations that will be required in the future.

Save to spend, cost cutting incentives and investment programmes

There are a number of well-recognised issues surrounding the States' 'save to spend' policy for the commercialised utilities, and the impacts such a policy may have on the incentives of the commercialised companies. The conservatism underlying the policy appears to have its roots in general fiscal policy, and we understand that there can be exceptions to this general

policy in funding projects that will create an income stream (we would conjecture that some investment in electricity systems could fall into this category).

What appears to be less widely recognised, however, is that the States' 'save to spend' policy reflects a particular intergenerational trade-off, and this raises questions about intergenerational equity. More specifically, one effect of the policy's application in the electricity sector is that *current* electricity consumers are, in effect, paying for assets that will only be used by *future* electricity consumers. This violates one of the ancient principles of government provision, called the 'benefits principle', which suggests that payments (sometimes in the form of taxation) should reflect, at least to some extent, the benefits received from the government services.

We appreciate from our discussions that there is a reluctance to allow the commercialised entities to borrow any funds at all. However, we agree with others who have reviewed aspects of public policy in Guernsey in thinking that this may be too extreme an approach, and note that a policy of fiscal conservatism can still be maintained, as a matter of States policy, by placing a fairly restrictive upper limit on the gearing of the commercialised entity. An immediate effect of allowing borrowing to some degree is that some of the capital costs associated with the new assets will be transferred to those who will benefit from their use. There are also likely to be potential benefits for the regulatory regime in allowing GE (and GP) to borrow. The availability of cash reserves, accumulated for future investment, means that the budget constraints on GE management are softer than would otherwise be the case, and as discussed earlier, this further weakens leverage on costs that might come from fixing prices. Put differently, one possible effect of the save to spend policy is that it reduces the incentives for GE and GP to focus on cost cutting measures. Moreover, it can potentially reduce incentives to produce robust and well justified 'business cases' to underpin their proposed investment plans

In any event, it is unclear to us how adequate the reserves built up under the policy might be in practice. In electricity, for example, there are currently significant investment requirements, but the cash balances have not been built up to the extent necessary to fully finance GE's forward looking programme. As a consequence, it is likely that prices will have to increase significantly in order to address these future capital investment requirements. Table 4 for example, shows that over the next ten years the amount of annual forecast capital expenditure is expected to increase by 100%, and that in 2016/17 the forecast capital expenditure *in that year alone* will be 86% of the closing save to spend balance.

Table 4: GE's save to spend and capital expenditure forecasts - 2007/08 to 2016/17 (£M)

	Save to Spend closing balance (£M)	Forecast capital expenditure (£M)	Forecast capex as a % of save to spend balance
2007/08	18.5	6.0	32%
2008/09	21.5	4.5	21%
2009/10	27.0	2.5	9%
2010/11	28.5	7.0	25%
2011/12	25.5	9.5	37%
2012/13	25.5	6.5	25%
2013/14	24.0	8.0	33%
2014/15	22.5	8.5	38%
2015/16	18.0	11.0	61%
2016/17	14.0	12.0	86%
Net change 2007/8 to 2016/17	**-4.5**	**6.0**	
% change	*-24%*	*100%*	

Source: Broad estimates based on figure 6.1 of GE Price Control Final Decision February 2007

7.2 Assessment of current arrangements

It was the general perception of those that we spoke to that the regulatory framework as applied in electricity had failed in the time since commercialisation. Of course, views differed widely as to sources or causes of the failure, but the general perception was one that things hadn't quite operated as they should have.

Some parties put to us that it was not the regulatory approach or framework that was inadequate, but the intransigence of GE, and its failure to recognise the legitimacy of the OUR. More specifically it was argued that GE had, for many years, seen itself as operating autonomously and in some respects outside the control of the States.

Perhaps unsurprisingly the opposite view was also put to us: the source of difficulties in the sector was an over-active and intrusive regulatory approach which was disproportionate, and did not clearly assign roles and responsibilities. Other more specific issues put to us included: that the OUR did not effectively communicate its longer term work programme; that the OUR sought to constantly second-guess GE's strategic and investment plans; and

that particular personalities made the relationship between GE and the OUR unnecessarily adversarial.

As noted above, more fundamental issues have also been suggested for the perceived failures of the regulatory regime in electricity, in particular: that the regulatory model has been inappropriate and the size of the market has not lent itself to the type of regulatory framework adopted.

Consistent with our approach in the earlier sections we have not sought not assess the individual merits of these various claims, but have used them to try to detect patterns that might help to us to identify the underlying issues and problems. In electricity, the discussions have led us to consider three specific matters, which we suspected might provide insights into the workings of the Guernsey regulatory system: two episodes involving the determination of the pass-through of changes in certain cost elements, and an issue concerning the structures of electricity tariffs.

Perhaps the most contentious matter in the relationship between the OUR and GE in recent years has been the issue of cost-pass through. In simple terms, the relevant questions have concerned whether, how, and when, GE is allowed, under its current price control settlement, to recover the costs associated with significant increases in (a) allowed fuel costs incurred in operating its own generating sets on the island and (b) the costs of electricity it purchases from EDF via the undersea cable. The matter raises issues of both process and substance.

It should be said at once that the rationale for a cost pass-through mechanism is not a matter of dispute. Under the standard price-cap model of regulation, it is normal to recognise a distinction between those costs over which a utility has a reasonable degree of control, and those over which it does not. In the case of GE, the latter category would include changes in fuel costs that are the result of changes in world prices of oil and its derivates, and also the cost of electricity purchases from EDF (where, although GE might be in a position to negotiate slightly better or worse terms, it cannot reasonably be expected to be able to avoid major swings in continental market prices for bulk electricity).

Where non-controllable costs are a significant fraction of total costs (as they are for GE), the resulting pricing formula is usually said to be of the RPI-X+Y type, where Y denotes the changes in the non-controllable costs that are allowed to be passed through, automatically

into retail prices. This formula was first used for British Gas in 1986, so we are not dealing with anything very innovative; and the fact that it can be expressed algebraically is an indication that the pass-through calculations are, or should be, formulaic and mechanistic.

Cost pass through: episode I

In terms of process, we have reviewed the timing and content of the consultations on the cost pass-through mechanism when it was first proposed to be introduced, and the final decision itself, in early 2007. We have also reviewed exchanges between the OUR and GE on this issue. In this respect, we were struck by correspondence from the OUR to GE, only days before the publication of the final price control decision, in which various alternative options for dealing with pass through costs were identified. This reveals that the precise details of the proposed pass-through mechanism were quite ambiguous and vague, even right at the very end of the price review process. This is highly abnormal relative to conventional practice. We would have expected to see clarity and precision on this issue, which, as the later evidence shows, relates to very major influences on the electricity prices paid by consumers. It is precisely to deal with technical tasks such as this that regulatory specialists are appointed, and the task in question was not a particularly challenging one intellectually.

An equally, if not, more important issue is the substantive form of the final pass-through mechanism adopted in the price control. A useful comparison when thinking about how a pass-through mechanism should operate is a long-term commercial contract. In such contracts, is not uncommon for provision to be made for various unforeseen changes in those variables which can be expected to have the most material impacts on the commercial value of the contractual arrangements. Thus, for example, long-term energy supply contracts typically contain various types of indexation provisions, which link the price paid to movements in measurable indices (such as the RPI, the producer prices index, oil price indices, gas price indices, bulk power price indices, coal price indices, and so on). The terms of the contracts will typically define precisely what indices are to be used, and how they are to be used in calculating contract prices. Ambiguity here can be expected to lead only to costly contractual disputes later, and, wherever realistically possible, it tends to be carefully avoided.

The cost-pass through mechanism adopted in the GE price control contained avoidable ambiguities, largely because it was not specified at a requisite level of detail. While the OUR

decision document did present worked examples of how the pass-through mechanism *could* work, it lacked precision, and the language implied that there would be later, discretionary choices (for the regulator to take) in relation to some of the elements of how cost pass through would work. This was highly non-standard.

We necessarily conclude that fault in determining the flawed, final form of the pass-through mechanism rests with both parties. While the OUR proposed the mechanism, GE accepted its form in accepting the final decision. However, we would qualify this assessment by noting that the extent of fault of GE is partly mitigated by a number of factors: the process by which the pass-through mechanism was proposed; an understandable reluctance to use the 'nuclear option' of appealing this decision to the Royal Court; and finally, the fact GE was under general instructions from its shareholder to cooperate with the OUR following the NAO Report.

Irrespective of the relative balance of fault, our conclusion is that, in this episode, the regulatory system failed the LNBTW test.

Cost pass through: episode II

Unfortunately, the failure of the regulatory system in the cost-pass through decision appears to have had significant and on-going effects. Lack of precision in the decision meant that there was ambiguity in how, if at all, changes in the sterling/euro exchange rate should be reflected in prices.

Again, we think that there should have been no substantive issue in resolving the ambiguity, once it became clear that it was a significant issue. To the extent that GE's fuel input costs and its bulk electricity purchase costs, *measured in sterling*, changed in consequence of exchange rate movements, such changes should be allowed as a cost-pass through item.

In the event, the OUR interpreted its final decision as meaning that the sterling/euro rate should be held fixed, at the value shown in its 'examples of calculations' around the time of the decision. On this interpretation, GE has been exposed to the full risk of variations between the actual euro/sterling exchange rate and the exchange rate used in the calculation examples. The issue became a very major one because of the subsequent, substantial movements in the sterling/euro rate, and was exacerbated by another provision

of the final price control decision, to the effect that changes in non-controllable costs could only be passed through after a lag of two years.

The cost-pass through element of the price control formula formed the basis of numerous exchanges between GE to the OUR, over a period of more than a year, during which GE requested a re-examination and adjustment of the pass-through mechanism to correct for this exchange rate exposure. In response to these requests, the OUR's general position was that, if GE wanted to adjust the pass-through mechanism it would be necessary to re-open the full price control decision.

The OUR's position on re-opening the price control decision was in line with normal practice in the conduct of regulation, which is designed to prevent cherry picking by regulated companies. That is, if a particular aspect of a price control settlement turned out to be unfavourable to the regulated company, but other aspects turned out to be more favourable than expected, there is obvious merit in preventing the regulatee from being able to insist on only the unfavourable development being reassessed. In this case, therefore, we think that GE should simply have asked for a full re-opening of the price cap (even though there was only one issue that it wanted resolved), and that it can be faulted for not so doing. It is perhaps indicative of a lack of trust that it did not do so, perhaps expecting that this would lead to a very major regulatory exercise, with its attendant costs. However, lack of trust can be self-fulfilling, and the amounts of money potentially at stake would have still justified the costs of an extensive exercise.

On the other side of the fence, it should have been clear to the OUR that there was an ambiguity in the final decision, that this was a major weakness, and that the matter should be cleared up in an administratively efficient manner. Without in any way abandoning the formal (and correct position) that a re-opening of a price control necessarily meant that any issue could be considered, OUR could have indicated to GE that, in the circumstances, it could see that the exchange rate issue was of a special kind – relating as it did to imprecision and ambiguity in the final decision – and that, in the event of a re-opening of the decision, that is where regulatory effort would be expended. Again, we think that it may indicative of a failed relationship that such simple steps were not taken.

Instead, after further correspondence on this matter, the OUR appears to have launched an investigation of GE's approach to the treatment of foreign exchange costs, and in particular its approach to hedging. As far we can discern, the OUR may at this point have taken the

view that that GE was aware, or should have been aware, of its exposure to the sterling/euro exchange rate, and that it should have taken measures to protect itself from risks of exchange rate fluctuations. If that was the case, our view is that it amounts to compounding error with error.

There is nothing inherently inefficient in a regulated company deciding not to hedge its exchange rate risk, or deciding to hedge it only partially (in whatever proportion it chooses). A hedge is a bet on future exchange rate movements: making the bet will cost something, and, at the time of making it, there will be prospects of losses as well as gains. The fact that GE would have done better to hedge is wisdom gained only with hindsight: there was no way that this could have been known at the time of the decision.

There is no reason for GE to think that it had any particular expertise in currency trading, so it unsurprising for us to learn that GE had not developed sophisticated hedging strategies. More generally, in a small economy, it might be considered more appropriate and effective for exchange rate hedging decisions to be the responsibility of a central treasury function, as it often is in large commercial companies running a range of different businesses.

We conclude that this second cost-pass through episode, encompassing the responses to ambiguity in the earlier decision, involves both a reluctance to act expediently to correct a previous mistake and regulatory over-reach (an unwarranted interest in currency trading), and for these reasons amounts to another failure of the LNBTW test.

Price structures

A third issue that featured in our discussions, and which appears to be an area of on-going complaint by Guernsey Gas about the regulatory system in electricity, is that the price structures that are set under GE's price control arrangements are anti-competitive. More specifically, the complaint is that some of the tariff levels established under GE's price control settlement are effectively below costs, and that this is having the effect of limiting the ability of alternative fuel providers (e.g Guernsey Gas) to compete effectively in the market.

This kind of problem can arise when tariff structures comprise fixed and variable parts, where the variable part is related to the number of kWhs consumed in the relevant period. When, as has been the case over recent years, higher electricity prices have been driven by

increases in electricity generation costs, retail prices, to be cost reflective, should pass through the higher costs into the variable part of the tariff, rather than the fixed part. If this is not done, parts of the tariff structure can move out of line with costs, and some prices may even fall below costs.

Our interest in this matter is that it is, in effect, a complaint that would ordinarily be investigated and considered under competition law in other jurisdictions (eg: under predatory/below cost pricing provisions). There is no such law presently in Guernsey, and while the matter has been investigated in the context of a breach of GE's licence conditions by the OUR, we would argue that this is not the appropriate mechanism by which to consider complaints of this type. In particular, there is a potential conflict in any investigation of this type, since the OUR will typically have previously approved the contested price structures for GE in its price control decision.

We recognise, however, that the specific procedural difficulties associated with the OUR hearing and investigating a complaint about a decision that it was involved in would remain (and may even increase) should the OUR assume competition law powers, at least if current price control arrangements are maintained. This is one, further reason why it may be advantageous to move away from *ex ante* price capping by the OUR, and toward a regulatory style based more on *ex post* assessments, consistent with the general approach adopted in the enforcement of competition law. Then, even if the OUR retained regulatory powers to approve or to not approve particular price proposals, a regulatory decision to approve could always be qualified by the statement that it was based on the reasonableness of prices on average, and that it was the responsibility of the enterprise itself to ensure that the details of the price structure were compliant with competition law.

7.3 Alternatives to the current arrangements

One of the puzzling questions we have wrestled with in reviewing the utility regulatory regime in Guernsey, particularly as applied in electricity, is why the recommendations of the National Audit Office do not appear to have worked. This result is especially perplexing as, following the publication of the NAO report, and following the directions given by the shareholder to GE, there appear to have been genuine efforts on both sides to improve the working relationships and to avoid the pitfalls of the past.

We have come to the conclusion that one reason for the NAO's recommendations falling flat in electricity may be that the NAO's overall assessment of arrangements in that sector (that the model of commercialisation and regulation adopted was appropriate for Guernsey, and that it was principally a matter of getting the model to operate effectively) may have been overly optimistic given the broader governmental/policy structure in Guernsey.

Here we refer to all of the points made previously regarding the appropriateness of the standard RPI-X (+ Y) price control framework to commercialised, publicly owned entities; the impacts of the States' save-to-spend policy on the incentives of the commercialised companies; and the inherent weaknesses and tensions in the framework of governance and accountability for the commercialised entities, particularly the lack of an activist shareholder interest in financial performance. Given that all of these aspects of the policy structure continued unchanged, it is perhaps unsurprising that the underlying issues remain.

For these reasons, we have concluded that the approach of sticking rigidly with the current model, and focusing on how to get it operate more effectively, may not be sufficient to resolve the underlying problems and move matters forward. Against this background, we have therefore considered a range of broader alternatives that may address the underlying and recurring problems in the sector.

An adjudication panel

The biggest glitch in the regulatory system in electricity in the time since the NAO report appears to us to have been the cost past through episodes discussed above. In our view, these are clear examples of the types of issues that an expert panel – such as a small adjudication panel of the type described above – could have dealt with expeditiously. In this context, we note that, at a technical level, the cost-pass through issues were much simpler in form than the issues that the OUR asked Byatt, Bolt and Newbery to opine on, which concerned asset valuations, and that expert report appears to have been a great success.

Specifically, once it became clear that the ambiguity surrounding the treatment of the sterling/euro exchange rate was a serious commercial issue, an experienced expert (or experts) could have been asked to give an opinion on an appropriate way to resolve the ambiguity. This would have been akin to an arbitration process in relation to a commercial contract – and we note that regulatory price control decisions have a number of features in common with longer-term commercial contracts – and we have little doubt that the matter

could have been dealt with quickly and authoritatively, within a matter of days or a relatively small number of weeks, at modest cost.

Had such a mechanism been in place at the time, we think that there is at least a good chance that the smoother relationship between the OUR and GE which, to the credit of both sides, appeared to have developed following the NAO Report and the States directions, would have been sustained. We are encouraged in this belief by views, expressed to us in our discussions on Guernsey, that such a mechanism would also likely have helped in the postal sector.

We have one residual puzzle concerning the use of appeals panels on Guernsey, which follows from the fact that we have been unable in our discussions to obtain a satisfactory account of why the States moved in the opposite policy direction, when the original Utility Appeals Tribunal (UAT) was abolished. The directional movement appears somewhat odd given the conclusions of previous reviews, which endorsed the value of an appeals function short of the Royal Court (albeit subject to the proviso that costs should be significantly lowered from those incurred as a result of the Tribunal's early outing in the CWG case), and given that the majority of those we met with took the view that, in principle, such an approach should work.

A number of reasons were suggested to us for why the UAT was not viewed as successful. Among these were that: the UAT was established at the same time as it heard its first appeal, leading to delay and muddle; the high costs and procedural issues associated with the CWG appeal; a concern that the operation of the UAT would lead to the introduction of concepts from the EU and UK into Guernsey law; and more general concerns about the status and role of such a body under Guernsey law.

These matters touch on broader questions of the appropriate design of any adjudication panel, and we note in this respect that there are many forms that such panels can take in practice. Our recommendation is based on our observation of what has worked in Guernsey (the Byatt, Bolt and Newbery panel), and is designed to avoid the pitfalls implied by the list of weaknesses in the UAT set out in the previous paragraph. To repeat earlier points, its main features would be that it would:

- Comprise a small panel of experienced authorities in regulation, to be called on an 'as needed' basis.

- Its views would not be determinative: they would have no immediate legal force.

- Its views would, however, be reasoned and written down, and would derive authority from the professional standing of its members.

- If the OUR subsequently rejected any or all of the panel's recommendations, it would be required to write down, with full reasoning, why it had done so.

- All documents would be available in any subsequent litigation.

As a final observation we note that, in some of our discussions on the possibility of introducing 'second opinion' or adjudication panel, it was sometimes suggested that this type of arrangement would simply introduce greater costs to the regulatory system. Whilst this is undoubtedly true assuming that all other things are equal, the whole point of the proposal is that it would change those 'other things', possibly in quite fundamental ways. For example:

- What is clear from recent months is that the costs of appealing decisions to the Royal Court appear to be an order of magnitude greater than those that might be expected to be associated with an adjudication panel of the type outlined. If an expedited dispute resolution process economises on such outcomes, it will save considerable sums of money for Guernsey residents.

- Although it was used by GP, the Royal Court option is, precisely because of its high costs, perceived by some as a kind of 'nuclear option', and this may discourage appeals where appeals are warranted. The Court option was not taken by GE, and, as explained above, the result has been a long, festering and unnecessary dispute, that must, when the time devoted by both sides to the issue is taken into account, have been considerably more costly than early resolution via an expedited adjudication panel would have been.

- For reasons explained earlier, we are not convinced that the use of outside consultants to assist the OUR has generally been anywhere close to as productive as the report of the three regulatory grandees (Byatt, Bolt and Newberry). With an expert panel as the fallback, OUR might be encouraged to rely more on the

development of its own in-house skills, which are likely to be more closely tuned to the Guernsey context, and rely less on outside reports. In doing this, it would know that when mistakes are made – as they inevitably will be when difficult issues are being addressed and resources are limited – they are reasonably likely to be corrected in a low key way. And using consultants less would obviously cost less.

- We suspect that, in practice, the expert adjudication panel would not be much used. The very fact of the existence of the safety net, can be expected to lead to better, more confident, less defensive decision making all round.

Ownership and governance issues

For the reasons stated, we believe that some of the worst regulatory episodes experienced in the electricity sector could have been avoided had an appropriate second-opinion, adjudication panel existed. Nevertheless, even in the event of the creation of such a panel, which we strongly recommend, other fundamental difficulties associated with the regulatory framework will still need to be addressed. In particular, we have in mind the difficulty of trying to influence GE's costs via standard price controls in the presence of a relatively inactive shareholder and a save to spend policy.

We consider that these difficulties are likely to remain more of a problem in electricity than in post in the future. As discussed in section 6, the postal sector is experiencing pressure from other forms of competition – bulk mailers and electronic mail – which could be expected to create natural incentives for cost reduction. Moreover, the enduring regulatory issue in postal services in the future is likely to be a fairly narrow one: determining and managing the level of the USO. All of these factors suggest the prospect for substantial deregulation in the future, and scope for the regulatory system to become more limited and focused.

In electricity, however, potential future policy issues are as broad as they are long, not least because of the priority given nowadays to environmental concerns. One way or another, the relevant matters can be expected to figure prominently in the States policy making for many years to come.

It is in this context that we have considered a number of different proposals for reform of the ownership and governance arrangements in relation to GE, some of which have been

raised before and others which were put to us during our meetings. These possibilities include:

- ***The full or partial privatisation of GE:*** As noted in relation to GP, the question of whether to fully or partly privatise the commercialised entities is one for the States to determine, and here we simply note some of the economic trade-offs involved. The first of these is that an immediate advantage of privatisation would likely be new, more focused corporate governance arrangements for GE. There would be a more activist, investor interest in enterprise performance.

  Such a move would also likely mean that the existing regulatory model adopted in Guernsey would be more effective, as both the management and shareholders should have a stronger natural incentive to ensure that costs were reduced below the price levels set in the price control under these arrangements.

  Privatisation would also address problematic issues associated with the States' save to spend policy. Even a part-privatisation of GE may be sufficient to reap some of these benefits, and to address the dulling of incentives associated with the save to spend policy. This might involve capital being raised by issuing a limited number of shares to the private sector, or issuing company debt instruments. More radically, and in line with international trends, consideration might be given to selling the generating assets of GE to a private company, or these assets could possibly be privatised via a management buy-out; whilst keeping the distribution and supply activities of GE within public ownership. Such partial divestment could be facilitated by the striking of a long term contract between the divested generation business and the GE distribution and supply business.

  However, being two-handed economists, we make two further observations on privatisation in the Guernsey context. The first is that, while privatisation might be expected to improve the operation of the standard regulatory model, it would be a strange logic to seek to change the context to suit the model, rather than the other way around (adapting the model to the context). If, therefore, the privatisation option is to be evaluated, it should properly be evaluated against a reformed, public sector approach; not the existing arrangements, which, for all the reasons set out above seem to us to require a number of adjustments if they are to work more effectively.

The second observation is that, while privatisation may lead to better regulatory relationships – insofar as shareholders insist that management has a good working relationship with the regulator – it is very far from being a panacea for all problems. There are numerous examples of where private, powerful monopolies have failed to recognise the legitimacy of independent oversight, and have sought to wage war to undermine their authority.

- ***A much more (financially) activist shareholder.*** A second possibility, working within the existing commercialisation arrangements, is to introduce a more financially active shareholder function. This possibility was already discussed in the context of GP, and we note again that, while this proposal may address some of the governance problems identified, it will not, on its own, address some of the other fundamental issues with the regulatory framework (e.g: it may have done little to help with the cost pass-through disputes, which have been such a major issue in electricity).

- ***'Adjudicative' price control procedures*** A third alternative, which we consider worthy of further investigation, is shifting the regulatory arrangements toward what can be termed a more 'adjudicative', and less activist, style of price control. By this we mean that the regulatory regime for electricity moves away from the existing *ex ante* price control framework, where OUR is active in setting a price cap, and shifts to one where prices are, in effect, determined by GE, but are subject to possible regulatory challenge.

  Under this approach, GE would bring forward proposals to the OUR when it wanted to change an existing pricing formula or agreement, and would be expected to supply, with the proposal, the relevant business case. The business case would, of course, be expected to contain details of projected future cost, and of cost efficiencies that could be achieved. To provide comfort that prices might be reduced in periods of falling costs, the arrangements could also provide for the OUR to require that GE come forward with proposals for pricing changes, in the event that the regulator had reasonable grounds for suspecting that prices had become excessive.

The procedure might then be along the following lines:

i. The default position would be that GE could go ahead with the changes if not challenged within a period of two months from the time of providing the OUR with the proposals and supporting documentation.

ii. If the OUR does wish to challenge, it would have two months to make a counter proposal.

iii. The OUR could consult and buy in any other resources to assist in this process, and it would be required to give reasons for its decision.

iv. There might be a period of, say, one month, during which OUR and GE would have an opportunity to seek comprise. If agreement is reached, the process stops there.

v. If no agreement is reached, the matter would go to the expert panel, who might be required to give their own assessment within, say, two months. If OUR and GE agree on this, the process stops there.

vi. In the event of disagreement, the three proposals (GE, OUR, experts) go to the shareholder, who chooses one.

Although there is potential political involvement here, it would only occur at the end stage, when other avenues have been closed off. Moreover, it is a 'passive' decision in the sense that T&R would choose one of three existing alternatives: it would not need to be pro-active in developing policy.

- ***'Deregulation' - Jersey style*** Another alternative put to us is for the regulatory arrangements for electricity to be modelled on those adopted in Jersey, and in this respect, it was suggested that Jersey electricity operated under a 'regulation by exception' regime. As it was explained, this arrangement means that Jersey electricity is effectively 'deregulated' (i.e.: not subject to any form of price control) but that it can be called upon to justify why it is charging its services in a particular way, or in circumstances where it is seeking to increase prices.

While such an approach seems attractive in terms of reducing the regulatory burden, it does not adequately address questions of appropriate oversight and governance arrangements. Specifically, given our discussions above regarding the weaknesses in current governance arrangements for the commercialised entities, particularly the shareholder function, we cannot be confident that there would be sufficient oversight and influence over the costs of GE under this type of arrangement. In this respect, we note that there is one important difference between Jersey electricity and GE: Jersey electricity is partly privatised and is in fact listed on the London Stock Exchange. As noted earlier, ordinarily it would be expected that private shareholders would place constant pressure on Jersey Electricity's management to ensure that costs are as low as possible (allowing for quality of service issues) in order to obtain the highest level of profits. No such pressure exists in the case of GE.

7.4 Conclusions and implications

Our examination of the electricity sector has been a lengthy one, which reflects the complexity of some of the issues that are raised by the regulatory arrangements in that sector. The general conclusion from our assessment is that the regulatory system in this area is need of significant reform; a conclusion that should not come as a great surprise to anyone familiar with the sector.

We have sought to identify the issues which we consider to have contributed to the poor performance of the regulatory system in this area. We will not repeat the points here, but emphasise the conclusion that some of the worst episodes could have been avoided had an appropriately designed expert adjudication panel existed.

For the future, we fear that instructing the parties to get along, as was done following the NAO Report, is unlikely to be an effective solution (even allowing for recent changes in management), and that more fundamental changes to the ownership, regulatory and governance arrangements may need to be considered.

Apart from strongly recommending the establishment of an expert adjudication panel, to be called on as and when required, our own recommendations would be to:

- Explore with Jersey the possibility of establishing a joint resource to better fulfil the shareholder role in relation to maintaining pressure on enterprise managements in relation to financial performance.

- Move to the suggested adjudicative style of regulation. In this context, we note again the similarity between the regulatory pricing arrangements and a long-term electricity supply contract, with suitable indexation provisions; and from this draw the conclusion that, with a well crafted initial pricing formula, price assessment exercises may only be required on a rather infrequent basis. We also note that such arrangements would represent a move toward the Jersey arrangement, and might provide a basis for eventual harmonisation of the two regulatory regimes (i.e. Jersey might converge on the new Guernsey system).

- Finally, we suggest that the States give serious consideration to the adoption of a formal energy policy to provide a clear and stable framework within which regulatory policy can be expected to operate. As noted, the instability caused by potentially significant changes in policy preferences has the potential to undermine independent regulation, and have a negative effect on the effectiveness of regulation going forward.

8. Summary of findings and recommendations

The States of Guernsey have followed an international trend by introducing an independent regulatory regime to oversee the operations of newly privatised and commercialised utilities. However, there are a number of contextual factors that potentially differentiate it from experience elsewhere. Among the most important of these are: the small scale of the relevant markets; Guernsey's structure of government; the approach to corporate governance for the commercialised utilities; and the States' 'save to spend' policy.

We considered the impact of the small scale of the economy on the prospects for an independent regulatory regime and concluded that this should not necessarily, in and of itself, imply that independent regulator is necessarily disproportionate. However, we also concluded that because of the small scale of the economy, it was of considerable importance that the regulator adopt a style that was proportionate – what we termed doing a 'limited number of biggish things well', but which might alternatively be called an approach based on 'limited regulation'.

This brought us to questions of competition and monopoly, which relate directly to the objectives of the regulatory regime. Contrary to the view put to us by some parties, we concluded that the scope for competition on the Island – and in the regulated sectors, including electricity – is greater than is generally assumed. Recognising that, given Guernsey's size, the intensity of competition may not be as vigorous as in larger economies, the possibility of challenge through competitive entry can nevertheless still be a powerful inducement in many sectors and industries (including the regulated sectors).

All of this suggested that, in principle, a framework based around an independent regulator who adopted a proportionate and limited regulatory approach, and who provided for the possibility of competition where competition was feasible, should be able to ensure that the benefits of regulation exceed the costs.

In practice, however, while it appears that regulation has been relatively effective in the telecoms sector (which suggests on-going role for the OUR) it does not appear to have had as much success in the postal and electricity sectors. There are a number of possible reasons for this:

- Both post and electricity are commercialised but remain in full States ownership. This type of structure tends, on average, to dull the managerial incentives for improving performance over time; and it requires a very activist shareholder or activist shareholder representative, focused on financial matters, to counteract this. In Guernsey, it is, in our view, unrealistic to expect T&R to fulfil such a role. In addition, there is a serious design issue associated with the application of the standard price-cap regulation approach to the commercialised entities. In particular, it is not immediately obvious that fixing prices will create the same desirable incentives for cost reduction in commercialised entities as it does in private companies.

- Although we heard many conflicting views about the OUR's conduct in implementing the regulatory framework, which we are not in a position to assess on a point by point basis, we noted some similarities across sectors in a few of the comments made. These included concerns about: the OUR's lack of forward agenda, particularly the absence of forward work plans; that the OUR's use of external consultants was problematic, and that the consultants did not take adequate account of the specific Guernsey context; that there was an over-reliance on detailed models, which imposed a disproportionate burden on companies to produce information which 'fitted the model'; and that the style of some OUR staff was, at times, unnecessarily adversarial and dogmatic.

- At the same time, however, it was put to us that the scope of the OUR's activities has broadened in the postal and electricity sectors because of an effective failure of other aspects of governance and oversight within the system of government on the island. Specifically, it was suggested that there was a 'gap' left by the failure of other bodies and institutional arrangements to oversee the operations of the commercialised entities, and that, as a consequence, the OUR represented the only form of external challenge to the management of the commercialised entities.

These points have led us to our recommendations for the future of Guernsey's utility regulatory regime, which encompass both general, structural recommendations for the design of the regulatory and institutional framework, and more specific recommendations for each of the sectors examined.

8.1 Sector Specific Recommendations

- The regulatory regime in telecoms appears to have generally 'worked', and to have been effective in allowing for new entry, and in creating a general environment of trust and professionalism (sees section 5). Given this, our recommendations are that the current regulatory structure be maintained, and the approach be tilted towards the gradual withdrawal of formal price controls as competition develops (which we believe is the current OUR approach). The primary aim of the regulatory framework in this sector should be keeping entry open to new competitors, which is of particular importance given the rate of innovation and technological change in the sector. We consider there to be considerable merit in proposals to allow for greater harmonisation with the regulatory framework in Jersey, and that this issue should be explored further.

  A consequence of these points is that we continue to see an on-going and important role for the OUR in the telecoms sector, which implies that the OUR's on-going role in regulating postal services and in electricity should be considered on an incremental basis.

- In post, the regulatory system has not, in our view, performed effectively, and we conjecture that this is the result of a combination of factors including the application of the standard price control approach, the weaknesses of the broader governance and oversight arrangements, and the absence of any second-opinion review panel which could deal with issues as and when they arise (see section 6). We discuss our recommendations to address these issues in detail below. However, our major recommendation in post is that issues surrounding the USO be addressed as a priority. This will likely make feasible the deregulation of GP's prices.

- Electricity has proven the most difficult case for us to assess in terms of the impacts of the regulatory regime, and in proposing practical alternative ways forward (see section 7). Our assessment is that recent episodes indicate that the regulatory arrangements have failed in some key respects. Again, we consider that an appropriately designed and constituted adjudicatory panel might have been able to deal with these issues swiftly and decisively, and we repeat our recommendation that such a panel be established. However, there are deeper issues in electricity relating to the ownership and governance arrangements. We suspect that the

approach of sticking with the current model, and focussing on how to get it to operate more effectively, may not resolve the underlying problems associated with the regulatory/institutional framework. More radical changes may be necessary. In this respect, we canvassed a number of possibilities including: the full or partial privatisation of GE; a more active shareholder function; a shift toward a more 'U.S style' price control arrangement; and the possibility of 'deregulating' GE and moving toward a 'regulation by exception' arrangement. All of these proposals have merits, and there are benefits and drawbacks associated with each of them. That said, our own conclusion is that a more adjudicative, less activist, style of regulation, more closely in tune with approaches to the enforcement of competition law, is most likely to provide a good fit with the Guernsey system of government.

As a final comment on electricity, we suggest that the States give serious consideration to the adoption of a clear and stable formal energy policy in order to avoid the instability caused by potential changes in policy preferences, which has the potential to have a negative effect on the effectiveness of regulation going forward.

8.2 General Recommendations

- The States establish a mechanism for getting an authoritative second opinion on disputed matters. While there are many possibilities, our preferred approach would be to assemble an adjudication panel, to be called (and remunerated) on an 'as needed' basis, to adjudicate on disagreements between the regulated companies and the OUR. Allowing for an authoritative second opinion on disputed matters, can provide for a quick, relatively inexpensive and focused assessment of specific matters as and when they arise, and we are of the view that this could have been sufficient to avoid some of most costly disputes that have arisen in the postal and electricity sectors in recent years.

- There is a pressing need to consider again the suitability of the current governance arrangements for the commercialised utilities, particularly the role of the non-executive directors and T&R as shareholder. There are various possibilities here including partial or full privatisation, or the transfer of the shareholder function from T&R to another department. One option that we consider has merit and should be explored further is the creation a 'shareholder resource' within the Treasury department, preferably in cooperation with Jersey, responsible for engaging with the

utilities on financial matters and holding them to account in terms of its performance against its plans and shareholder objectives.

- A question that recurred throughout many of our meetings was; *who is overseeing the regulator?* A comment expressed by a number of parties we spoke to was that, while they did not necessarily think that the OUR was doing a poor job, they were concerned that there was not a formal institutional mechanism or process through which they could pose questions to the OUR, or gain a better understanding of its general approach to implementing its objectives. Some respondents suggested that, as a result of this, the media, and OUR press releases, had become the main forum for understanding, and forming an opinion, about the regulatory system.

  In other jurisdictions there are numerous ways in which a regulatory authority is called to account for its actions, including through appeals of specific decisions; but also through regular and periodic questioning by members of parliament under the select committee process. While there is a formal appeals process in Guernsey to the Royal Court, it is clearly considered a 'nuclear option' by many parties, and therefore does not appear to represent an effective constraint on the regulator's behaviour. Similarly, while we understand that the OUR is under the auspices of C&E, it is unclear the extent to which this mechanism can be expected to provide any formal oversight of its activities and decisions. Accordingly, a further general recommendation is that thought be given to possible ways, and forums in which, the OUR might be called to publicly account for its activities on a regular basis.

- Finally, we are strongly supportive of the introduction of competition law in Guernsey, provided only that care is taken to adjust 'standard' thresholds relating to market shares towards the realities of competition in a small market. Competition law enforcement is, at its best, more adjudicative in style than it is 'activist', and it tends to rest more on *ex post* than on *ex ante* assessments. Given that our recommendations point toward a less activist, and more *ex post* style of regulation, and hence to a form of regulation that is, in fact, much closer to competition law enforcement, we are of the view that our recommendations should assist in the harmonisation of regulatory and competition policies. Further, since Jersey relies chiefly on a competition law approach, the recommendations should assist with any future policy harmonisation between the Islands.

List of abbreviations

AAP	Aviation Appeals Panel (Ireland)
C&E	Commerce and Employment Department
CER	Commission for Energy Regulation (Ireland)
Comreg	Commission for Communications Regulation (Ireland)
CWG	Cable & Wireless Guernsey
EDF	Électricité de France
EU	European Union
GE	Guernsey Electricity
GP	Guernsey Post
JCRA	Jersey Competition and Regulation Authority
LNBTW	The 'limited number of biggish things well' test/criterion
NAO	National Audit Office
OECD	Organisation for Economic Co-operation and Development
OFGEM	Office of Gas and Electricity Markets
OFCOM	Office of Communications
OUR	Office of Utility Regulation
POSTCOMM	Postal Services Commission
T&R	Treasury and Resources Department
UAT	Utility Appeals Tribunal
UK	The United Kingdom of Great Britain and Northern Ireland
USO	Universal Service Obligation