

National Audit Office

Review of Commercialisation and Regulation in the States of Guernsey

REPORT BY THE NATIONAL AUDIT OFFICE | September 2005



National Audit Office

Review of Commercialisation and Regulation in the States of Guernsey

CONTENTS

PREFACE	2
EXECUTIVE SUMMARY	4
PART 1	
Telecoms	14
The objectives of commercialisation for telecoms are being or have been achieved	15
Regulation of telecoms is essential but the cost could be reduced	18
Evaluation	21
PART 2	
Post	22
The objectives of commercialisation for post are achievable but have yet to be achieved	24
Regulation is necessary to protect consumer interests although it has been costly to date	29
There are alternative models for commercialisation of post but none offers significant advantages over the model adopted in Guernsey	31
Evaluation	33

This review was undertaken by Richard Eales, Ed Humpherson, Charles Nancarrow, Simon Reason and Kevin Browne.

For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

© National Audit Office 2005

PART 3**Electricity** 34

The objectives of commercialisation for electricity are achievable and some have been achieved 36

The practical application of the commercialisation model needs to be improved 38

Regulation is necessary to protect consumer interests but has caused friction with Guernsey Electricity and has been costly 42

There are alternative models for commercialisation of electricity but none offers significant advantages over the model adopted in Guernsey 45

Evaluation 47

PART 4**The Office of Utility Regulation** 48

The accountability arrangements for the OUR need to be strengthened 50

Succession planning needs to be developed 50

A more risk-based approach would reduce the regulatory burden and cost 51

The appeals process has proved to be very costly so far and is under review 52

There are alternative models that could be adopted for regulation in Guernsey 54

APPENDICES

1 Terms of Reference 56

2 NAO Methodology 58

3 Principles for the States as Shareholder 60

3a States Guidance in exercising on behalf of the States the Role of Shareholder of Guernsey Post Limited 63

3b States Guidance in exercising on behalf of the States the Role of Shareholder of Guernsey Electricity Limited 64

4 The Commercialisation context in Guernsey 65

5 Public perception of Commercialisation and Regulation in Guernsey 69

6a Telecoms Case Study 72

6b Post Case Study 74

6c Electricity Case Study 76

7 Price Comparisons 77

PREFACE

Commercialisation and Regulation: Evaluating the Risks¹

1 From the 1970s onwards, OECD states, developing economies and economies in transition have sought to amend the structures through which utility services are delivered to the public. These principles are directly relevant to the States of Guernsey as a fully developed economy. The classic model up until that point had been state ownership and control of utility businesses, accompanied by strong political direction and oversight. Since then, many states have sought to increase management discretion and reduce political intervention, sharpen incentives on the businesses to deliver financial and quality of service objectives, and thereby increase the efficiency, profitability and consumer focus of the businesses. Taken together, these developments are known as commercialisation.

2 Commercialising utility businesses has generally been considered successful in delivering the benefits expected of it, including higher quality management, increased efficiency and higher profitability. Management is key to the delivery of these benefits. Commercialisation is more likely to be successful where: management is commercially-experienced and incentivised; it is given clear strategic guidance from its shareholders as to what it should deliver; and it has a clear mandate of operational freedom to run the business.

3 But commercialisation has also brought risks, particularly to the end consumers of utility services.

4 These risks derive from the dominant economic position most utility businesses retain in their national markets. Telecommunications, post and electricity businesses hold positions of dominance because of their historical background as public sector monopolies, and because of the inherent economics of the underlying operation, which tend towards natural monopoly. Natural monopoly arises because of the economies of scale involved in operating a national electricity, post or telecommunications network, which mean that it would be uneconomic for new entrants to invest in a separate, competing network.

5 With a dominant position, commercialised utilities could achieve the objective of increased profitability not by using their newfound commercial freedom to strive for increased efficiency, but by increasing prices or cutting quality of service. In other words, freed from the moderating influence of direct political control, dominant businesses could exploit consumers.

6 The standard approach across the OECD to mitigate this risk is the creation of a strong regulatory framework. The newly commercialised entity – whether in private hands or not – is provided with a licence which includes quality of service standards, controls over prices and clauses concerning good corporate behaviour. For this reason, commercialisation is usually accompanied by regulation.

¹ Source: National Audit Office

7 Enforcement of this framework is often entrusted to an independent regulatory agency (called a National Regulatory Agency in European Union directives). The rationale for an independent regulatory agency is twofold:

- An independent agency can become a centre of expertise in the legal and economic issues of regulation.
- An independent agency can provide a bulwark against political intervention that might reduce the commercial freedom of the commercialised business. The independent agency can provide certainty, which is particularly important where a business has been sold to private investors who want to be reasonably confident that they will earn a return on their investment. This is also important where investment in future security of supply is an issue.

8 But regulation itself entails risks:

- Regulators can be captured – that is, their independence can be compromised by their closeness to the regulated business.
- Regulators suffer from an asymmetry of information – they can never know as much about the regulated business as the management itself. This can mean that the regulation is too soft: prices are set at too high a level, or quality of service targets are too easy to reach.
- Regulators seek to confront the asymmetry of information by asking for the regulated company to provide a wide range of data on the regulated business. But this can lead to a disproportionate regulatory burden, and may lead to excessive and costly information requests as the regulator is sucked into examining ever more fine levels of detail.
- By contrast to capture, the regulator can be drawn into a series of highly adversarial stand-offs with the regulated company from which neither has much to gain in the longer run.

9 This analysis of the background to commercialisation and regulation generates a high-level series of criteria against which we have evaluated the Guernsey experience (Figure 1). These criteria focus on the institutional frameworks as well as the outcomes.

1 Criteria for evaluating Commercialisation and Regulation in Guernsey

Commercialisation

- The quality of the management
- Clarity of shareholder expectation
- Operational freedom

Leading to:

- Improved commercial performance, including:
 - increased efficiency
 - enhanced profitability

Regulation

- Independence and absence of capture
- Only limited problems of information asymmetry
- Proportional information requests
- Avoiding an excessively adversarial relationship

Leading to:

- Improved consumer outcomes:
 - lower prices
 - quality of service improved
 - long-term security of supply

Source: National Audit Office

EXECUTIVE SUMMARY



1 Between October 2001 and February 2002, the States of Guernsey transferred responsibility for the provision of post, electricity and telecoms services from the existing political bodies to States Trading Companies. This was achieved through a process of commercialisation that also involved the introduction of independent statutory regulation. The States Trading Company providing telecoms services was subsequently privatised.

2 The key players in the commercialisation and regulation model adopted in Guernsey are shown in **Figure 2**.

3 Following concern by some States Members and others about how well these arrangements were working, the Treasury & Resources and Commerce & Employment Departments undertook to review the outcomes of the commercialisation process and report back to the States. The National Audit Office (NAO) was commissioned to undertake the review. The detailed terms of reference for the review are at Appendix 1. The methodology adopted by the NAO is at Appendix 2.

Overall conclusions

4 The NAO review concluded that:

- **The States of Guernsey has adopted an appropriate model to meet the objectives of commercialisation in the three industries examined. The objectives of commercialisation can be achieved if the model is operated properly.**
- **However, in post and electricity improvements need to be made to the operation of the model. In particular, greater clarity is needed in the respective roles of shareholder, policy maker and operational management.**

- **Regulation has facilitated the benefits of commercialisation and is essential in all three industries, but it has come at a high cost. There are various ways in which the regulatory burden could be reduced.**

5 The review considered in detail the objectives for commercialisation in three of Guernsey's utilities – telecoms, post, and electricity. This covered an assessment of whether the objectives of commercialisation have been achieved and if not, the extent to which this is due to either failures in policy or the discharge of duties of either the States, the regulator, or the management of the companies. Detailed findings in respect of each utility and the regulator are in the main body of the report. We have distilled the findings for each of the key functions of commercialisation and regulation into **Figure 3**.

6 The review has also considered alternatives to the commercialisation and regulation model adopted in Guernsey. Given the current political and business climate, we consider that none of the alternatives offers a better solution.

7 We observe that neither Guernsey Electricity nor Guernsey Post are indebted. In most companies operating in equivalent business sectors there is a level of debt on the balance sheet. The benefits of debt can include: a greater flexibility in long term planning; removing some of the burden of scrutiny from the regulator, thereby reducing the cost of regulation; and, reducing the weighted average cost of capital. There are, however, risks associated with taking on debt which include: the risk of default; changes in interest rates; and, the inclusion of restrictive debt covenants. We consider these points further in the main body of the report.

8 Detailed findings for each of the three utilities examined and for the OUR are given below and in the main parts of the report.

2 Commercialisation and Regulation in Guernsey – Key Players

States of Deliberation	Determines legal framework and strategic policies for the utilities, regulation and the shareholder role.
Commerce & Employment Department	Puts proposals to the States for the appointment of the Director General and any changes to the Regulation Law and direction to the Office of Utility Regulation.
Treasury & Resources Department	Acts as shareholder of Guernsey Electricity and Guernsey Post on behalf of the States and puts proposals to the States for guidance in that role and the appointment of non-executive directors.
Office of Utility Regulation (OUR)	The regulatory agency in Guernsey for the three utility sectors of telecommunications, post and electricity.
Guernsey Electricity Ltd	A limited liability company wholly owned by the States of Guernsey. The company is the sole provider of electrical energy to Guernsey. Its core businesses of electricity generation, conveyance and supply are regulated by the OUR.
Guernsey Post Ltd	A limited liability company wholly owned by the States of Guernsey. The company provides postal services to the Bailiwick of Guernsey and is also responsible for producing stamps for the Island. It is licensed and regulated by the OUR.
Cable & Wireless Guernsey	A wholly owned subsidiary of the Cable and Wireless Group. The company provides a range of telecommunications services for business and residential customers in Guernsey and is regulated by the OUR.

3 Findings of the report for each key function of commercialisation and regulation

Strategic direction of utilities

The strategic direction of the three utilities is as to be expected. The key strategy in electricity is security of supply; in post it is the universal service obligation, and in telecoms it is the development of competitive networks.

Strategic direction of regulation

Our examination found that the strategic direction of regulation is effective and should be continued in its current form. However, it has come at high cost and as regulation matures in Guernsey there is scope to move the regulator towards a more risk based approach and to lighter touch regulation. There is evidence that this is beginning to happen. The ultimate goal of any regulatory regime is that the regulator creates such an effective market that it may ultimately withdraw from regulation.

The shareholder role

The recent appointment by the Treasury and Resources Department of two of its members as “observers” on the Board of Directors of Guernsey Post Limited has blurred responsibilities for “social” aspects of the company’s activities. Since the regulator is charged with protecting consumers in the long term it is not efficient to have the shareholder duplicating this responsibility. The shareholder should focus on commercial issues and the regulator should deal with consumer issues.

The management of the companies

Commercialisation has brought about improvements in the management of all three companies, and new management teams have been introduced in both the telecoms and post sectors with external commercial expertise.

The implementation of regulation

An effective regulatory regime has been put in place, although the cost is high, at least partly due to the lack of opportunities for economies of scale on Guernsey. The development of the regulatory regime is in its early stages when compared to more settled regulatory environments such as in the UK. There will be a difference in the costs of a more stable regulatory environment compared with one which is still in the initial phase resulting from the utilities putting in place systems to produce regulatory information and from the regulator being able to move towards lighter touch regulation. A timely and cost effective appeals tribunal process is an integral part of regulation and we note that this is subject to a separate review.

Telecoms (Part One of the Report)

9 Our main conclusion is that the commercialisation and regulation model adopted in telecoms is the correct one; benefits have been gained for consumers, but regulation has been costly. In particular we found that:

- The objectives of commercialisation for telecoms are being or have been achieved.
- Regulation of telecoms is essential but the cost could be reduced.

10 The primary aim of commercialisation was to exploit telecoms services in order to grow existing businesses and attract new internet-related businesses. The objectives were:

- to remove state control from the incumbent telecommunications company, allowing more flexible working practices and greater investment;
- to attract the expertise of a world class service provider;
- to improve the Island's infrastructure; and
- to improve the Island's e-commerce offering.

Furthermore, each of these objectives was to be achieved whilst maintaining a Universal Service.

11 These objectives have been, or are being, achieved. The incumbent telecommunications company was removed from States control in May 2002, and the sale of Guernsey Telecom brought in the expertise of Cable & Wireless, a world class service provider. The sale has allowed more flexible working practices and the potential for greater investment. The contract for the sale to Cable and Wireless included a requirement to improve the Island's e-commerce offering. There has been an improvement in the Island's infrastructure, although it is not clear how much of this improvement is a result of commercialisation. It is too early to tell whether local business has fully exploited these new communications products, but the initial signs are positive.

12 Once States control of telecommunications passed to Cable and Wireless it was important to put in place an independent regulator to ensure that competition could develop and that the new operator would not abuse its dominant position. Regulation of the telecoms service in Guernsey is essential and has brought benefits to consumers. For example, charges for broadband, exchange line rental reconnections, leased lines and calls to the UK and Jersey, have all been reduced as a result of intervention by the Office of Utility Regulation.

13 However, regulation of telecoms has also proved costly to date. The annual cost of the Cable and Wireless's licence has recently been increased from £350,000 to £600,000. Given the size of the market, the Office of Utility Regulation will not possess the economies of scale available to regulators in other countries. Nevertheless, a more risk-based approach by the regulator would reduce the costs of regulation.

Recommendations on Telecoms

A The objectives of commercialisation have been or are being achieved for telecoms. We do not believe that any significant changes are needed to the commercialisation model as far as telecoms is concerned.

B There is a continued and ongoing need for a regulator of telecoms in Guernsey. Regulation has been an essential element of commercialisation and has brought benefits to consumers.

C Regulation of telecoms in Guernsey is costly. A substantial element of this cost is inevitable because of the limited economies of scale in a small island economy. However, the Office of Utility Regulation should seek to reduce the cost by taking a more risk-based approach to its work and concentrating its regulatory efforts on measures that will bring the greatest benefit to Guernsey consumers and businesses over the longer term.

Post (Part Two of the Report)

14 Our main conclusion is that the principle of commercialisation and regulation is sound for post; regulation has brought benefits, but there has been a lack of clarity on stakeholder objectives, roles and responsibilities. The situation has improved as the commercial and regulatory framework has matured. In particular we found that:

- The objectives of commercialisation for post are achievable but have yet to be achieved.
- Regulation is necessary to protect consumer interests although it has been costly to date.
- There are alternative models for commercialisation of post but none offers significant advantages over the model adopted in Guernsey.

15 The primary aim of commercialisation for Post was to free it from the constraints of public sector controls and what was perceived as political interference, thereby allowing it to provide an ‘updated modern framework’ for Post. The principal objectives were:

- to clarify and separate the roles of owner, regulator, and operator;
- to put the postal operator in the best position to respond to technological changes;
- to give the postal operator in Guernsey the commercial freedom for flexible working practices and to allow investment;
- to improve the quality of service of postal delivery.

16 The framework set up at commercialisation in 2001 has in principle separated out the respective roles of owner, regulator and operator. Guernsey Post Limited was created in October 2001 with a Board of Directors and corporate governance procedures and has responsibility for delivery at the operational level. The Treasury and Resources Department acts as the sole shareholder on behalf of the States. The Commerce and Employment Department is tasked with providing policy oversight and recommending strategic objectives to the States. The Office of Utility Regulation is in place to protect consumers and Guernsey’s sustainability through price control, target setting and monitoring. These arrangements separate the roles of operations, ownership, policy and regulation and in principle should allow clear and accountable decision making.

17 However, there have been some problems with the workings of the model. In practice the respective roles of owner and operator need further clarification. The Shareholder needs to make clear what it expects from Guernsey Post in terms of the objectives it wishes the company to achieve and the financial return it expects from the business. Political observers appointed to the Board need to have a clear mandate and Guernsey’s Post’s social obligations need to be more clearly articulated.

18 After some severe quality of service problems at Christmas 2002, both the Managing Director and the Chairman resigned. Since then, the performance of Guernsey Post has steadily improved. However, the public in Guernsey still have a poor perception of the commercialised postal service. This poor public perception is in large part due to the disruption at Christmas 2002 and recent rises in postal charges. Both problems have been blamed by many on commercialisation. However, the Christmas 2002 problems related to commitments entered into by the previous Board and in many ways demonstrate the weaknesses of the pre-commercialisation arrangements when these decisions were made. Much of the increase in prices has been due to Royal Mail substantially increasing its charges to Guernsey Post, a development that Guernsey Post had no control over and a separate issue from commercialisation.

19 Guernsey Post enjoys a dominant position in the Guernsey postal market. Regulation is therefore essential to prevent Guernsey Post from abusing this position and to provide the incentives for improved efficiency and quality of service that would normally exist in a competitive market. Our review has found that there have been several benefits from regulation of post in Guernsey, including improved quality of service and remedies for quality of service failures.

20 The cost of regulation has been high. The relationship between the Regulator and Guernsey Post has been adversarial at times but is improving.

21 We have considered a number of alternatives to the current commercialisation model for post, including a return to full States control, full privatisation and a merger of Guernsey Post with Jersey Post. Only a merger with Jersey offers any advantages over the current model but there would also be a number of risks and disadvantages of this option. We consider that there would be much to be gained by rebalancing the capital structure of Guernsey Post to include an element of corporate debt.

Recommendations on Post

A The objectives of commercialisation can be achieved for post and the commercialisation model adopted is sound if executed properly.

B The Treasury and Resources Department, acting as the Shareholder on behalf of the States, needs to set overall objectives for Guernsey Post. It also needs to make clear what sort of financial return it expects the business to achieve and must set a clear dividend policy for the company.

C The States of Guernsey should revise its guidance to the Treasury and Resources Department to ensure there is no ambiguity, and to address any new developments that may have occurred in the first few years of commercialisation.

D If the Treasury and Resources Department wishes to continue to appoint political observers to the Board of Guernsey Post, it should set out clearly the roles and responsibilities of such observers in line with good corporate governance. Without a clear exposition of roles and responsibilities there is a real danger that the Department will get drawn into the day to day management and commercial decisions of the company.

E The Universal Service obligation for postal services should be subject to review and a consultation process with the aim of clarifying the social obligations on the company's activities.

F There is a continuing need for a regulator of post in Guernsey. Regulation has been an essential element of commercialisation and has brought benefits to consumers.

G The OUR needs to ensure that its requirements are only those that are essential for the efficient operation of the regulatory regime and that no unnecessary additional information requirements or costs are imposed. The OUR should also make clear to Guernsey Post why demands are being made so as to increase the transparency of the process.

H The OUR should adopt a more risk-based approach to its regulation of Guernsey Post. It should only get deeply involved in matters which are fundamental to the well being of consumers and the Island as a whole. Other issues should be given a light touch. Such an approach could reduce further the cost of regulation.

I Merging Guernsey Post and Jersey Post would bring clear efficiency savings but there would also be a number of risks and drawbacks. Although a detailed examination of this option has been outside the scope of this review, we do believe that it is worth exploring further by the States.

J Consideration should be given to rebalancing the capital structure of Guernsey Post to include an element of corporate debt and for future investment to be financed from borrowing rather than the build up of cash reserves. These moves would bring the scrutiny and due diligence of a corporate lender to bear on Guernsey Post and give the company the flexibility to plan for future investment when it is most needed.

Electricity (Part Three of the Report)

22 Our main conclusion is that the principle of commercialisation and regulation is sound for electricity but there has been a lack of clarity on objectives, roles and responsibilities, and the cost of regulation has been higher than might be expected. In particular we found that.

- The objectives of commercialisation for electricity are achievable and some have been achieved.
- The practical application of the commercialisation model needs to be improved.
- Regulation is necessary to protect consumer interests but has caused friction with Guernsey Electricity and has been costly.
- There are alternative models for commercialisation of electricity but none offers significant advantages over the model adopted in Guernsey.

23 The primary aims of commercialisation for Electricity were to: free Guernsey Electricity from the constraints which prevented it from acting efficiently and effectively; and to separate clearly the roles of management, the shareholder and the regulator. The secondary objectives were:

- to ensure security, continuity and reliability of supply;
- to ensure that consumers receive supplies of the highest possible standard at the best possible price;
- to facilitate the economic development of the jurisdiction.

24 The framework set up at commercialisation has reduced the constraints on Guernsey Electricity and in principle has separated the roles of manager, shareholder and regulator. The reliability of supply has continued to improve whilst prices for electricity have not increased in the last 14 years.

25 Guernsey Electricity Limited was created in February 2002 with a Board of Directors and corporate governance procedures, which it was expected to follow. The States would still be involved, however. On the recommendation of the Commerce and Employment Department, the States sets policy and strategic objectives, which are communicated to the OUR. Guernsey Electricity is expected to deliver at the operational level. The Treasury and Resources Department operates as the single shareholder on behalf of the States. The States appointed regulator, the Office of Utility Regulation (OUR), aims to protect consumers and to ensure continuity of supply for Guernsey through price control,

target setting, and monitoring. These arrangements separate the roles of operations, policy, ownership and regulation and in principle should allow clear and accountable decision making.

26 There are, however, problems with the way the commercialisation model is working in electricity and its practical application needs to be improved:

- Misunderstandings about the respective roles of owner and operator have caused tension and need to be resolved.
- There is currently no energy strategy for the Island although this is to be addressed later in 2005.
- There is a lack of agreed clarity about the purpose of Guernsey Electricity's non-core activities.

27 The arrangements made between the Treasury & Resources Department and Guernsey Electricity for operating the commercialisation model in practice lack some clarity. There is insufficient common understanding between the parties as to how their respective responsibilities should be discharged. The Treasury & Resources Department as Shareholder needs to make clearer what it expects from Guernsey Electricity in terms of the objectives it wishes the company to achieve and the financial return it expects from the business. The Shareholder also needs to give Guernsey Electricity the operational freedom to deliver the agreed objectives for the business.

28 Guernsey Electricity enjoys a dominant position in the Guernsey electricity market. In the absence of full competition there is little external pressure to increase efficiency or improve quality of service. Regulation is necessary to prevent Guernsey Electricity from abusing its dominant position and to provide the incentives for improved efficiency and quality of service that would normally exist in a competitive market.

29 However, there have been a number of problems with the way the regulatory regime for electricity has operated in practice. Excessive demands for information have led to an adversarial relationship between the OUR and Guernsey Electricity. Regulation has been costly and the poor relationship between the parties has added to the costs.

30 Over the longer term, there are some difficult issues to confront, including the potential for increased electricity charges from Electricite de France (EdF), the perceived need for more environmentally friendly forms of generation on Guernsey itself, and the relationship between Guernsey Electricity and Jersey Electricity. Dealing with these issues

will not be straightforward and all parties need to work together in a clear, open and cooperative manner if the Island's objectives are to be achieved.

31 We have considered a number of alternatives to the current commercialisation model for electricity, including a return to full States control, full privatisation and a merger of Guernsey Electricity with Jersey Electricity. Only a merger with Jersey offers any advantages over the current model but there would also be a number of risks and disadvantages of this option. We consider that there would be much to be gained by rebalancing the capital structure of Guernsey Electricity to include an element of corporate debt.

Recommendations on Electricity

A The commercialisation model adopted for electricity should remain in place and is sound if executed properly. The objectives of commercialisation can thereby be achieved for electricity.

B The States of Guernsey should review its guidance to the Treasury & Resources Department to ensure that there is no overlap or ambiguity, and to address any new developments that may have occurred in the first few years of commercialisation.

C The Treasury and Resources Department, acting as the Shareholder on behalf of the States, needs to set overall objectives for Guernsey Electricity. It also needs to make clear what sort of financial return it expects the business to achieve and must set a clear dividend policy for the company.

D The Treasury and Resources Department needs to make clear to Guernsey Electricity what information it expects from the company to enable it to fulfil its monitoring role as shareholder. It should also agree with the company the sorts of circumstances in which it would wish to be involved in strategic decisions.

E The importance of energy to the economy and the long term issues involved mean that the States has a key role to play in formulating a clear energy strategy for the Island. An agreed energy strategy would reduce business uncertainty for Guernsey Electricity and allow better planning of future needs and revenues. It would also give Guernsey Electricity and the OUR a clear framework against which to make their own operational decisions.

F There should remain in place clear accounting separation between core and non-core activities. Guernsey Electricity should seek guidance from the shareholder as to which activities it should participate in.

G There is a continuing need for a regulator of electricity in Guernsey. Regulation is an essential element of commercialisation.

H The OUR needs to ensure that its requirements are only those that are essential for the efficient operation of the regulatory regime and that no unnecessary additional information requirements or costs are imposed.

I The OUR should seek at all times to act in accordance with the principles of Better Regulation. It should apply flexibility to ensure that the requirements are appropriate and proportionate to Guernsey's needs and size. The OUR should also make clear to Guernsey Electricity why demands are being made so as to increase the transparency of the process.

J The OUR should adopt a more risk-based approach to its regulation of Guernsey Electricity. It should only get deeply involved in matters which are fundamental to the well being of consumers and the Island as a whole. Other issues should be given a light touch. Such an approach would reduce the cost of regulation and could be the foundation of a less confrontational relationship in future.

K The OUR and Guernsey Electricity should take immediate steps to improve their working relationship. A clear, open dialogue and cooperative relationship would help each party to understand the other's needs and concerns. The current adversarial relationship is not acceptable and can only be of detriment to consumers. The OUR should work with Guernsey Electricity to seek to reduce the regulatory burden on the company. Guernsey Electricity should respond positively by accepting the need for regulation and appreciating the different roles that the shareholder and regulator undertake.

L Merging Guernsey Electricity and Jersey Electricity would bring clear efficiency savings but there would also be a number of risks and drawbacks. Although a detailed examination of this option has been outside the scope of this review, we do believe that this and other potential merger options are worth exploring further by the States.

M Consideration should be given to rebalancing the capital structure of Guernsey Electricity to include an element of corporate debt and for future investment to be financed from borrowing rather than the build up of cash reserves. These moves would bring the scrutiny and due diligence of a corporate lender to bear on Guernsey Electricity and give the company the flexibility to plan for future investment when it is most needed.

The Office of Utility Regulation (Part Four of the Report)

32 As noted above, the Office of Utility Regulation (OUR) has had some considerable successes but regulation has been costly and the regulatory burden could be reduced. We found that:

- The accountability arrangements for the OUR need to be strengthened.
- Succession planning needs to be developed.
- A more risk-based approach would reduce the regulatory burden and cost.
- The appeals process has proved to be very costly so far and is under review.
- There are alternative models that could be adopted for regulation in Guernsey but none are superior to the regulation model currently adopted.

33 Neither the States Internal Audit nor representatives of the States Public Accounts Committee have rights of access to the books and records of the OUR to ensure that the OUR has proper systems of internal control and corporate governance and is operating with due regard to value for money. This is a significant omission and its correction is particularly pressing in view of the widespread concern about the cost and methods of operation of the OUR.

34 With an office of the size of the OUR, there is a risk that with the departure of any member of staff, and the difficulty of recruiting suitable replacements, the Office may not be able to fulfil its functions. It is therefore important to have in place contingency plans for this eventuality. Contingency plans could include making arrangements to draw on the resources of an overseas regulator, to contract out much of the work normally undertaken by the secretariat, or to instigate one of the alternative models for regulation, such as self regulation by the industry.

35 A more risk-based approach by the OUR could reduce the regulatory burden and hence the cost of regulation. Under a risk-based approach, the regulator would explicitly assess the risks to consumers and commit to adopting a different regulatory approach depending on the level of risk. At the margin, the regulator would adopt a proactive position on very high risk issues and not intervene in issues with a very low risk.

36 Cable and Wireless and Guernsey Post have both appealed to the Utility Appeals Tribunal. The Cable and Wireless appeal was costly and time consuming. Given the limited resources of the OUR and the potential impact on consumers of an expensive tribunal case in the form of higher charges it is important that an appeals process should be in place which is efficient in terms of the time and cost of resolving disputes. The operation of the appeals process is currently under review by the Commerce and Employment Department.

37 There are other models for utility regulation, which have some significant attractions. Alternative models include a consumer watchdog approach; a secretariat model where the Director General is replaced by a Board or Commission; and a self-regulatory model, where the regulatory function is performed by the industry itself through codes of practice. These different models could to varying degrees reduce the costs of the regulator and the costs of regulation on business. But there are also some risks inherent in these different approaches and, in terms of the OUR's current remit, we do not believe they are superior to the regulation model currently adopted.

Recommendations on the Office of Utility Regulation

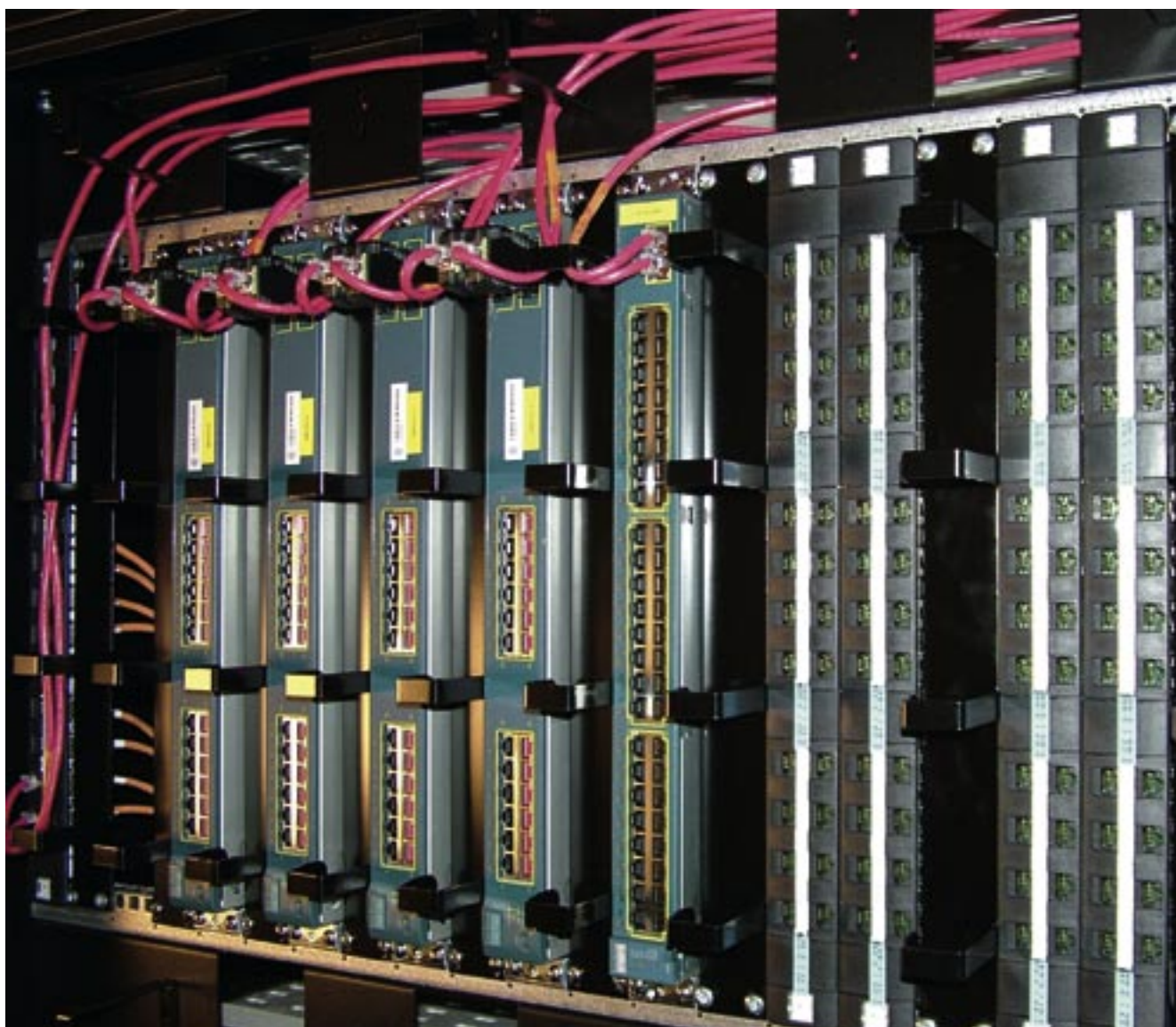
A The States Internal Audit and representatives of the States Public Accounts Committee should have automatic rights of access to the books and records of the OUR. This would ensure that there is proper and independent oversight of the operations of the OUR in line with best practice elsewhere.

B Contingency plans need to be drawn up to enable regulation to continue to operate in the event that staff numbers at the OUR fall below the minimum necessary for it to carry out its statutory functions.

C Given the importance of the appeals mechanism as an integral part of the commercialisation and regulatory framework, the results of the review by the Commerce & Employment Department need to be dealt with alongside the other recommendations in this report.

PART ONE

Telecoms



1.1 Until 30 September 2001, telecoms services in Guernsey were provided by the former States Telecommunications Board. Commercialisation of telecoms took place on 1 October 2001 when the undertaking of the Board was transferred and vested in Guernsey Telecoms Ltd. Guernsey Telecoms Ltd was wholly owned by the States of Guernsey and subsequently sold to Cable & Wireless PLC in May 2002.

1.2 Cable & Wireless Guernsey provides a range of telecommunications services for business and residential customers, including voice and data, mobile and internet solutions. Cable & Wireless Guernsey is a wholly owned subsidiary of the Cable and Wireless Group, an international telecommunications company.

1.3 Cable & Wireless Guernsey is licensed and regulated by the Office of Utility Regulation (OUR). Cable & Wireless Guernsey is not obliged to publish a full set of accounts, but is required by the OUR to publish regulatory accounts for the purposes of regulation within the Bailiwick of Guernsey.

1.4 This Part of the Report examines how well the commercialisation and regulation model is working in telecoms. **Our main conclusion is that the commercialisation and regulation model adopted in telecoms is the correct one; benefits have been gained for consumers, but regulation has been costly.** In particular we found that:

- The objectives of commercialisation for telecoms are being or have been achieved.
- Regulation of telecoms is essential but the cost could be reduced.

The objectives of commercialisation for telecoms are being or have been achieved

1.5 The primary aim of the commercialisation of telecoms in Guernsey was to place the Bailiwick in the strongest possible position to exploit telecoms services. This would enable existing businesses, including those in the financial services sector, to grow and would help to attract new internet-related business.

1.6 The objectives for the commercialisation and subsequent privatisation of Guernsey Telecoms Ltd were:

- to remove state control from the incumbent telecommunications company, allowing more flexible working practices and greater investment;
- to attract the expertise of a world class service provider;
- to improve the Island's infrastructure;
- to improve the Island's e-commerce offering.

Furthermore, each of these objectives was to be achieved whilst maintaining a Universal Service.

It is too early to tell whether local business has fully exploited telecoms services, but initial signs are positive

1.7 The commercialisation of the telecommunications market has brought about several changes. Cable and Wireless is now the incumbent operator, having purchased Guernsey Telecoms Ltd. There are currently seven other licensees offering telecommunications services as defined by the Office of Utility Regulation. The two largest of these companies, Newtel and Wave, can be seen as direct competitors to some parts of Cable and Wireless's business. Newtel operates leased lines, private circuits and acts as an internet service provider. Wave operates 2G and 3G mobile telephone networks. These new entrants have created competition in the market.

1.8 During our fieldwork we identified several organisations that felt they had benefited from a competitive telecommunications market. There is a choice of provider for many services and, as one would expect, it is the obligation of the new entrant to promote its services. We have seen several examples of businesses switching away from Cable and Wireless to either Newtel or Wave. It is too early to gauge whether this competition, either as an alternative or as an incentive to Cable and Wireless, will have a material effect on the growth of existing businesses, or increase internet-related business.

Fieldwork Comment

"We are still going through a transition phase and therefore have not yet achieved the result we are looking for. It will probably take five years to achieve the necessary culture changes." – focus group

The incumbent telecommunications company has been removed from States control, allowing more flexible working practices and the potential for greater investment

1.9 Prior to commercialisation, telecoms, post and electricity services in Guernsey were provided by States Trading Boards. The Trading Boards were intended to be self financing, with charges levied for the services provided, and a monopoly of service provision. The Trading Boards were subject to States resolutions in respect of staffing, land and assets and operated under the same constraints as the civil service. There was a lack of efficiency incentives, and States control constrained management decisions. For example, States control of staffing levels and wages meant there was great difficulty in ensuring that staff numbers and remuneration were appropriate to the optimum level of service provision. Commercialisation was intended to remove the barriers to greater efficiency, flexibility, investment and quality of service.

1.10 Commercialisation aimed to free the States Trading Boards from these constraints and from overt political interference whilst ensuring that there was sufficient control to protect the interests of consumers and the sustainability of Guernsey. In creating Guernsey Telecoms Ltd and then selling it as a going concern, the States allowed Cable and Wireless to operate without the constraints placed on the Trading Boards.

1.11 Cable and Wireless purchased Guernsey Telecoms Ltd as a going concern for a consideration of £30 million (**Figure 4**). Some £6.2 million of property was, in effect, transferred from Guernsey Telecoms Ltd back to the States before the sale and then leased back to Cable and Wireless, leaving a total cash payment of £23.8 million. Guernsey Telecoms Ltd had a cash balance of £12 million and total assets valued at £49 million. Some commentators have suggested that the price paid by Cable and Wireless was affected by a number of factors, leading to a reduction in the price that bidders were willing to pay for Guernsey Telecoms. These are understood to include: pension liabilities; the length of exclusivity periods during which the newly privatised entity would have time to prepare for competition; the exact nature of the telecommunications regulatory regime; and the state of the telecoms market following the dot com crash.

4 Purchase of Guernsey Telecoms Ltd by Cable & Wireless

Total offer	£30.0m
Of which, value of properties	£6.2m
Total cash payment	£23.8m
Made up of:	
Payment on sale	£13.8m
Payment deferred 12 months	£5.0m
Payment deferred 24 months	£5.0m
Capital expenditure	
Total planned by Cable & Wireless to end of 2004 (of which £20.0m was in Guernsey Telecoms' business plan)	£26.0m
Of which contractual commitment to e-commerce	£5.2m

1.12 There is some concern amongst stakeholders that Guernsey Telecoms was sold too cheaply. However, the NAO is not in a position to express an opinion on the value of this transaction; it is outside the scope of our review.

1.13 Some consideration was given at the time of the sale to the possibility of the States maintaining a minority shareholding to protect its strategic telecoms interests on the Island. However, Cable and Wireless was not prepared to purchase on this basis and it was felt that the development of a robust regulatory regime would ensure sufficient consumer protection in a commercialised environment.

The sale of Guernsey Telecom attracted the expertise of a world class service provider

1.14 Cable and Wireless has extensive international experience, with operations in over 50 countries, and experience of operating in similar small island economies. Its cable systems provide connectivity across every continent in the world, which should enable the Bailiwick to benefit from developments worldwide.

There has been an improvement in the Island's infrastructure, but it is not clear how much of this is as a result of commercialisation

1.15 In its final year of operation, the Guernsey Telecoms business plan envisaged capital expenditure of some £20 million over three years. Cable and Wireless committed to deliver £5.2 million of expenditure on e-commerce (see below).

1.16 Since entering the Guernsey market Cable and Wireless has developed data connectivity to 90 countries. It has also developed a solution to prevent internet extortion for business customers; the implementation of broadband for residential and business users; and, in mobile telephones, a GPRS network and a Blackberry service. The NAO is not in a position to evaluate how many of these new services would have been implemented had the States Telecommunications Board not been commercialised and Guernsey Telecoms had not been sold. For example, whilst certain elements of the broadband network were already committed to by Guernsey Telecoms, Cable and Wireless Guernsey has been able to bring other benefits to the Bailiwick as a result of its connections with the rest of the Cable and Wireless Group and other global suppliers. In addition, other operators have also invested in new technology and communication links.

There is a contract in place with Cable and Wireless to improve the Island's e-commerce offering

1.17 As part of the purchase of Guernsey Telecoms, Cable and Wireless entered into a legally binding commitment to invest £5.2 million in e-commerce related projects. In December 2004 an internal audit identified expenditure of £5.5 million on e-commerce related items: a data centre; off-island connectivity; and, the Channel Islands Electricity Grid. Of this expenditure, 15 per cent had been made, with the remainder being 'committed' rather than actual expenditure. Discussions are continuing between the States and Cable and Wireless on how to enhance the Island's e-commerce offering further.

Recommendation: The objectives of commercialisation have been or are being achieved for telecoms. We do not believe that any significant changes are needed to the commercialisation model as far as telecoms is concerned.

Regulation of telecoms is essential but the cost could be reduced

1.18 Once States control of the incumbent telecommunications operator was ceded to Cable and Wireless it was important to ensure independent statutory regulation. This was necessary to ensure that competition could develop and that the new operator would not abuse its dominant position. Regulation has brought benefits to consumers, although many members of the public perceive that they are getting worse value for money now than before commercialisation. The cost of regulation has been high to date, although this must be seen in the context of the jurisdiction's size; the initial costs of developing a regulatory framework and systems; and the costs related to the appeals mechanism. There is, however, scope to develop a more risk-based approach to reduce the cost.

To maximise the benefits of commercialisation regulation of telecoms is essential

1.19 Where a strategic asset, in this case a telecommunications network, is privately held there is a risk that in seeking to maximise profits the monopolist will act to the detriment of consumers. Such actions could take several forms, including charging customers higher prices for services than they would otherwise have to pay and preventing the development of competition.

1.20 In general, competitive markets provide greater benefits to consumers than markets served by monopoly suppliers. Competition provides stronger incentives for suppliers to operate efficiently and constrains suppliers from charging prices above cost-reflective levels. Competition generally leads to lower prices and provides consumers with more choice.

1.21 However, where a supplier has a very strong position in a particular market as in the case of Guernsey there is a risk that it might take advantage of its position and act anti-competitively (for example, by driving out new entrants). Similarly, where a market is dominated by a small number of suppliers they may act anti-competitively through collusion (for example, by agreeing not to compete on price). Such behaviour can be detrimental to consumers in the form of higher prices, less choice and poorer quality of service. It is therefore crucial for consumers that anti-competitive behaviour is stopped and deterred through robust regulatory action.

1.22 Most, if not all, economies with a liberalised telecommunications market have some form of regulatory oversight. Several of the new entrants to the Guernsey market that we spoke to perceived regulation as a necessary control on any of the international telecommunications markets in which they wished to do business.

Regulation of telecoms has brought benefits to consumers

1.23 Our review has found that there have been several benefits from regulation of telecoms in the Bailiwick. Since regulation was established in 2001, the Office of Utility Regulation (OUR) can point to a series of successes where benefits have been brought to consumers:

- Vulnerable users – the OUR called a meeting of the utilities to discuss their schemes for vulnerable consumers. Cable and Wireless had formulated a scheme which the OUR amended and in March 2004 a more targeted scheme was introduced, reducing the line rental rate for those on supplementary benefit.
- Broadband charges – in October 2002, following an investigation by the OUR, wholesale broadband charges were reduced by £10 per month. The Telecoms case study (Appendix 6A) gives further details.
- Exchange line rental reconnections – the OUR directed Cable and Wireless to reduce its reconnection rate from £101.30 to £24.80 where engineering work was not required, and pay compensation to those who had been over-charged.
- Leased line prices – the OUR froze the price of leased lines in a price control basket; since 2001 Cable and Wireless has reduced these prices significantly, in some cases by up to 70 per cent.²
- Price controls – the price of a national call and a call to Jersey (pence per minute) have both been reduced as a result of the first price control imposed by the OUR.³

In addition to this regulation, the introduction of competition has resulted in choice for consumers in the telecommunications market and has seen a host of new services launched by many operators.

Recommendation: There is a continued and ongoing need for a regulator of telecoms in Guernsey. Regulation has been an essential element of commercialisation and has brought benefits to consumers.

² The OUR believes this to be as a direct result of the introduction of competition in the telecommunications market. However, the NAO cannot verify this assertion as there is no counterfactual data available.

³ Cable and Wireless observes that, in compliance with the OUR price control regime, exchange line rental and local call prices have increased.

Many members of the public perceive that they are getting worse value for money now than before commercialisation

1.24 Our telephone survey found that 43 per cent of respondents believed that Cable and Wireless offered worse value for money than Guernsey Telecoms and only 7 per cent felt that they were getting better value for money (see Appendix 5). Some 28 per cent felt that customer service was worse and only 7 per cent considered that it was better. The only positive outcome was that 21 per cent considered that the range of services on offer was better than before compared with 3 per cent who felt that it was worse.

1.25 The public's view that Cable and Wireless offers worse value for money than Guernsey Telecoms could in part be due to the cross-subsidisation that took place before commercialisation. Guernsey Telecoms used revenue from business customers to subsidise residential customers. Cable and Wireless has been rebalancing its tariffs to ensure that prices more closely reflect the costs of delivery and that, as per OUR directions, unfair cross-subsidisation does not occur.⁴

1.26 There was not a consistent view on the value for money offered by competitors to Cable and Wireless. For some consumers there is a perception that Wave Telecom is more expensive than Cable and Wireless, whereas, for others, the perception is that Wave Telecom is cheaper.

Fieldwork Comments

"The cost of telecoms is extortionate when compared to the UK".
– telephone survey

"They all rip us off because there's no competition".
– telephone survey

"Commercially Cable and Wireless have sharpened up superbly. For example, the time taken to install a line has reduced from six weeks to three days". – focus group

"The OUR can't be doing a good job because prices are going up". – telephone survey

"We need a regulator because we need someone to do something to stop the companies running amok".
– telephone survey

1.27 However, the widespread consumer perception that the cost of telecoms provision on the Island is higher than elsewhere is not correct. For most fixed line services, with the exception of broadband, the Island receives a very price competitive tariff when compared with BT in the UK (see price comparisons at Appendix 7). Within the mobiles market the picture is more mixed. Rises in standing quarterly charges on land lines, mobile charges in general and higher broadband fees may all have contributed to the perception of higher prices in Guernsey than elsewhere.

The cost of regulation has been high to date but there is scope to develop a more risk-based approach to reduce the cost

1.28 The UK's Better Regulation Task Force was established in September 1997. It is an independent body that advises the UK Government on action to ensure that regulation and its enforcement accord with five principles of good regulation: Proportionality; Accountability; Consistency; Transparency; and, Targeting (Figure 5).

5 The Five Principles of Good Regulation as defined by the UK's Better Regulation Task Force

Proportionality	Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised.
Accountability	Regulators must be able to justify decisions, and be subject to public scrutiny.
Consistency	Government rules and standards must be joined up and implemented fairly.
Transparency	Regulators should be open, and keep regulations simple and user-friendly.
Targeting	Regulation should be focused on the problem, and minimise side effects.

⁴ Article 28.1 and 28.2 of the fixed telecommunications licence states that "The Licensee shall not unfairly cross subsidise or unfairly subsidise the establishment, operation or maintenance of any Telecommunications Network or Telecommunications Services".
"To enable the Director General to evaluate where any unfair cross-subsidisation or unfair subsidisation is taking place, the Licensee shall record at full cost in its accounting records any material transfer of assets, funds, rights or liabilities between a part and any other part of its business, and between it and any Associated Company, and shall comply with any directions issued by the Director General for this purpose".

1.29 The competitors to Cable and Wireless that we spoke to felt that the Office of Utility Regulation (OUR) generally followed the principles of regulation suggested by the UK's Better Regulation Task Force, although there were some reservations expressed about the flexibility of the regulator in discussing technical issues. In almost all cases, competitors to Cable and Wireless felt that regulation was necessary and not an undue burden in terms of licence fees or management time spent dealing with regulatory requests. In one case, however, there was a feeling that being regulated as a telecommunications provider was inappropriate for the company's type of business.

1.30 Cable and Wireless, on the other hand, considered that the OUR's regulatory actions were disproportionate in terms of the burden imposed on the company and the costs involved. Cable and Wireless also considered that the OUR was sometimes not sufficiently transparent in its operations.

Proportionality

1.31 Cable and Wireless has estimated that the direct costs to it of telecoms regulation in 2003-04 was £1.4 million and in 2004-2005 was forecast to be £1.2 million. Within these figures, the licence fee has risen from £350,000 in 2003-04 to an estimated £600,000 in 2004-05.⁵ Cable and Wireless estimates the cost of this regulation at over £50 per household. Cable and Wireless also considers that it took three employee years to put together all the necessary information for the current price control business plan. However, such figures are difficult to assess. It is unlikely that, without regulation, average household bills would have reduced by the amount they have. There is also no clear definition of which costs form part of the regulatory burden; for example, as noted in Part 2, Guernsey Post estimates its regulatory burden to be relatively low as the information requests from the OUR are closely linked to the management data that would have been collected irrespective of OUR requests.

1.32 Cable and Wireless recognises the need to have an independent regulator but is concerned that the costs are currently too high. It considers that the equivalent regulator in the UK, the Office of Communications, can ask for reasonable information, whereas the OUR can ask for anything: there is no clause of reasonableness in the licence. The OUR believes that this does not accurately reflect the legislation as one of the grounds upon which operators can appeal is a "lack of proportionality or unreasonableness". The OUR believes that this provides a similar safeguard as exists in other jurisdictions.

1.33 A report by Sunrise Consultants⁶, commissioned by Cable and Wireless Guernsey, concluded that the cost of telecoms regulation in Guernsey was amongst the most expensive in developed nations. Although the NAO does not agree with all the assumptions made in the Sunrise report, it is clear that the costs to Cable and Wireless of telecoms regulation in the Bailiwick are high compared with those experienced in the U.K: Cable and Wireless's licence fee represents around 1.5 per cent of turnover. The Office of Communications in the UK levies a fee of 0.0625 per cent of relevant turnover.⁷ The OUR considers this comparison to be unfair, however, as the Office of Communications in the UK regulates some of the world's largest telecommunications companies. The OUR would rather compare the cost of regulation in terms of cost per employee. This analysis of the costs of the OUR is outlined in Part 4, and shows the OUR to compare well against local peers.

1.34 Given the size of the market, the OUR will not possess the economies of scale available to other regulatory regimes. Regulatory costs in Guernsey per head of population will inevitably be higher than those in larger economies elsewhere. Nevertheless it seems to us that the costs of telecoms regulation in Guernsey are high, although account must be taken of the fact that regulation is still comparatively new in Guernsey and there were always likely to be higher costs in the initial phase. Given its limited resources, the OUR needs to prioritise its workload and concentrate its efforts on those regulatory actions that will bring the greatest benefits to consumers and businesses in Guernsey over the longer term. To some extent this is already undertaken in the form of the OUR's annual work programme which sets out the priorities for regulation in the coming year. However, a more risk-based approach may help the OUR to achieve the aim of maximising benefits to consumers and businesses whilst reducing the cost of regulation.

1.35 Under a risk-based approach, the regulator would explicitly assess the risks to consumers and commit to adopting a different regulatory approach depending on the level of risk. The start point of this process is to assess all the risks and rank them in descending order. It is the regulator's responsibility to address each risk in turn from most to least severe until resources are exhausted. At the margin, the regulator would adopt a proactive position on very high risk issues and not intervene in issues with a very low risk. We discerned the operation of an implicit risk-based approach to some extent, with the OUR intervening in a number of important ways as described in

⁵ Much of this increase was due to the costs associated with the first appeal to the Utility Appeals Tribunal and this figure is due to decrease in 2005 and 2006.

⁶ Effectiveness and Efficiency in National Regulatory Authorities, Sunrise Consultants, August 2004.

⁷ http://www.ofcom.org.uk/consult/condocs/socp/tariff/tariff_2005_06.pdf

paragraph 1.23 above. But it would improve transparency and enable a more proportionate approach if the assessments of risks to consumers were explicitly stated.

Recommendation: Regulation of telecoms in Guernsey is costly. A substantial element of this cost is inevitable because of the limited economies of scale in a small island economy. However, the Office of Utility Regulation should seek to reduce the cost by taking a more risk-based approach to its work and concentrating its regulatory efforts on measures that will bring the greatest benefit to Guernsey consumers and businesses over the longer term.

Evaluation

1.36 Our overall evaluation of commercialisation and regulation in telecoms is set out in **Figure 6**.

6 Evaluation of Commercialisation and Regulation of Telecoms in Guernsey

Commercialisation

- The quality of the management
- Clarity of shareholder expectation
- Operational freedom of current management
- Improved commercial performance, including:
 - increased efficiency
 - enhanced profitability

Regulation

- Independence and absence of capture
- Only limited problems of information asymmetry
- Proportional information requests
- Avoiding an excessively adversarial relationship

Outcomes

- Improved consumer outcomes:
 - lower prices
 - quality of service improved
 - long-term security of supply

Degree of Success

- Unknown (private company)
- High
- High
- Commercialisation has brought increased efficiency and enhanced profitability. Efficiencies have been found by Cable and Wireless from within the previous organisation.
- High
- High
- Medium
- Low
- Some prices are lower, some higher than before commercialisation, but tariffs now appear to reflect costs more closely.
- Perception amongst public that quality of service has reduced but too soon for an objective assessment to be made.
- There is an increased choice of services and service providers.
- There is no way of measuring security of supply.

Source: National Audit Office

PART TWO

Post



2.1 Commercialisation of postal services in Guernsey took place on 1 October 2001. On that date the business undertaking of the former States of Guernsey Post Office Board was passed to Guernsey Post Ltd, a newly incorporated States Trading Company 100 per cent owned by the States of Guernsey.

2.2 Guernsey Post Limited provides postal services to the Bailiwick of Guernsey and also produces stamps as indicators of paid postage. It is licensed and regulated by the Office of Utility Regulation. Some key facts and figures about the business are at **Figure 7**.

2.3 This Part of the Report examines how well the commercialisation and regulation model is working in post. **Our main conclusion is that the principle of commercialisation and regulation is sound for post; regulation has brought benefits, but there has been a lack of clarity on stakeholder objectives, roles and responsibilities.** In particular we found that:

- The objectives of commercialisation for post are achievable but have yet to be achieved.
- Regulation is necessary to protect consumer interests although it has been costly to date.
- There are alternative models for commercialisation of post but none offers significant advantages over the model adopted in Guernsey.

7 Guernsey Post – Key Facts and Figures

Guernsey Post handles some 32 million standard and express mail items per year, of which:

- 8 million are circulated and delivered within the Bailiwick.
- 5.5 million are sent to the UK.
- 0.5 million are sent to Jersey.
- 2 million are sent internationally.
- 16 million are received from the UK, Jersey and abroad for delivery in the Bailiwick.

The company also exports 13 million bulk mail items each year, largely to the UK.

Guernsey Post delivers to 27,000 points.

Guernsey Post employs 318 staff: 216 postmen, 23 retail staff, 8 ancillary staff, and 71 managers and administrative staff.

Guernsey Post has four 'crown offices' at Smith Street (St Peter Port), Envoy House (St Peter Port), Rohais, and Cobo. In addition, it has seven 'sub post offices' at Bridge, Forest, L'Islet, St Martin's, St Pierre du Bois, Alderney and Sark.

Guernsey Post made a loss of £193,000 in 2003-04 on turnover of £21.4 million.

The objectives of commercialisation for post are achievable but have yet to be achieved

2.4 The primary aim of commercialisation for Post was to free it from the constraints of public sector controls and what was perceived as political interference, thereby allowing it to provide an ‘updated modern framework’ for Post.⁸ The principal objectives were:

- to clarify and separate the roles of owner, regulator and operator;
- to put the postal operator in the best position to respond to technological changes;
- to give the postal operator in Guernsey the commercial freedom for flexible working practices and to allow investment;
- to improve the quality of service of postal delivery.

2.5 As noted in paragraph 1.9 prior to commercialisation, telecoms, post and electricity services in Guernsey were all provided by States Trading Boards. The Trading Boards were intended to be self financing, with charges levied for the services provided, and they had a monopoly of service provision. The Trading Boards were subject to States resolutions in respect of staffing, land and assets and operated under the same constraints as the civil service. There was a lack of efficiency incentives and States control constrained management decisions. For example, States control of staffing levels and wages meant there was great difficulty in ensuring that staff numbers and remuneration were appropriate to the optimum level of service provision. Commercialisation was intended to remove the barriers to greater efficiency, flexibility, investment and quality of service.

The framework set up at commercialisation in 2001 has in principle separated out the respective roles of owner, regulator and operator

2.6 For commercialisation to work well and to avoid conflicts of interests and objectives, responsibilities for policy making, operational delivery, ownership and consumer protection need to be vested in different bodies. Commercialisation of post in Guernsey achieved this separation in principle.

2.7 Guernsey Post Limited was created in October 2001 with a Board of Directors and corporate governance procedures and has responsibility for delivery at the operational level. The Treasury and Resources Department acts as the sole shareholder on behalf of the States. The Commerce and Employment Department is tasked with providing policy oversight and recommending strategic objectives to the States. The Office of Utility Regulation is in place to protect consumers and Guernsey’s sustainability through price control, target setting and monitoring. These arrangements separate the roles of operations, ownership, policy and regulation and in principle should allow clear and accountable decision making. For the avoidance of doubt, the States of Guernsey has issued Directions to the OUR and guidance to the Advisory and Finance Committee (now the Treasury and Resources Department) in the discharge of their respective roles pertaining to the postal market.

2.8 The NAO believes that the principle underlying this model is sound if executed appropriately. Guernsey Post has the potential to operate more efficiently if it faces the proper incentives and is able to make its own commercial decisions.

Recommendation: The objectives of commercialisation can be achieved for post and the commercialisation model adopted is sound if executed properly.

In practice the respective roles of owner and operator need further clarification

The Shareholder needs to make clear what it expects from Guernsey Post

2.9 One of the drivers behind the commissioning of this report was the perceived degree of influence held by the States of Guernsey over the commercialised utilities. Appendix 3 sets out the principles by which we believe the States of Guernsey should operate in its role as Shareholder, and its expectations for the businesses for which it is responsible. In particular, the Treasury and Resources Department, acting as the Shareholder on behalf of the States, needs to be clear about the objectives it wishes Guernsey Post to achieve, including the financial return it expects from the business.

⁸ The Postal (Bailiwick of Guernsey) Law, 2001.

2.10 Until 2002, the States received regular payments from the former States of Guernsey Post Office Board in respect of the profits earned on philatelic sales. Over the last ten years the payment has varied between £300,000 and £750,000 a year reflecting a changing philatelic market. The separation of philatelic profits was discontinued on commercialisation and the dividend policy was based on overall profits. In 2003 and 2004 Guernsey Post did not pay any dividend as it made an operating loss in each year (see below). With the company's likely return to profit, a clear dividend policy now needs to be established based on the company's whole operations.

2.11 As is the case in the United Kingdom postal market, there is a balance to be struck between financial performance and social objectives. In Guernsey this inherent tension can be seen in the aborted L'Islet Post Office closure – discussed further on in this review. It is the responsibility of the shareholder to set clear short, medium and long term objectives to ensure that the company can focus its strategy to deliver the shareholder's expectations.

2.12 In the case of the guidance on the role of the shareholder offered by the States of Guernsey to the Treasury and Resources Department (Appendix 3A), there are improvements that could be made to remove any ambiguity. The opportunity could also be taken to reflect changes since commercialisation. For example, the guidance suggests that the activities of Guernsey Post shall generally be....., and that it shall have regard to the economic, social and environmental policies adopted by the States. These phrases leave the responsibilities open to interpretation.

Recommendation: The Treasury and Resources Department, acting as the Shareholder on behalf of the States, needs to set overall objectives for Guernsey Post. It also needs to make clear what sort of financial return it expects the business to achieve and must set a clear dividend policy for the company.

Recommendation: The States of Guernsey should revise its guidance to the Treasury and Resources Department to ensure there is no ambiguity, and to address any new developments that may have occurred in the first few years of commercialisation.

Political observers appointed to the Board need to have a clear mandate

2.13 For commercialisation to work successfully the Board needs to be given clear strategic objectives by the shareholder, but otherwise to be left free to take operational decisions, and to be accountable if those operational decisions subsequently prove to be wrong. The Treasury and Resources Department, as the sole shareholder, should therefore give the Board of Guernsey Post the operational freedom to take action necessary to deliver the agreed business plan. The Department will need to obtain sufficient information on the company's operations to enable it to fulfil its oversight role.

2.14 The Department has appointed two political 'observers' to the Board of Guernsey Post. These observers were appointed in September 2004, in reaction to the 2002-03 year end operating losses announced that month; poor operational performance in Christmas 2002; and political anxiety about the benefits of commercialisation, including the Guernsey Post consultation on the closure of L'Islet Post Office. The observers were appointed as a temporary measure but are still in post. The political observers are on the board without voting rights and, paradoxically, without any responsibility and thus accountability. Whilst the Department, as shareholder, is entitled to make non-executive appointments to the Board as it sees fit, such appointees should have a clear role in accordance with accepted rules on good corporate governance.

2.15 It is unusual for a shareholder to undertake an observer role of this type, and it risks bringing political interference into day to day operations. There is also a risk that the Department will itself become too closely involved with the operational decisions of the company unless the observers fulfil their promise to be just a temporary measure.

Recommendation: If the Treasury and Resources Department wishes to continue to appoint political observers to the Board of Guernsey Post, it should set out clearly the roles and responsibilities of such observers in line with good corporate governance. Without a clear exposition of roles and responsibilities there is a real danger that the Department will get drawn into the day to day management and commercial decisions of the company.

Guernsey Post's social obligations need to be more clearly articulated

2.16 As stated in paragraph 2.4 above, the primary aim of commercialisation for Post was to free it from the constraints of public sector controls and what was perceived as political interference, thereby allowing it to provide an 'updated modern framework' for Post. One of the principal objectives was to clarify and separate the roles of owner, regulator and operator.

2.17 It is understandable that politicians will wish to ensure that commercial decisions made by the company are informed by an appreciation of the company's social obligations and its need to respond appropriately to public expectations and the community interest. An example of this is demonstrated by the case of L'Islet sub post office. Guernsey Post wished to close this office for commercial reasons: in a period of very poor financial performance by Guernsey Post, L'Islet sub post office was losing money and was poorly used. However, this decision aroused much concern amongst the public and States Members and the closure is currently on hold pending a further review.

2.18 The separation of roles introduced with commercialisation requires the States to determine the social/community requirements of Guernsey Post as a Universal Service Obligation to be funded from the Reserved Area of activities within which the company enjoys a monopoly. Separate to this, Guernsey Post's customer charter looks to ensure that all customers have access to a retail point within two miles of their residence.

2.19 Because of the availability of other retail points in adjacent areas, there is no regulatory obligation on Guernsey Post to retain L'Islet sub post office and so any losses incurred in keeping it open will not be taken into account when setting prices for Reserved Area activities. It is worth noting that even before commercialisation there had been a trend of closing sub post offices to reflect the changing pattern of use of postal services.

2.20 The Universal Service Obligation has reasonable clarity with regard to postal activity, although it could be improved through identification of actual services. This would circumvent the need for debate on which services are, or are not, within the universal service obligation, for example, whether delivery to Bailiwick addresses includes value-added services such as delivery to private boxes where customers have elected not to have mail delivered to their properties.

2.21 Guernsey Post observes that the Universal Service Obligation is unclear and unhelpful in determining access to services. The density of the retail network and access to services via posting boxes are not specified. These are specified through the company's customer charter but, as outlined in 2.17, other pressures, including the definitions of the regulatory function, create some conflict.

2.22 Under the current arrangements issues such as those related to L'Islet sub post office are likely to arise from time to time and will put the Department and Guernsey Post in a difficult position and their relationship with stake holders will come under strain. It will never be possible to anticipate every eventuality. However, now that the social implications of the Universal Service Obligation are more apparent it would make sense for the OUR, in consultation with Guernsey Post, to review the obligations and subject them to a further consultation process so that all stakeholders can make their views known.

Recommendation: The Universal Service Obligation for postal services should be subject to review and a consultation process with the aim of clarifying the social obligations on the company's activities.

Technological investments and modernisation were poorly managed by the previous Board of Guernsey Post and the Board was replaced by one with more commercial experience

2.23 It is vital in a corporatised utility, such as Guernsey Post, that the Board has a sufficient and appropriate mix of business and market skills to operate the business commercially. In the case of post, one of the main aims of commercialisation was to modernise the infrastructure, a task requiring significant business skills. However, in the event, the board of the time did not display the commercial or project management skills necessary to manage the modernisation programme.

2.24 At the time that commercialisation was being discussed in Guernsey, the postal operator was still operating a manual sorting system, although automation had been committed to by the Post Office Board. Shortly after commercialisation in October 2001 Guernsey Post invested in automated machinery to help improve performance. The move was intended to make sorting more efficient, to reduce the dependency on staff to sort mail and to reduce overtime hours worked. Two machines were purchased from Germany and introduced in December 2002. Overtime was also limited by Guernsey Post as it was felt that the machines would be able to cope with the additional mail. At the same time it was decided to move operations to a new, more modern location, Envoy House.

2.25 In normal circumstances these would have been prudent moves for any postal operator trying to improve efficiency and drive down costs. However, neither of the sorting machines operated effectively, for reasons of specification or staff training, and post still had to be sorted manually with the result that a significant backlog of third class mailsort post built up. This problem was further compounded by the fact that all these changes were being introduced just before Christmas which is historically the busiest time of year for any postal business. Employees were also reluctant to work more overtime, initially as the result of an overtime ban by the Communications Worker's Union. Guernsey Post was also in the process of moving to Envoy House. As a result of these factors there was a complete collapse in the service provided, resulting in huge delays to deliveries. The cost of clearing up the backlog was £0.5 million and Guernsey Post subsequently made a loss of £1.5 million for the year 2002-03. Full details of the quality of service problems at this time are given in the post case study at Appendix 6B.

2.26 Following the breakdown in service at Christmas 2002, the Managing Director resigned and the Chairman publicly took responsibility for the quality of service problems, and also subsequently resigned. Six months later a new Managing Director was appointed and new executive and non-executive directors are now in place who have more experience of the postal industry. The new Board put in place a recovery plan and reduced the loss to £0.8 million in 2003-04 (**Figure 8**). The Board expects Guernsey Post to return to profit in 2004-05.

Quality of service targets have been put in place by the regulator

2.27 Guernsey Post is not subject to a competitive market for items below £1.35⁹ and is not therefore incentivised through competition to improve its quality of service. Commercialisation was introduced to give the postal service incentives to improve quality of service through the setting and monitoring of targets by an independent regulator. It is, however, operating in a competitive market with regard to bulk mail, express and parcel services.

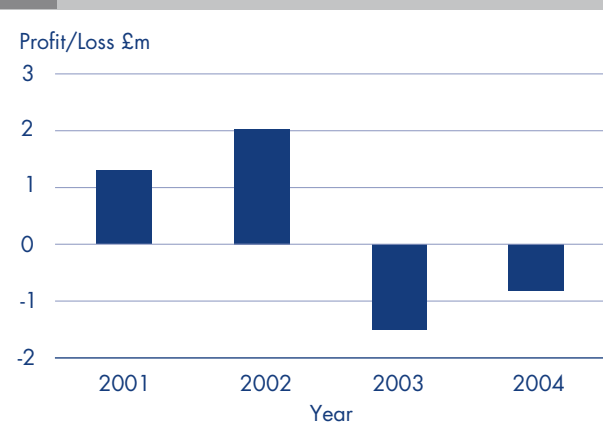
2.28 Prior to commercialisation in 2001, the postal service in Guernsey did not have any quality of service targets so there is no objective way of comparing performance before and after commercialisation. The Office of Utility Regulation (OUR) has set 23 quality of service targets that need to be met to ensure that Guernsey Post is providing the Bailiwick with a good service and is not in breach of its universal service obligations.

Fieldwork Comments

"Guernsey Post management tell us that they have made a great deal of improvement and that confirms our organisation's experience of dealing with them" – focus group

"Industrial relations have improved beyond recognition" – focus group

8 Guernsey Post operating profits/losses 2001 to 2004



NOTES

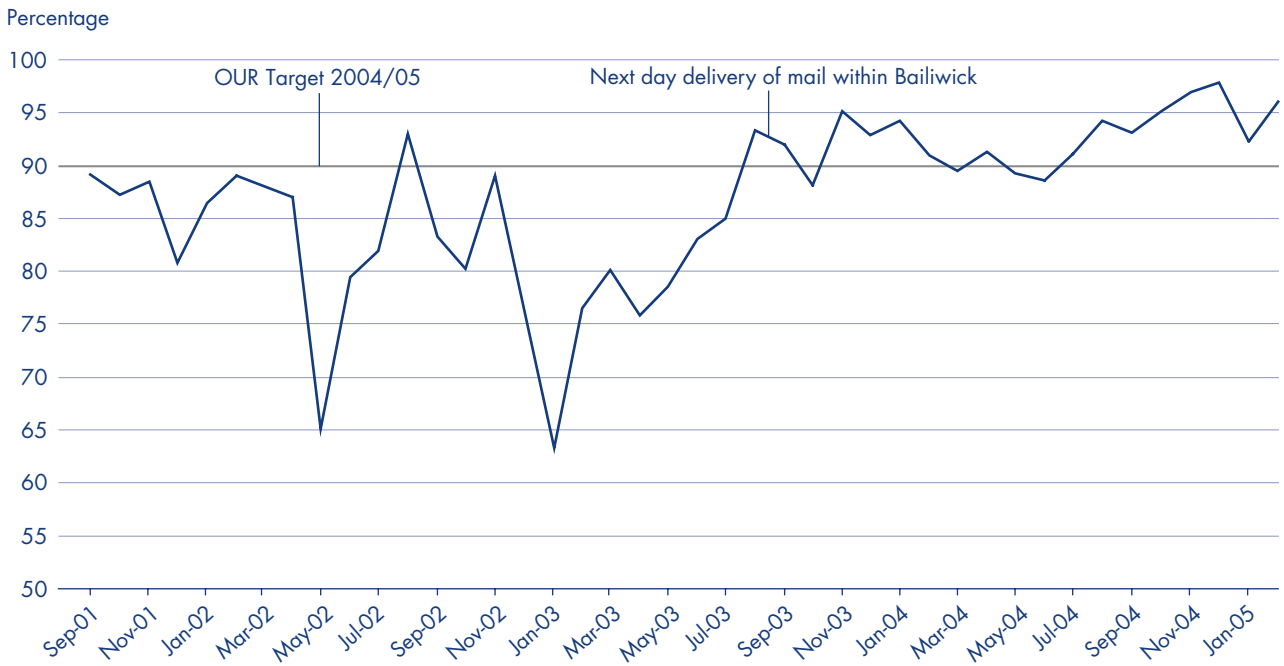
- 1 The figures represent operating profit/loss on ordinary activities before other income and are for the years ending 30 September.
- 2 The figures for 2001 are for the States of Guernsey Post Office Board.

Guernsey Post has welcomed the targets and believes they provide a good indication of how the business is performing. Guernsey Post is currently exceeding 18 of the 23 targets. Five of the 23 targets are also outside the control of Guernsey Post since Royal Mail's performance will also impact on the measures. Our review found that the regulator has put in place appropriate arrangements to monitor quality of service; and the available evidence suggests that quality is improving. For example, the percentages of local mail delivered by the next day within the Bailiwick, to the UK, and from the UK have all risen over the last two years and are all now above the OUR's target (**Figures 9 and 10** overleaf).

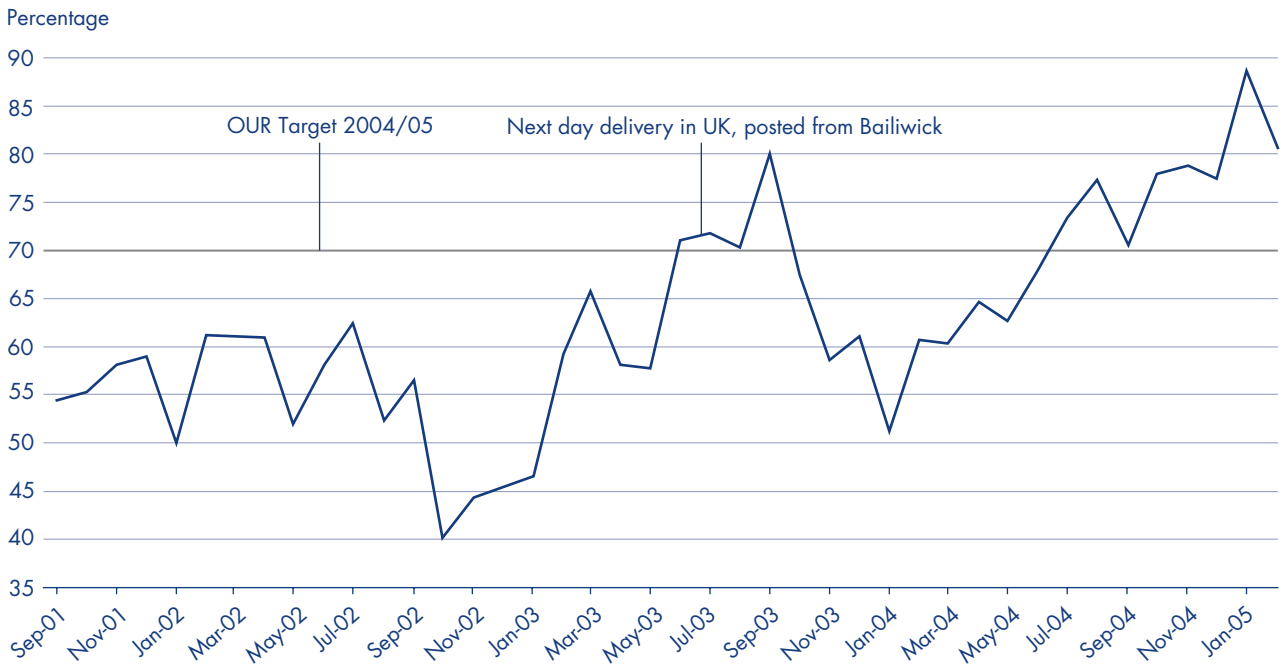
2.29 Despite recent increases in charges by Guernsey Post, our analysis shows that its charges compare favourably with those in Jersey (see Appendix 7). For example, the tariffs for a local delivery letter or for air mail are consistently cheaper in Guernsey than in Jersey.

⁹ Known as the Reserved Area maxima.

9 Guernsey Post – Quality of Service for local deliveries



10 Guernsey Post – Quality of Service for deliveries to the UK



The public still have a poor perception of the commercialised postal service

2.30 Although it is meeting most of its quality of service targets, Guernsey Post has the worst public image of the three commercialised utilities (see Appendix 5). Between 37 and 45 per cent of those surveyed felt that Guernsey Post was performing worse than before commercialisation in the areas of customer service, value for money and reliability. Only between 1 and 10 per cent felt that the company was doing any better in these areas. However, our survey also found that the public thought that the service has improved greatly since the quality of service problems of Christmas 2002.

2.31 Two major causes for concern stood out in the more general discontent expressed in our telephone survey. First, recent rises in the cost of sending small packages overseas were seen as having resulted in particularly poor value for money. This issue was discussed widely in the media: 12,000 of the 2 million over the counter items despatched each year were ‘small packets’ each being subsidised by other customers as Guernsey Post was charged the same for their handling as it was for any other item. As it commenced an exercise of tariff rebalancing, which still continues, Guernsey Post believed that this cross-subsidisation had to be removed. Secondly, there was widespread reporting of mis-delivery of both business and residential post. The frequency and extent of such mis-delivery was thought to have increased and complaints or requests for action were believed to be ineffective.

2.32 Guernsey Post’s poor public perception is in large part due to the disruption at Christmas 2002 referred to above and recent rises in postal charges. Both issues have been blamed by many on commercialisation. However, the Christmas 2002 problems largely related to commitments made by the previous Board and in many ways demonstrate the weaknesses of the pre-commercialisation arrangements when these decisions were made. Much of the increase in prices has been due to Royal Mail substantially increasing its charges to Guernsey Post, a development over which Guernsey Post has limited control.

Regulation is necessary to protect consumer interests although it has been costly to date

2.33 Regulation of Guernsey Post by the Office of Utility Regulation (OUR) is essential to protect the consumer. The OUR aims to follow similar principles of regulation to those of the UK’s Better Regulation Task Force: Proportionality, Accountability, Consistency, Transparency and Targeting.¹⁰ Our review has found that regulation has brought benefits to consumers but the cost of regulation has been high. The relationship between the OUR and Guernsey Post has also been adversarial at times but is improving. In any new regime there is a learning curve and the OUR feels that the lack of regulation expertise of the Guernsey Post Board may have been a contributory factor.

Regulation of post is essential to protect the consumer

2.34 Guernsey Post enjoys a dominant position in the Guernsey postal market. In the absence of competition it has little incentive to increase efficiency or improve quality of service. Regulation is therefore necessary to prevent Guernsey Post from abusing its dominant position and to provide the incentives for improved efficiency and quality of service that would normally exist in a competitive market.

Fieldwork Comments

Opinions of users are mixed:

“The basic issue is that we have no expectation that delivery will actually happen and we are starting to accept this as normal” – focus group

“Their reliability is generally excellent for the domestic user” – focus group

“I keep getting everyone else’s mail” – telephone survey

“Guernsey Post are much better and they’re a delightful lot” – telephone survey

¹⁰ *Proportionality*: Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed, and costs identified and minimised. *Accountability*: Regulators must be able to justify decisions, and be subject to public scrutiny. *Consistency*: Government rules and standards must be joined up and implemented fairly. *Transparency*: Regulators should be open, and keep regulations simple and user-friendly. *Targeting*: Regulation should be focused on the problem, and minimise side effects.

There have been financial benefits to the consumer from regulation

2.35 Our review has found that there have been several benefits from regulation of post in Guernsey:

- As noted above, the Office of Utility Regulation (OUR) has been the driving force behind the introduction and monitoring of quality of service targets for Guernsey Post. Quality of service has improved as a result.
- The OUR has obtained remedies for the consumer for quality of service failures (for example, the price reduction following the Christmas 2002 problems).
- In setting price controls, the OUR has sought to ensure that prices are kept at a reasonable level compared with international benchmarks. In establishing its price proposals, Guernsey Post applied the same competitor benchmark analysis; it believes the differences in outputs were due to allowances on profit, capital employed and social subsidy reclaimed through tariff.

2.36 Following the poor postal service that all customers experienced in December 2002, the OUR required Guernsey Post to offer all customers a reduced rate local post service in the run-up to Christmas 2003. The local stamp price was reduced from 22p to 10p resulting in customer savings, estimated by the OUR, of some £80,000. This measure also brought some benefit to Guernsey Post in smoothing out the volume of business in the weeks leading up to Christmas, reducing the overtime burden on the company. Guernsey Post, therefore, decided to repeat the approach in 2004, reducing the local stamp price from 26p to 20p. Again, the OUR estimates this gesture saved consumers some £70,000 – see appendix 6B for further information.

2.37 In addition to the savings made in Christmas post, Guernsey Post requested a price increase in 2004 which was granted by the OUR but at a rate lower than that requested by the company. This reduced the price consumers would otherwise have paid. The quantum of this saving has not been estimated.

Recommendation: There is a continuing need for a regulator of post in Guernsey. Regulation has been an essential element of commercialisation and has brought benefits to consumers.

The cost of regulation has been high

2.38 Guernsey Post believes that the actions of the OUR have occasionally been disproportionate to the size of the company and the regulated market. It claims that large quantities of information have been required, sometimes without warning, and the same information has sometimes been asked for more than once.

2.39 The licence fee has increased from £120,000 to £180,000 in one year. The current licence fee represents an annual cost of £3 a head for the whole Guernsey population or some £6.70 for each of Guernsey Post's 27,000 delivery points. Although the fee increase was a large one, the current fee represents less than one per cent of Guernsey Post's annual turnover, which is within the one per cent estimate for the costs of regulation made while the policy was being formed. The OUR believes that the increased fee more accurately reflects those costs it incurs in regulating Guernsey Post, particularly given the quality of service issues which need to be addressed.

2.40 Taking into account the estimated costs to the company of meeting the OUR's requirements, Guernsey Post estimates that the total annual cost of regulation falls between £200,000 and £220,000¹¹, excluding the costs of its current appeal. This amount represents some £3.50 a head or £7.80 per delivery point.

The relationship between the OUR and Guernsey Post has been adversarial at times but is improving

2.41 Guernsey Post has told us that the OUR demands a great deal of information covering the company's three to five year business plan. The OUR, on the other hand, has told us that it asks only for information that it would expect a commercial company to prepare as part of its normal business. The OUR feels that commercial firms should undertake long-term investment business planning as part of their normal business. The requirement for such information should not therefore be seen as a regulatory burden, it is just a sign that the companies were not prepared for commercial operation when they were run by the States. The OUR has suggested that, in respect to each of the utilities, relatively more effort was put into preparing for commercialisation than in preparing for the subsequent regulation and, as a result, difficulties arose within each of the three companies that were outside of the OUR's control. Guernsey Post, however, believes

¹¹ Guernsey Post's estimate is based on the £180,000 licence fee plus £40,000 for additional consultancy support to achieve necessary internal management information which had to be bought in to meet the timetable that the OUR was working to.

that too much detail is required by the OUR in a volatile market. Additionally, the company believes that the OUR, at times, involves itself too deeply in specific customer relationships, allowing customers to use it as a tool to attack Guernsey Post for their own benefit.

2.42 Although it is clear that the OUR needs to have sufficient information on which to base its price controls and other regulatory functions, we have seen evidence that the OUR has been somewhat heavy handed in the past. Demands for information have been made in terms which seem aggressive, quoting specific obligations under Guernsey Post's licence and allowing only short response times. The OUR has said that certain timeframes (such as the tariff proposals and quality of service issues) were driven by factors outside the OUR's control, and the OUR has granted extensions to Guernsey Post where this has been considered feasible by the OUR. The OUR is also of the view that it is standard regulatory practice to quote the powers under which certain requests for information are made and that this is just a matter of form, rather than any 'heavy handedness' on its part. However, a better, more open dialogue would allow greater cooperation which could benefit both parties and ultimately the consumer. There is evidence that the relationship has improved and that a more regular dialogue is occurring. More regular and constructive meetings are taking place and greater preparation and planning aims to lessen the need for follow-up information requests. Additionally the OUR has allowed access to its advisors on the price control to assist Guernsey Post in its tariff application and has simplified the quality of service targets to reduce the workload for the company. These are welcome developments.

Recommendation: We consider that the OUR needs to ensure that its requirements are only those that are essential for the efficient operation of the regulatory regime and that no unnecessary additional information requirements or costs are imposed. The OUR should also make clear to Guernsey Post why demands are being made so as to increase the transparency of the process.

Recommendation: We consider that the OUR should adopt a more risk-based approach to its regulation of Guernsey Post. It should only get deeply involved in matters which are fundamental to the well being of consumers and the Island as a whole. Other issues should be given a light touch. Such an approach could reduce further the cost of regulation.

Fieldwork Comments

"The regulator should act as a surrogate competitor but hasn't managed to look after the consumers' interests."
– telephone survey

"The OUR creates a lot of extra work but that's not necessarily a bad thing."
– telephone survey

"The cost of regulation partly reflects the declared need for total independence of the regulator. Independence of the regulator is essential. If the States Department were carrying out the regulation it is likely that they would put a great deal of energy into covering their backs."
– focus group

There are alternative models for commercialisation of post but none offers significant advantages over the model adopted in Guernsey

2.43 As discussed earlier in this Part of the report, our review has found that an appropriate model of commercialisation and regulation has been chosen for post in Guernsey, although the execution of the model could be improved. This section briefly discusses other models of commercialisation that could be adopted in Guernsey. It outlines some of the merits or problems associated with these, bearing in mind Guernsey's characteristics and needs. We consider that none of the other models offers significant advantages over the current model but some elements are worth exploring further.

Return to full States control

2.44 Some have argued to us that the States should take back Guernsey Post under full States control, with political Boards running the businesses as was the case before commercialisation. We consider that this would be a retrograde step, however. In our view, there were powerful arguments that led to the utilities being commercialised in 2001-02, for example, freeing them from the constraints of public sector controls and political interference and allowing the businesses the commercial freedom to manage their operations. We believe that these arguments are just as valid today.

Full privatisation

2.45 At the opposite extreme to full States control, the States could decide to privatise Guernsey Post and relinquish all States ownership of the company. The company could then operate fully commercially and the OUR could set the regulation regime to ensure the needs of Guernsey are met and customers' interests are

protected. The laws governing the commercialisation and regulation of Guernsey Post have been drafted as though competition from other companies was a realistic possibility. However, we believe it very unlikely that Guernsey Post will face significant competition in a relatively small market of some 27,000 delivery points. Some competition from international parcel companies is possible but this is unlikely to threaten Guernsey Post's overall market share.

2.46 Guernsey Post could be put up for sale to prospective bidders who might wish to take over the utility. Possible partners might include other national postal operators, including the Royal Mail in the UK. Indeed, until 1969 the postal operations in Guernsey were part of the British General Post Office. The funding and backing of such an organisation could help to improve not only the quality of service but also the reputation of the company. There would also be scope for economies of scale across management and support services and possibly some greater buying power, although this is untested and in the regulated UK market may not be achievable.

2.47 However, full privatisation could lead to the business being owned off-island by a monopoly supplier, which may not understand Guernsey's needs and characteristics. There would, therefore, be little advantage in this process compared with the current regime, and the States would have lost all controlling interests in the industry.

A merger with Jersey Post

2.48 Merging Guernsey Post with Jersey Post would bring some clear benefits. There would be some economies of scales from operating a unified postal service, particularly in terms of management and support services. Guernsey Post feels it would be unlikely that a more favourable contract with Royal Mail could be negotiated as a result of the increased collective mail being sent to the UK from both islands because the regulatory framework in the UK is already driving pricing equality into contractual terms. Forming a single postal network would also circumvent potential "threats" from bulk mailers to take their business to the other island. If this single operation was not competitive, however, there is a risk that bulk mail businesses would leave the Channel Islands altogether.

2.49 There would be a number of drawbacks, however. Guernsey would lose some influence over a key utility service which is crucial to the island's development. There is also concern that Jersey, as the larger market, would become dominant and that Guernsey's postal service would

suffer as a result. Guernsey's competitive position might also be undermined if Jersey, as the dominant partner, were to act in its own interests to the detriment of Guernsey. These difficult issues would need to be carefully addressed in the way that any joint island regime was set up. Nevertheless, there would be clear efficiency benefits in a joint supplier and these would need to be balanced against the political and other benefits of continuing with separate suppliers.

2.50 A detailed examination of the relative costs, advantages and disadvantages of merging with Jersey is outside the scope of this review. However, we do believe that this option is worth considering further.

Recommendation: Merging Guernsey Post and Jersey Post would bring clear efficiency savings but there would also be a number of risks and drawbacks. Although a detailed examination of this option has been outside the scope of this review, we do believe that it is worth exploring further by the States.

Rebalancing the capital structure of Guernsey Post

2.51 We note that Guernsey Post is not indebted and operates purely on a cash basis. To pay for any major investments the company needs to build up cash reserves. As at 30 September 2004, Guernsey Post had cash of £16.6 million on its balance sheet out of total net assets of £23.0 million.

2.52 Operating in this way restricts the flexibility of the company as it needs to plan its revenue carefully to ensure that it will have sufficient cash when investments are due, for example in automated machinery. It also exacerbates the risk that there may be an unforecast shock to the system which may not be covered by existing reserves. Guernsey Post informs us that an absence of debt should not indicate an unwillingness to take on debt if it were appropriate. Guernsey Post also told us that its current operations and strategic plans do not have any expectations of requiring capital funds.

2.53 In the UK it is more usual for utility companies to carry a significant amount of debt on their balance sheets. For example, in the gas and electricity markets, the standard assumption of the UK's Office of Gas and Electricity Markets (OFGEM) is that companies will have a capital structure with around 50 per cent debt and 50 per cent equity. These companies are all privatised of course and different considerations as regards the weighting of corporate debt and shareholder equity apply.

2.54 Nevertheless, there could be some advantages if Guernsey Post were to rebalance its capital structure to incorporate an element of debt and if future investment were to be financed from borrowing rather than the build up of cash reserves. It would open up commercial advantages and bring the commercial disciplines of the capital markets to bear on the company. Having a more conventional balance sheet containing both equity and debt would bring a number of advantages:

- The company would have better long term financial flexibility:
 - there would be no need to build excessive cash reserves;
 - there would be a reduced need for spuriously accurate long term forecasts.
- The company would be subject to a second level of scrutiny from the banks or other lenders, thus increasing due diligence.
- Because of the scrutiny provided by the lenders of finance, there would be less oversight needed by the OUR, reducing costs to both the OUR and Guernsey Post

2.55 There are, however, risks involved with taking on debt in this way (whether it be in the form of loans, bonds or other forms of lending). These risks include:

- the risk of default;
- the risk from changes in interest rates;
- the application of potentially limiting debt covenants.

Recommendation: Consideration should be given to rebalancing the capital structure of Guernsey Post to include an element of corporate debt and for future investment to be financed from borrowing rather than the build up of cash reserves. These moves would bring the scrutiny and due diligence of a corporate lender to bear on Guernsey Post and give the company the flexibility to plan for future investment when it is most needed.

Evaluation

2.56 Our overall evaluation of commercialisation and regulation in post is set out in **Figure 11**.

11 Evaluation of Commercialisation and Regulation of Post in Guernsey

Commercialisation

- The quality of the management
- Clarity of shareholder expectation
- Operational freedom
- Improved commercial performance, including:
 - increased efficiency
 - enhanced profitability

Regulation

- Independence and absence of capture
- Only limited problems of information asymmetry
- Proportional information requests
- Avoiding an excessively adversarial relationship

Outcomes

- Improved consumer outcomes:
 - lower prices
 - quality of service improved
 - long-term security of supply

Degree of Success

- Improved since commercialisation
- Medium
- Low to Medium
- Efficiency and profitability are improving

- High
- High
- Medium
- Medium

- Tariffs have risen, in part due to exogenous factors, but still represent relatively good value.
- Quality of service is being measured for the first time and can be monitored going forward. 18 of the 23 targets are currently being met.

Source: National Audit Office

PART THREE

Electricity



3.1 Commercialisation of electricity in Guernsey took place on 1 February 2002 when the business of the former States of Guernsey Electricity Board was transferred to Guernsey Electricity Ltd. Guernsey Electricity is a limited liability company wholly owned by the States of Guernsey.

3.2 Guernsey Electricity is the sole provider of electrical energy to Guernsey. Its core businesses of electricity generation, conveyance and supply are licensed and regulated by the Office of Utility Regulation. Some key facts and figures about Guernsey Electricity are at **Figure 12**.

12 Guernsey Electricity – Key Facts and Figures

Until 2001 all electricity was generated on-island, using gas oil and heavy fuel oil. The completion of a cable link to France via Jersey has enabled Guernsey Electricity to import units from the European Grid.

Importation through the cable link provided 81 per cent of the Island's needs in 2003-04, the remaining 19 per cent being generated on island.

In 2003-04 some 266,000 MWh of electricity was imported and 63,000 MWh was generated on island.

In 2003-04 Guernsey Electricity had 237 employees (full-time equivalents).

Guernsey Electricity serves some 28,000 customers.

Guernsey Electricity made a pre-tax profit of £1.3 million in 2003-04 on turnover of £26.9 million. It paid a dividend to the States of £281,000.

3.3 This Part of the Report examines how well the commercialisation and regulation model is working in electricity. **Our main conclusion is that the principle of commercialisation and regulation is sound for electricity but there has been a lack of clarity on objectives, roles and responsibilities, and the cost of regulation has been higher than might be expected.** In particular we found that:

- The objectives of commercialisation for electricity are achievable and some have been achieved.
- The practical application of the commercialisation model needs to be improved.
- Regulation is necessary to protect consumer interests but has caused friction with Guernsey Electricity and has been costly.
- There are alternative models for commercialisation of electricity but none offers significant advantages over the model adopted in Guernsey.

The objectives of commercialisation for electricity are achievable and some have been achieved

3.4 The primary aims of commercialisation for electricity were:

- to free Guernsey Electricity from the constraints which prevented it from acting efficiently and effectively;
- to separate clearly the roles of management, the shareholder and the regulator.

In short, the States of Guernsey were seeking to establish an organisation that was free from political interference and could adapt to technical and commercial changes, increase the speed of its decision making and be more flexible.

3.5 These aims were supported by the following secondary objectives:

- To ensure security, continuity and reliability of supply.
- To ensure that consumers receive supplies of the highest possible standard at the best possible price. With a homogenous good such as electricity, standards are closely linked to reliability of supply.
- To facilitate the economic development of the jurisdiction.

The framework set up by commercialisation has reduced the constraints on Guernsey Electricity and in principle has separated the roles of manager, shareholder and regulator

3.6 As noted in paragraph 1.9, prior to commercialisation, telecoms, post and electricity services in Guernsey were all provided by States Trading Boards. The Trading Boards were intended to be self financing, with charges levied for the services provided, and they had a monopoly of service provision. The Trading Boards were subject to States resolutions in respect of staffing, land and assets and operated under the same constraints as the civil service. There was a lack of efficiency incentives and States control constrained management decisions. For example, States control of staffing levels and wages meant there was great difficulty in ensuring that staff numbers and remuneration were appropriate to the optimum level of service provision. Commercialisation was intended to remove the barriers to greater efficiency, flexibility, investment and quality of service.

3.7 Guernsey Electricity Limited was created in February 2002 with a Board of Directors and corporate governance procedures, which it was expected to follow. The States would still be involved, however. The Commerce and Employment Department recommends to the States policy and strategic objectives which are communicated to the OUR. Guernsey Electricity is expected to deliver at the operational level. The Treasury and Resources Department operates as the single shareholder on behalf of, and subject to guidance from, the States. The government appointed regulator, the Office of Utility Regulation (OUR), aims to protect consumers and to ensure continuity of supply for Guernsey through price control, target setting, and monitoring. These arrangements separate the roles of operations, policy, ownership and regulation and in principle should allow clear and accountable decision making. In order to implement policy, the States of Guernsey has issued Directions to the OUR and guidance to the Advisory and Finance Committee (now Treasury and Resources) in the discharge of their respective roles pertaining to the electricity market.

3.8 The NAO believes that the principle of commercialisation for Guernsey Electricity is sound and an appropriate model of ownership and regulation has been chosen. Monopoly suppliers such as Guernsey electricity are much more likely to operate efficiently if they are given proper incentives and are able to make commercial decisions free from day to day political oversight and possible interference.

Recommendation: The commercialisation model adopted for electricity should remain in place and is sound if executed properly. The objectives of commercialisation can thereby be achieved for electricity.

Recommendation: The States of Guernsey should review its guidance to the Treasury & Resources Department to ensure that there is no overlap or ambiguity, and to address any new developments that may have occurred in the first few years of commercialisation.

There are mechanisms in place to ensure security of supply

3.9 The transition to a commercialised industry has not removed the need for Guernsey to ensure that there will always be a secure supply of electricity. The Bailiwick's strategic policy (known as "n-2") requires that the demands of the market should be capable of being met even if the two largest means of electricity generation fail. This policy is being delivered by Guernsey Electricity and is being monitored by the OUR. The approach is not without its shortcomings given the additional cost of maintaining excess capacity. The decision by Guernsey Electricity to fund capital projects through cash reserves rather than borrowings, consistent with the traditional local approach to financing without debt, also has additional costs and complexity associated with it given the need to forecast electricity demand for up to 25 years ahead; and the need, in a cash-funded business, to ensure sufficient reserves are available to meet estimated future expenditure. Under current arrangements, such an approach imposes costs that have to be met. This is the price that has to be paid to ensure that there is a secure electricity supply on the Island and to allow the current approach to funding capital expenditure.

Reliability of supply has continued to improve and prices for electricity have not increased in the last 14 years

3.10 Our fieldwork has shown that Guernsey Electricity clearly has the best public image of the three commercialised utilities. Between 65 per cent and 81 per cent of those questioned in our telephone survey felt that the performance of Guernsey Electricity was about the same as before commercialisation. Those expressing a different opinion felt that the organisation had improved on customer service and reliability. Opinion was roughly evenly divided on Guernsey Electricity's delivery of value for money: over 9 per cent thought that things had got better; nearly 11 per cent thought that things had got worse.

3.11 It is difficult to account for the public's perception of value for money given that Guernsey Electricity has held its prices for some 14 years and that the price of electricity has fallen significantly in real terms over that period. The previous States Trading Board's policy was to fund all investment from its cash reserves. It was therefore necessary to increase prices at the start of an investment cycle to ensure that the electricity board had sufficient cash reserves to avoid funding any capital expenditure through debt finance.¹² The States Trading Board's cash accounting approach has been continued through to commercialisation and as a result Guernsey Electricity has a much higher level of cash liquidity than one would expect for an electricity operator in the competitive markets that exist outside Guernsey. The company also has a good and improving record on maintaining the supply of electricity with the extent of excess capacity due to the States' "n-2" generation policy a major contributory factor.

3.12 Business users we interviewed had two different views about the importance of security of supply and cost. A view shared by many in the financial services sector is that security of supply is of primary importance and cost is a secondary consideration. Other business sectors – agriculture for example – feel that the cost of electricity is the main consideration as it added so much to fixed overheads. They felt that more should be done to keep costs under control and at a reasonable level.

Fieldwork Comments

"Guernsey Electricity has fewer black outs" – telephone survey

"If all commercialisation had gone as smoothly as Guernsey Electricity we wouldn't have any problems" – telephone survey

"Guernsey Electricity may seem better as it has less interface with the customer" – focus group

"Of the three utilities Guernsey Electricity is probably the easiest business to run" – focus group

¹² The States of Guernsey Electricity Board did not increase prices to fund the cable link. Prices were last increased in 1991 to generate sufficient cash reserves for the Board's future capital investment programme.

It is too early to say whether the current environment will facilitate the economic development of the jurisdiction

3.13 It takes time for a structural change such as commercialisation and regulation to yield positive results for consumers and market participants. Once these arrangements have become fully established, the pressure to increase costs should be contained. Maintaining security of supply and driving down costs are the two key measures that will help to facilitate the economic development of the jurisdiction.

3.14 The laws governing the commercialisation and regulation of Guernsey Electricity are written as though competition from other companies is a realistic possibility.

3.15 It seems very unlikely, however, that Guernsey Electricity will ever face real competition in a relatively small market of some 28,000 customers. The start up costs and planning issues effectively preclude a competitor from setting up a new power station. The limited size of the market also makes it unlikely that a competitor would invest in another cable link. The OUR in its report to the Board of Industry in 2002 stated that:

“Taking into account the available information and applying conservative assumptions on the degree of savings which would be required to encourage customer switching, the DG considers that likely customer savings that could be achieved in this market structure, would be insufficient to provide for meaningful price based competition in electricity retailing. Furthermore, the cost of implementing that competition would be likely to be equal to, or greater than the level of potential savings to customers, thus negating the price benefits.”

3.16 Although Guernsey Electricity faces some minor competition from unregulated gas, it seems doubtful that this could have any significant effect. The issue of competition is considered in more detail in the electricity case study at Appendix 6C.

Fieldwork Comment

“Competition is obviously a difficult issue in an island of only 60,000” – telephone survey

The practical application of the commercialisation model needs to be improved

3.17 Earlier in this report we considered the main purposes of the commercialisation of public utilities: to increase management discretion; to reduce political intervention; and to sharpen incentives on the business to deliver financial and quality of service objectives. In short, the aim is to increase the efficiency, profitability and consumer focus of the business. Most of the risks that commercialisation may entail can be mitigated by a strong regulatory framework. An independent regulator can ensure that there is sufficient competition in the market to achieve an acceptable level of prices and quality of service for the end consumer. Where there is insufficient competition, the regulator can introduce rigour and challenge by means of licence conditions and price controls that mimic market forces. The shareholder and regulator perform very different and often conflicting tasks and independent oversight from a regulator provides consumers with a degree of protection that would not otherwise exist. Guernsey Electricity believes, however, that, since the company is 100 per cent State owned and due to the content of States guidance to the shareholder, in practice the theoretical model is not followed and customer protection is also effected via the shareholder.

3.18 In theory, there is no reason why commercialisation should not work as effectively in Guernsey’s electricity sector as it has done in other developed economies and other sectors. We found, however, that the principles and good practices successfully adopted in other jurisdictions have not been fully or properly applied to Guernsey Electricity:

- Misunderstandings about the respective roles of owner and operator have caused tension and need to be resolved, although steps have been taken to improve this.
- There is currently no energy strategy for the Island although this is to be addressed later in 2005.
- There is a lack of agreed clarity about the purpose of Guernsey Electricity’s non-core activities.

Misunderstandings about the respective roles of owner and operator have caused tension and need to be resolved

3.19 Commercialisation and regulation will only work effectively if objectives and roles are precisely defined and each party clearly knows its responsibilities and how these should be discharged. Each party should also understand the limits of its role and the functions that properly need to be undertaken by other stakeholders. Accountability is strengthened when this interlocking takes place without overlap and duplication and when the parties stick to their respective responsibilities and consciously seek to avoid friction.

3.20 Appendix 3 discusses further the role that the Treasury & Resources Department could take as the single shareholder on behalf of the States. It is for the States to determine the degree to which it requires the Shareholder in the electricity sector to act in accordance with this model. The key principles are:

- the Shareholder appoints the Board, and agrees the terms on which the Directors are appointed and incentivised (annually and for the longer term).
- the Shareholder sets overall objectives for the business.
- the Shareholder agrees the business's strategic plan with the Board.
- the Board is accountable to the Shareholder for delivering the agreed plan.
- the Shareholder gives the Board the operational freedom to take the action necessary to deliver the strategic plan.
- the Shareholder monitors the performance of the business to satisfy itself that the strategic plan is on track.

3.21 The arrangements made between the Treasury & Resources Department and Guernsey Electricity for operating the commercialisation model in practice lack some clarity. There is insufficient common understanding between the parties as to how their respective responsibilities should be discharged. This has at times led to friction between Guernsey Electricity and the Treasury and Resources Department and there are instances when it has not been helpful to the efficient and effective management of the business.

3.22 One factor affecting this lack of clarity could be the guidance on the role of the shareholder offered by the States of Guernsey to the Treasury and Resources Department (Appendix 3B). There are improvements that could be made to increase clarity and remove any ambiguity and in the medium term the opportunity could be taken to reflect changes since commercialisation. For example, the guidance suggests that the activities of Guernsey Electricity include 'any other services that are ancillary related to or may be conveniently combined with such electrical energy services in the Bailiwick of Guernsey and elsewhere'. No examples are given of what could be included in 'ancillary' services. As a further example, the guidance also suggests that the shareholder should be "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". Guernsey Electricity has interpreted this as involving the shareholder in a consumer protection role akin to regulation.

The Shareholder needs to make clearer what it expects from Guernsey Electricity

3.23 The Treasury & Resources Department is the sole shareholder in Guernsey Electricity. It is bound by States Billet to balance financial performance targets with the need to provide appropriate consumer protection. As a shareholder operating within the principles outlined above, the Department should agree the strategic plan for Guernsey Electricity. It should then be the responsibility of the Board of Guernsey Electricity to deliver the strategic direction through its various operational activities.

3.24 The main way that the Treasury & Resources Department can affect Guernsey Electricity's financial performance is to set clear dividend targets. Since commercialisation in 2002, Guernsey Electricity has paid two dividends to the States: £230,000 in 2002-03 and £281,000 in 2003-04. Dividend targets should contain a degree of stretch and provide an incentive for Guernsey Electricity to operate efficiently. The regulator's role should be to ensure that Guernsey Electricity does not find the money to pay dividends simply by increasing prices to consumers. The company would have to demonstrate that its performance had improved.

Recommendation: The Treasury and Resources Department, acting as the Shareholder on behalf of the States, needs to set overall objectives for Guernsey Electricity. It also needs to make clear what sort of financial return it expects the business to achieve and must set a clear dividend policy for the company.

The Shareholder needs to give Guernsey Electricity the operational freedom to deliver the agreed objectives for the business

3.25 For the commercialisation model to work effectively the Treasury & Resources Department as Shareholder must give the Board of Guernsey Electricity the operational freedom to take the action it considers necessary to deliver the strategic plan and secure sufficient returns to pay the dividend. The Department needs to have sufficient information about the company to enable it to monitor that the company is fulfilling this role effectively. But it should not get involved in day to day management of the company.

3.26 Guernsey Electricity has told us that it is concerned that the Department has at times become heavily involved in the management of the company. For example, the Department has asked Guernsey Electricity not to conclude any negotiations with EdF in respect of the purchase of future generation capacity without its agreement. Guernsey Electricity believes it is best placed to conduct such negotiations and that the Department is becoming too involved with operational decisions. The disagreements on this issue and the poor communications at the time did strain the relationship between the Department and the company.

3.27 Sometimes the Shareholder may need to get involved in operational aspects because it believes that company management is failing in its duty of care to the Shareholder. Such cases will be the exception rather than the rule, however, and generally the Shareholder's engagement with operational matters should be conducted at arm's length. There may also be occasions when an issue of such fundamental or strategic importance for the Island is under consideration that the Shareholder would justifiably wish to be involved. This would generally be in the nature of a watching brief and proportionate to the importance of the issue at stake. The Shareholder would need to step in, however, if it thought that there was a possibility of things going seriously wrong or believed the company was being committed to an agreement with long term consequences for the company.

3.28 It is not the purpose of this review to examine the issues pertaining to the EdF contract. But clearly the commercialisation model is not operating as it should if the two parties have very different and strongly held views on the same issue. There is a need for proper communication, an honest and open dialogue and a mutual understanding of each other's position.

Recommendation: The Treasury and Resources Department needs to make clear to Guernsey Electricity what information it expects from the company to enable it to fulfil its monitoring role as shareholder. It should also agree with the company the sorts of circumstances in which it would wish to be involved in strategic decisions.

There is currently no energy strategy for the Island although this is to be addressed later in 2005

3.29 In the UK the Department of Trade and Industry has issued Social and Environmental Guidance to the gas and electricity markets authority.¹³ This outlines a series of Government objectives which can be achieved through regulation; for example, the reduction of carbon emissions by, amongst other things, producing 10 per cent of electricity from renewable sources by 2010. Production of such guidance is important for a regulated utility since the Board are then clear on what is required of them and can decide on the most effective operational strategy.

3.30 There is currently no clear energy policy for the Island. As a result, Guernsey Electricity is operating and planning for the future supply of electricity under considerable uncertainty. For example, it is currently pursuing renewable energy, in the form of tide turbine technology. This is a very clean form of energy, but it is also more expensive than a similar output from a conventional fossil fuel powered turbine. Guernsey Electricity's investment in renewable energy has created friction with the OUR as the regulator has indicated that such investment may not be accepted within the forthcoming price control arrangements because the OUR may not recognise this investment as an efficient way of supporting the environmental agenda. Guernsey Electricity believes, on the other hand, that its small investment is in accordance with current States guidelines.

3.31 This uncertain situation should soon be resolved as the States recently commissioned a report on future generation investment options for Guernsey from consultants Mott MacDonald. A debate on Guernsey's future energy policy is to be held later in 2005. Once future policy has been decided by the States, the OUR will be obliged to take account of this policy when framing its decisions and Guernsey Electricity will be able to plan its future needs and revenues within this context.

13 http://www.dti.gov.uk/energy/leg_and_reg/acts/sandeguide.pdf

3.32 The States will also be able to clarify the policy which the OUR can then take into account in undertaking future regulation. The policy should clarify the recommended energy sources to meet Guernsey's requirements and enable the OUR to take into account the energy policy when regulating Guernsey Electricity and considering its price controls. A clear policy would reduce business uncertainty and allow better planning.

Recommendation: The importance of energy to the economy and the long term issues involved mean that the States has a key role to play in formulating a clear energy strategy for the Island. An agreed energy strategy would reduce business uncertainty for Guernsey Electricity and allow better planning of future needs and revenues. It would also give Guernsey Electricity and the OUR a clear framework against which to make their own operational decisions.

There is a lack of agreed clarity about the purpose of Guernsey Electricity's non-core activities

3.33 Regulators of any market will normally seek to regulate only the core business of an organisation. For Guernsey Electricity, that is the generation, transmission and supply of electricity to the Bailiwick. All other operations are considered non-core and are usually unregulated. As a result, only the efficient costs associated with the provision of electricity are normally allowed to be recovered through electricity charges. Any losses or profits in the non-core areas should not be taken into account in determining the charges made to customers for core services.

3.34 It is important, therefore, that there is strong management focus on the core business, as this will be the most heavily scrutinised by the regulatory authority. We note that Guernsey Electricity is involved in several non-core activities on which it has received no clear direction from the States. It has purchased equity in an experimental tide turbine technology company (although Guernsey Electricity considers that this is related to its core generation business); it sells white goods at a retail outlet in Guernsey Electricity headquarters; and it has purchased property near its headquarters to remove a legal uncertainty on boundaries.

3.35 Guernsey Electricity has received guidance on how it is to manage its commercial operations, including its non-core business. The Billet D'Etat XXIV 2001 contains reference to the need for the company to seek to achieve a balance between achieving a commercial return on investments and the effects on electricity tariffs but with an expectation of commercial returns on non-core services provided in competition, or in partnership with the private sector. The OUR considers that it is clear from the company's regulated accounts that Guernsey Electricity has made a significant loss on its non-core activities. In a regulated environment it is appropriate that customers are not asked to fund investment in non-core activity. In most regulated markets 'core activities' are very narrowly defined for this very reason.

3.36 Given that Guernsey Electricity's operations are entirely funded from cash revenues from consumers, how the revenues are used is particularly important. For example, if these non-core activities were not to generate sufficient revenue, Guernsey Electricity would need to seek clear direction from its shareholder that it is able to continue these operations¹⁴ and it should justify why it is involved in such activity. A different funding mechanism might be necessary for these peripheral activities, such as a venture capital scheme or the creation of an independent subsidiary for non-core business which is stand-alone and is not financed or supported by electricity prices.

3.37 Many other electricity companies elsewhere, as in the UK, have moved out of white goods retailing. Until the early 1990s the former electricity boards in the UK each had an energy show-room where they would sell white goods and other electrical appliances. This activity proved to be loss making in most cases and distracted management attention from the core business. The electricity boards therefore took a commercial decision to leave the market. We note that, in jurisdictions such as Jersey and the Isle of Man, electricity companies have remained in white goods retailing. Guernsey Electricity should itself periodically re-examine whether it makes sense to remain in this area of business.

Fieldwork Comment

"The retail outlet is a luxury" – focus group

"I could buy a hob from Guernsey Electricity but was surprised that they couldn't fit it" – telephone survey

¹⁴ Guernsey Electricity sought and obtained agreement from the Treasury & Resources Department as Shareholder before investing £250,000 in tide turbine technology research through an equity stake in Marine Current Turbines Ltd (MCT). The UK government has provided major support to MCT in the form of grant aid towards its development programme. Strategic guidance from the States to the former Guernsey Electricity Board specifically required it to continue to examine renewable energy sources.

Recommendation: There should remain in place clear accounting separation between core and non-core activities. Guernsey Electricity should seek guidance from the shareholder as to which activities it should participate in.

Regulation is necessary to protect consumer interests but has caused friction with Guernsey Electricity and has been costly

3.38 Regulation of Guernsey Electricity by the Office of Utility Regulation (OUR) is essential to protect the consumer. The OUR aims to follow similar principles of regulation to those of the UK's Better Regulation Task Force: Proportionality, Accountability, Consistency, Transparency and Targeting. However, we found that the OUR has had some difficulty implementing these principles as a result of a very poor relationship between the regulator and the company which has impacted on areas such as proportionality and transparency. These factors have added to the cost of regulation.

Regulation of electricity is essential to protect the consumer

3.39 Guernsey Electricity enjoys a dominant position in the Guernsey electricity market. In the absence of full competition there is little external pressure to increase efficiency or improve quality of service. The improvements that have been made in these areas have been at the company's own volition. Regulation is necessary to prevent Guernsey Electricity from abusing its dominant position and to provide the incentives for improved efficiency and quality of service that would normally exist in a competitive market.

3.40 Guernsey Electricity believes that a separate regulator is unnecessary for any period whilst it is 100 per cent State owned and whilst States guidance for the shareholder to take account of the impact of any price increases upon the community is in place. It considers that because, as noted in paragraph 3.23, the Treasury & Resources Department is bound by States Billet to balance financial performance targets with the need to provide appropriate consumer protection, there is little role for the OUR. Furthermore it emphasises that the associated costs of regulation are very high and would benefit the island more if focused elsewhere. It also notes that regulatory costs currently exceed the level of dividends to its shareholder. Guernsey Electricity believes that in effect the OUR is duplicating the role of the shareholder in present and foreseeable circumstances. Guernsey Electricity recognises the need for regulation if ever any of these contributory circumstances were to change.

3.41 We do not accept this argument. In our view, the shareholder and regulator have quite separate and important roles, which are essential features of the commercialisation and regulation model adopted in Guernsey. The model can be made to work if those involved commit to it and are sensible and pragmatic in the way the model is operated.

Recommendation: There is a continuing need for a regulator of electricity in Guernsey. Regulation is an essential element of commercialisation.

Excessive demands for information have led to an adversarial relationship between the OUR and Guernsey Electricity

Demands for information by the OUR have been greater than might be expected

3.42 The UK's Better Regulation Task Force defines proportionality as ensuring that "Regulators should only intervene when necessary" and any "remedies should be appropriate to the risk posed and costs identified and minimised." Transparency is defined as ensuring that "Regulators should be open, and keep regulations simple and user-friendly".¹⁵ Those being regulated should be made aware of their obligations, with law and best practice clearly distinguished. Those being regulated should be given the time and support to comply.

15 <http://www.brtf.gov.uk/docs/pdf/principlesleaflet.pdf>

3.43 The OUR has been requiring Guernsey Electricity to provide substantial amounts of detailed information. It is reasonable that Guernsey Electricity should be asked to substantiate its Business Plan proposals over, say, the next five to ten years. The OUR's requirements go well beyond this, however. It has asked Guernsey Electricity to provide detailed information for the next 25 years.

3.44 The OUR considers that this information is necessary because of the nature of the funding of Guernsey Electricity's business – cash funded with a large asset base and long investment horizon – and the need for longer term planning to ensure security of electricity supply. The OUR believes that it is necessary to go into so much detail to ensure that Guernsey Electricity will be able to build up sufficient cash resources to pay for its longer term large investments. The contract between Guernsey Electricity, Jersey Electricity and EdF is complex and the OUR considers that it cannot be modelled accurately without a lot of detailed information. On the other hand, Guernsey Electricity faces considerable uncertainty in planning ahead due to the lack of a formal energy policy and in common with other electricity companies it faces more general uncertainties in the electricity sector. Guernsey Electricity believes that the additional costs of providing this information are disproportionate, given the availability of alternative cheaper techniques to model costs and revenues for the electricity company of such a small island community.

3.45 Any long term forecast should take account of the inherent difficulty of making accurate estimates for many years ahead and recognise that assumptions and data are likely to prove less and less reliable the further ahead plans are projected. Forecasting figures down to the last penny or pound merely lend the estimates a spurious accuracy. Although it is reasonable that the regulator may require some information for a 25 year period, given future investment needs, the NAO believes that the detail required by the OUR is excessive especially when it has not yet been decided how Guernsey's future energy requirements will be met and when the contract with EdF is still under negotiation.

3.46 Guernsey Electricity feels that the OUR does not follow what the NAO would describe as "a risk-based" approach and asks for information, not because it is absolutely necessary, but because under the terms of the law it can. We have seen requests for information which support this view. The OUR maintains that the scale of information required is in direct response to Guernsey Electricity's requests for greater complexity in the price control model, although Guernsey Electricity disputes this. There is some evidence, however, that the OUR is

beginning to be more proportionate in its demands for information and the implementation of the regulatory regime. For example, Guernsey Electricity is in theory required to provide a series of reports covering technical commercial codes and transmission prices. The OUR could have directed Guernsey Electricity to provide these reports but chose not to enforce these requirements because the absence of competition within the market does not require the provision of such information. This is a sensible example of the OUR using some flexibility in its practices.

The relationship between the OUR and Guernsey Electricity has been particularly poor

3.47 An important function of the Board of Guernsey Electricity is to provide a first level of scrutiny for the company's accounts and business performance reports. This is to ensure that the Board is fully satisfied that the business has shown itself to be accountable and is able satisfactorily to report to the shareholder and regulator. The level of information required by a regulator and a shareholder are very different as both have very separate and different uses and needs for this information. For example, in assessing a particular capital project, such as the Automated Meter Reading project, the board and shareholder's concerns may include efficiency, deliverability and ensuring the appropriate return on that investment. The regulator's interest will be much more focussed upon whether the cost is an efficient one which customers should reasonably be expected to contribute to. The level and nature of the information that the different bodies will need to assess this same project will be very different. This point is important in understanding the nature of a regulator's requests for information compared to that which the company may need for its own purpose.

3.48 The OUR has concerns that the information provided to the current Board is insufficient for its own price control purposes. Guernsey Electricity management has stated to the OUR on a number of occasions that given the uncertainty surrounding certain key issues it would not be appropriate to seek Board approval prematurely when better decisions will be made at the appropriate time, which is often not at the time of the price review. The OUR considers that as a result it has had to request more information than would be needed for operational and business decisions and this has led to tensions and a conflict of opinions.

3.49 Guernsey Electricity believes that some of the OUR's demands are unreasonable. The OUR in turn feels that Guernsey Electricity should expect to be able to meet these demands as part of its normal business. We noted demands for information by the OUR that were heavy handed, often quoting licence or legal terms, and allowing very little time to reply. A better, more open dialogue would foster greater co-operation which would be of benefit to both parties. There are signs that relationships between the OUR and Cable and Wireless Guernsey and Guernsey Post are improving, but this does not appear to be the case with Guernsey Electricity. The present poor and sometimes adversarial relationship has led to continuing problems. While there are more regular meetings between the parties at management level there continues to be little meeting of minds. Guernsey Electricity hopes that the OUR will recognise some of its observations as a catalyst to commence change and thereby an improved relationship. We consider that, until Guernsey Electricity accepts the need for regulation and understands the role of the regulator and the OUR reassures the company of the need for and the use to which it puts the information that it seeks, there will continue to be difficulties with the model insofar as it relates to the electricity sector.

Regulation has been costly

3.50 The licence fee is currently £180,000 representing an annual cost of £3 a head for the whole Guernsey population or some £6.40 for each of Guernsey Electricity's 28,000 customers. Nevertheless, the licence still represents only about three quarters of one per cent of Guernsey Electricity's annual turnover, which is within the one per cent estimate for the costs of regulation made when the policy was being formed. The OUR's costs per employee are also in line with that of regulators in the UK.

3.51 Guernsey Electricity has told us that it believes regulatory costs to be many times higher than in other jurisdictions and that, in addition, providing the information required by the OUR is resource intensive. The company believes that there is no evidence of costs coming down, whereas this was initially predicted for the period once licences had been issued. Guernsey Electricity has estimated that it costs the company £500,000 a year to meet the OUR's demands. This figure has not been audited and must therefore be treated with some caution since it is unclear how much of these costs would have been incurred anyway in moving to a more commercial environment. If the estimated costs to Guernsey Electricity of meeting the OUR's requirements are taken into account, regulation is costing £8.30 per

head of population and £17.85 per customer, and is equivalent to some two per cent of Guernsey Electricity's annual turnover. These costs are very high relative to regulation costs in other economies such as the UK. However, some of this is because of the small size of the population in Guernsey and the fact that there are fairly high costs to operate a regulatory regime. Regulation is also in its early stages in Guernsey and ongoing costs ought to come down over time. We would not expect the costs to be as low as the costs in the UK which are spread over a much larger population and customer base. Nevertheless, even taking into account these factors, the cost of regulating Guernsey Electricity does appear to be higher than might be expected.

3.52 The poor relationship between the two parties has also added to the costs. If too much management time is spent dealing with the regulatory regime the efficiency of the business can be affected. A clear, open dialogue and cooperative relationship would help each party to understand the other's needs and concerns.

Fieldwork Comments

"We need regulation, but it is not clear that we need regulation of this onerous kind" – focus group

"Guernsey Electricity needs only a minimal amount of regulation compared with Cable and Wireless" – focus group

Recommendation: We consider that the OUR needs to ensure that its requirements are only those that are essential for the efficient operation of the regulatory regime and that no unnecessary additional information requirements or costs are imposed.

Recommendation: The OUR should seek at all times to act in accordance with the principles of Better Regulation. It should apply flexibility to ensure that the requirements are appropriate and proportionate to Guernsey's needs and size. The OUR should also make clear to Guernsey Electricity why demands are being made so as to increase the transparency of the process.

Recommendation: The OUR should adopt a more risk-based approach to its regulation of Guernsey Electricity. It should only get deeply involved in matters which are fundamental to the well being of consumers and the Island as a whole. Other issues should be given a light touch. Such an approach would reduce the cost of regulation and could be the foundation of a less confrontational relationship in future.

Recommendation: The OUR and Guernsey Electricity should take immediate steps to improve their working relationship. A clear, open dialogue and cooperative relationship would help each party to understand the other's needs and concerns. The current adversarial relationship is not acceptable and can only be of detriment to consumers. The OUR should work with Guernsey Electricity to seek to reduce the regulatory burden on the company. Guernsey Electricity should respond positively by accepting the need for regulation and appreciating the different roles that the shareholder and regulator undertake.

There are alternative models for commercialisation of electricity but none offers significant advantages over the model adopted in Guernsey

3.53 As noted earlier, we have concluded that an appropriate model was chosen for the commercialisation and regulation of electricity in Guernsey, but improvements could be made in the way the model is executed. This section of the Report briefly discusses other models of commercialisation that might be adopted in Guernsey. It identifies their strengths and weaknesses and their appropriateness and applicability to Guernsey. We consider that none of the other models offers significant advantages over the current model but some elements are worth exploring further.

Return to full States control

3.54 As with Guernsey Post, some have argued to us that the States should take back Guernsey Electricity under full States control, with political Boards running the businesses as was the case before commercialisation. As noted already in paragraph 2.44, we consider that this would be a retrograde step. In our view, there were powerful arguments that led to the utilities being commercialised in 2001-02, for example, freeing them from the constraints of public sector controls and political interference and allowing the businesses the commercial freedom to manage their operations. We believe that these arguments are just as valid today.

Full privatisation

3.55 The States could decide to privatise Guernsey Electricity and relinquish all States ownership of the company. The company could then operate fully commercially and the OUR could set the regulation regime to ensure the needs of Guernsey are met and customers' interest are protected. This would be similar to the situation in the UK. But in the UK competition amongst electricity suppliers helps drive down prices and brings benefits to the consumer. It seems unlikely that the electricity market in Guernsey will ever be large enough to support more than one supplier so no realistic competition would occur. Full privatisation could lead to the business being owned off-island by a monopoly supplier, which may not understand Guernsey's needs and characteristics. There would, therefore, be little advantage in this process compared with the current regime, and the States would have lost all controlling interests in the industry.

A merger with Jersey Electricity

3.56 Most of the electricity used by Guernsey and Jersey comes through the cable link with France. But both islands maintain on-island power generation sources to ensure security of supply. Both islands are therefore able to produce more than enough electricity to satisfy peak demands and have about 100 per cent surplus capacity. Guernsey Electricity notes, however, that there is only one power cable between Guernsey and Jersey, with a time to repair of potentially three months. The key risk for the island of non-supply would therefore not be removed by a merger.

Fieldwork Comment

"One of our concerns is that following the cable link we are now subsidising a dormant Power Station" – focus group

3.57 If the electricity companies of both islands were to merge there might be scope to achieve significant cost reductions by reducing the amount of surplus capacity although this would need to take account of on-island back up supply. There would also be economies of scale by eliminating duplicated roles in the two companies. There is already a degree of joint working with Jersey through the Channel Island Electricity Grid (CIEG) arrangements for the cable link.

3.58 As already noted with any possible merger of the two postal operations, there would also be a number of drawbacks from a merger of the two electricity companies. Guernsey might lose some influence over a key utility service which is crucial to the island's development. There would also be concern in Guernsey that Jersey could become dominant and that Guernsey Electricity might suffer and be forced to shed staff. In addition, there is the practical difficulty that Guernsey Electricity is 100 per cent owned by the States whereas Jersey Electricity is 38 per cent owned by private shareholders. These difficult issues would need to be addressed head on if this option were to be taken forward. The clear efficiency benefits of having a joint supplier would have to be balanced against the political difficulties and possible undermining of Guernsey's position.

3.59 A detailed examination of the relative costs, advantages and disadvantages of merging with Jersey is outside the scope of this review. However, we do believe that this option is worth considering further. Similarly, other options outside the scope of this review, such as a merger with the water sector, could also be considered.

Recommendation: Merging Guernsey Electricity and Jersey Electricity would bring clear efficiency savings but there would also be a number of risks and drawbacks. Although a detailed examination of this option has been outside the scope of this review, we do believe that this and other potential merger options are worth exploring further by the States.

Structural reform

3.60 Three licences were issued for electricity at commercialisation, covering different areas of the supply chain. These allowed for different periods of exclusivity for Guernsey Electricity before these areas were opened up to competition. Guernsey Electricity was offered no period of exclusivity for electricity generation so this area was opened up to competition immediately upon commercialisation. The company received a ten year exclusivity period for conveyance and one year for supply. The latter, however, only represents about five per cent of electricity bills.

3.61 Given the small size of the Guernsey electricity market, it is unlikely that it would be very attractive to competitors. It therefore also seems unlikely that structural reform of the different areas of the electricity market would lead to significant interest from possible new entrants to the market in any of the three areas.

Rebalancing the capital structure of Guernsey Electricity

3.62 As with Guernsey Post, we note that Guernsey Electricity is not indebted and operates purely on a cash basis. As at 31 March 2004, Guernsey Electricity had cash of £15.5 million on its balance sheet out of total net assets of £111.2 million.

3.63 Guernsey Electricity has to build up cash reserves to pay for any major investments, such as the cable link to France. Although Guernsey Electricity believes that this limitation does not restrict the company's overall flexibility since it can still use debt funding if it were to be beneficial, it does mean that it has to plan carefully to ensure it will have sufficient cash to pay for necessary investments, such as replacing its ageing generators. Guernsey Electricity is therefore not in a position to take advantage of beneficial investment opportunities that might present themselves or to respond as quickly to adverse events that may hit current reserves. It also results in customers having to pay now for investments that will be made in the future, possibly as far as 10-15 years later.

3.64 As noted in paragraph 2.53, in the UK it is more usual for utility companies to carry a significant amount of debt on their balance sheets. For example, in the gas and electricity markets, the standard assumption of the UK's Office of Gas and Electricity Markets (OFGEM) is that companies will have a capital structure with around 50 per cent debt and 50 per cent equity. These companies are all privatised of course and different considerations as regards the weighting of corporate debt and shareholder equity apply.

3.65 Nevertheless, there could be some advantages if Guernsey Electricity were to rebalance its capital structure to incorporate an element of debt and if future investment were to be financed from borrowing rather than the build up of cash reserves. It would open up commercial advantages and bring the commercial disciplines of the capital markets to bear on the company. Having a more conventional balance sheet containing both equity and debt would bring a number of advantages as noted in paragraph 2.54:

- The company would have better long term financial flexibility:
 - there would be no need to build excessive cash reserves;
 - there would be a reduced need for spuriously accurate long term forecasts.

- The company would be subject to a second level of scrutiny from the banks or other lenders, thus increasing due diligence.
- Because of the scrutiny provided by the lenders of finance, there would be less oversight needed by the OUR, reducing costs to both the OUR and Guernsey Electricity.

3.66 There are, however, risks involved with taking on debt in this way (whether it be in the form of loans, bonds or other forms of lending). These risks include:

- the risk of default;
- the risk from changes in interest rates;
- the application of potentially limiting debt covenants.

Recommendation: Consideration should be given to rebalancing the capital structure of Guernsey Electricity to include an element of corporate debt and for future investment to be financed from borrowing rather than the build up of cash reserves. These moves would bring the scrutiny and due diligence of a corporate lender to bear on Guernsey Electricity and give the company the flexibility to plan for future investment when it is most needed.

Evaluation

3.67 Our overall evaluation of commercialisation and regulation in electricity is set out in **Figure 13**.

13 Evaluation of Commercialisation and Regulation of Electricity in Guernsey

Commercialisation

The quality of the management

Clarity of shareholder expectation

Operational freedom

Improved commercial performance, including:

- increased efficiency
- enhanced profitability

Regulation

Independence and absence of capture

Only limited problems of information asymmetry

Proportional information requests

Avoiding an excessively adversarial relationship

Outcomes

Improved consumer outcomes:

- lower prices
- quality of service improved
- long-term security of supply

Degree of Success

No change of personnel since commercialisation but efficiency is improving

Low

Low

Efficiency and profitability are improving

High

High

Low

Low

Prices have not risen in 14 years but may need to as a result of the renegotiated EDF contract.

Customer outages have fallen to a very low level.

Supply is secure, but reduction in capacity could see efficiency gains.

Source: National Audit Office

PART FOUR

The Office of Utility Regulation



4.1 The Office of Utility Regulation (OUR) was established in October 2001, at the same time as telecoms and postal services in Guernsey were commercialised. It is the regulatory agency in Guernsey for the three utility sectors of telecommunications, post and electricity.

4.2 The OUR's strategic aims are to ensure that:

- consumers receive the best value, choice and access to high quality utility services; and
- the Bailiwick of Guernsey has vibrant, sustainable utility sectors capable of maintaining pace with global developments and thereby contributing to the economic and social well-being of the islands.

4.3 In accordance with Section 3 of the Regulation of Utilities (Bailiwick of Guernsey) Law 2001, the States of Guernsey may, by Resolution, give to the Director General directions regarding the following specified matters:

- the identity of the first licensee in each sector to have a universal service obligation included in its licence;
- the scope of the universal service obligation in each sector;
- the extent and duration of any exclusive rights in each sector, and as a result the pace of the introduction of competition; and
- any actions necessary arising from international obligations.

Throughout the development of the new regulatory regime, the States of Guernsey has issued States Directions on a number of occasions.

4.4 The OUR's functions are governed by the Regulation law, and sector specific legislation. The OUR issues licences to organisations to enable them to operate in the regulated part of the utility sector. To date it has issued eight telecommunications licences, one post licence and one electricity licence.

4.5 The relationships between the OUR and the organisations it licenses have already been considered in the first three parts of this report. We note that the OUR has had some considerable successes but that the cost of regulation is high and the regulatory burden could be reduced. This Part of the Report examines issues specific to the OUR itself. We found that:

- The accountability arrangements for the OUR need to be strengthened.
- Succession planning needs to be developed.
- A more risk-based approach would reduce the regulatory burden and cost.
- The appeals process has proved to be very costly so far and is under review.
- There are alternative models that could be adopted for regulation in Guernsey but none are superior to the regulation model currently adopted.

The accountability arrangements for the OUR need to be strengthened

4.6 The Director General of Regulation is accountable to the States of Guernsey and each year must submit a report on the activities of the OUR and audited accounts. The accountability function within the States of Guernsey is performed by the Commerce and Employment Department, which, with States approval, has the right to appoint or, in very exceptional circumstances, to remove the Director General and approve the overall numbers of staff in the OUR.

4.7 The full responsibilities of the Commerce and Employment Department (as applied to the former Board of Industry) are outlined in The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001. In summary the Department's role includes the following requirements:

- To recommend to the States the appointment and, where necessary, the removal of the Director General of Regulation.
- To receive, review and pass onto the States the annual report of the operations of the OUR. This report to include:
 - the exercise of the Director General's functions and powers;
 - the steps undertaken to uphold the Director General's duty; and,
 - the audited accounts of the OUR.
- To recommend to the States, where necessary, the addition or removal of the OUR's powers.
- To recommend to the States Directions to be given to the OUR in the exercise of its functions.

4.8 Whilst these reporting arrangements are satisfactory in themselves, there is no independent oversight of the operations of the OUR. Neither the States Internal Audit nor representatives of the States Public Accounts Committee have rights of access to the books and records of the OUR to ensure that the OUR has proper systems of internal control and corporate governance and is operating with due regard to value for money, although it is noted that the OUR has met, and discussed this issue, with the Public Accounts Committee. This is a significant omission and its correction is particularly pressing in view of the widespread concern about the cost and methods of operation of the OUR.

4.9 The OUR has indicated that it is conscious of the need to increase the accountability of the Office above that already provided for by the States in establishing the Office. It is intending to appoint an Independent Audit Committee and external internal auditors who will report to the internal audit committee. It is hoped to have the arrangements for this in place for the start of the next financial year on 1 January 2006, subject to clarification of the legal position of such a body under the existing legislation.

Recommendation: The States Internal Audit and representatives of the States Public Accounts Committee should have automatic rights of access to the books and records of the OUR. This would ensure that there is proper and independent oversight of the operations of the OUR in line with best practice elsewhere.

Succession planning needs to be developed

4.10 When the OUR was established in 2001, it had a Director General and four other staff. It has approval from the Commerce and Employment Department for up to seven staff, but this number has never been reached. The small team of in-house experts can draw on outside consultants as needed: a small pool of consultants is held on retainer contracts for day to day work assistance; for larger projects consultants are engaged after competitive tender.

4.11 Since January 2005 the OUR has had its first major turnover in staff since it was established. Whilst staff numbers, including the Director General, remain at five, finding staff with the appropriate experience of regulation on a small island can present problems. With an office of this size, there is a risk that with the departure of any member of staff, and the difficulty of recruiting suitable replacements, the Office may not be able to fulfil its functions. It is therefore important to have in place contingency plans for this eventuality. Contingency plans could include making arrangements to draw on the resources of an overseas regulator, to contract out much of the work normally undertaken by the secretariat, or to instigate one of the alternative models for regulation discussed later in this Part of the report, such as self regulation by the industry.

Recommendation: Contingency plans need to be drawn up to enable regulation to continue to operate in the event that staff numbers at the OUR fall below the minimum necessary for it to carry out its statutory functions.

A more risk-based approach would reduce the regulatory burden and cost

4.12 The cost of the OUR since its formation in 2001 is shown in **Figure 14** below.

4.13 As noted in Parts 1 to 3 of this report, Cable and Wireless, Guernsey Post and Guernsey Electricity have all complained of the significant regulatory burden imposed on them. Each has provided an estimate of its own cost of compliance (which includes the licence fee): Cable & Wireless (£1.4 million), Guernsey Post (£220,000) and Guernsey Electricity (£500,000). Although these figures have not been audited and must therefore be treated with some caution, they do provide an indication of the regulated companies' estimate of the cost of utility regulation in Guernsey.

Fieldwork Comment

"The OUR spends a lot but appears to do little in return."
– written comment

4.14 As can be noted from these figures, and contrary to some public perception, the cost of regulation has fallen since 2002. In 2004, the OUR's costs amounted to £845,000, a 9 per cent drop on the 2002 costs and a drop of 7 per cent on 2003. The 2004 costs also include a further

£50,000 in costs attributed to the Utility Appeals Tribunal. In assessing the current costs of regulation it is important that they are considered within context. The development of the regulatory regime is in its early stage when compared to more settled regulatory environments such as in the UK. There will be a difference in the costs of a more stable regulatory environment compared with one which is still in the initial phase. The OUR considers that the work currently being undertaken can be viewed as the building blocks upon which future work depends. There is often additional regulatory – and as a result one-off costs – in this stage and there should continue to be a decrease in both the OUR's own costs and the costs to the regulated companies of complying. The OUR envisages its costs in total falling to around £750,000 by 2007 and a decrease in the cost of compliance for the regulated companies.

4.15 Each of the three parts of this report lists the fees levied on the regulated companies as a percentage of turnover for 2005: Cable and Wireless, 1.5 per cent; Guernsey Post, 0.8 per cent; and Guernsey Electricity, 0.65 per cent. These figures are higher than the corresponding regulatory levies in the UK. The OUR prefers to compare its costs to other National Regulatory Agencies by using a cost per employee basis. This information is given in **Figure 15**.

14 OUR income and expenditure, 2001 to 2003

		2001 (£)	2002 (£)	2003 (£)
Income	Licence fees	105,000	732,381	793,886
	Grants from the former Board of Industry	62,008	287,359	-
	Bank interest	98	1,125	8,319
	Total income	167,106	1,020,865	802,205
Expenditure	Salaries and staff costs	80,638	271,297	315,781
	Consultancy fees	-	506,820	189,344
	Legal fees	-	56,787	313,975
	General overheads	18,598	69,204	71,625
	Total expenditure	99,236	904,108	890,725

NOTES

- 1 The OUR began operations in 2001. The figures for 2001 represent the partial year from 1 October to 31 December.
- 2 Figures for 2004 are not yet available but OUR estimates costs to be approximately £840,000, including a further £50,000 incurred due to the appeals process.

15 OUR cost per employee compared to other NRAs

NRA	Sectors	Staff Numbers	Total Costs (£,000)	Cost per Staff (£,000)
OUR	Telecoms/Electricity/Post	5	840	168
JCRA	Telecoms/Competition	5.5	760	138
Ofcom	Communications (including telecoms)	763	127,000	166
Postcomm	Post	57	9,000	163
Ofgem	Gas/Electricity	291	50,000	171

NOTE

Figures for Ofgem, Ofcom and Postcomm are for the year ending 31st March 2005. Figures for the JCRA are for the year ending 31st December 2004. Figures for the OUR are its estimates of out-turn for the year ending 31st December 2004. The OUR also estimates that its total costs for 2005 will be in the region of £750,000, a cost per staff of £150,000. Figures may not cast correctly due to rounding.

4.16 Figure 15 demonstrates that the OUR's costs on a cost per employee basis are in line with other regulatory agencies. It must also be recognised that larger offices will inevitably have economies of scale which will not be available to an office of five staff. However, cost per employee is only one measure of efficiency and the need to bear down on overall costs is also important.

4.17 A more risk-based approach by the OUR could reduce the regulatory burden and hence the cost of regulation. As noted earlier, under a risk-based approach, the regulator would explicitly assess the risks to consumers and commit to adopting a different regulatory approach depending on the level of risk. At the margin, the regulator would adopt a proactive position on very high risk issues and not intervene in issues with a very low risk. In adopting such an approach, the OUR should seek to intervene only where the benefits of doing so are likely to outweigh the costs.

4.18 A risk-based approach has recently been adopted in the UK by the Occupational Pensions Regulatory Authority (OPRA) and the Office of Communications (OFCOM). Where the size of the budget is a constraint, and the interventions made by a body could be limitless, to maximise the output for a given level of input the regulated body must target its work programme to address the issues which will maximise the outcomes. In short, the regulator must rank all the risks to competition and the consumer and focus on the high risks that are likely to occur at the expense of small risks that are unlikely to occur. **Figure 16** illustrates this risk-based approach with some hypothetical examples from the telecoms sector.

4.19 There are, of course, risks inherent in adopting this approach. In its simplest form, if the risks cannot be identified, ranked or offset, then the approach will fail. However, there are more subtle risks that would need to be addressed; these include the crystallisation of risks that could not reasonably have been forecast, or indeed the changes in relative levels of risk over time. Most economic regulators try to overcome, or at least manage, these risks by developing a risk register.¹⁶

The appeals process has proved to be very costly so far and is under review

4.20 A person who disagrees with a decision of the Director General made in the exercise of the Director General's functions and powers, may (subject to the provisions of any Sector Law) appeal against the decision to the Utility Appeals Tribunal. This may be done provided that the appellant believes that:

- an error of law has been made;
- a material error as to the facts has been made;
- there was a material procedural error; or,
- there was some other material irregularity, including unreasonableness or lack of proportionality.

4.21 The Tribunal may either dismiss the appeal or quash the decision of the Director General. An appellant who is unhappy with the outcome may appeal again to the Royal Court.

¹⁶ A risk register is a document which captures risks identified within an organisation, the possible actions to mitigate those risks and action plans should those risks crystallise.

16 Illustrative risk matrix for regulatory interventions

	Likely to occur	Unlikely to occur
High risk	High priority (For example local loop unbundling: the risk is that new entrants will not be able to enter the market or will pay too much to enter)	Low priority (For example the risk of collusion between the four large mobile companies in the UK)
Low risk	Medium priority (For example access to broadband: the risk is that a proportion of consumers may be too far from a strong signal to get an effective service)	Lowest priority (For example the risk that Directory Enquiries might forward an enquiry to a premium rate number where the customer is unaware of the cost)

NOTE

The risk examples are hypothetical.

4.22 Cable and Wireless and Guernsey Post have both appealed to the Utility Appeals Tribunal. The Cable and Wireless appeal was costly and time consuming (see **Figure 17** for details). Cable and Wireless estimates the total cost of the appeal process as in excess of £600,000. The OUR's component of this cost was in the region of £300,000 and has been passed back to the telecoms licensees in increased fees.

17 Cable and Wireless appeal to the Utility Appeals Tribunal

In July 2002 the OUR directed Cable and Wireless to include leased lines in its Reference Offer to other licensed operators who were entering the market. The direction was issued on the basis that Guernsey Telecom had a dominant position in 'the fixed network and services telecommunications market'. Cable and Wireless failed to abide by the direction believing the OUR was wrong and had erred in law; been guilty of material procedural errors; and, erred in fact. Cable and Wireless subsequently appealed to the Tribunal.

The Utility Appeals Tribunal found that the Director General had erred in law, but not as far as Cable and Wireless claimed. It found that the Director General had not erred in procedure, and also that it arguably should find that the Director General erred in fact, but again, not as far as Cable and Wireless claimed.

4.23 Certain licensees mentioned to us that the cost of the current appeals process acts as a deterrent to their making a complaint. This high cost may act in favour of the incumbent in a sector where there is competition. Guernsey Post considers that utilities have no option but to go to appeal if confronted by what they consider to be an unacceptable regulatory decision. Guernsey Electricity believes that given the very strong regulatory powers granted under Guernsey Law, the current appeal arrangements need to be protected as a vital safeguard within the whole framework. Like other parties, Guernsey Electricity would like to see reduced costs for any appeals in the future. It believes that experience of initial appeals will help this and that some form of arbitration route would be a sensible part of any process.

4.24 The OUR told us that it fully supports the need for an appeals process to protect the interests of its licensees and other affected parties. Since early 2004 the OUR has drawn attention to the costs of the appeals process and believes that a more appropriate process for Guernsey should be considered. In addition, to mitigate against appeals the OUR has changed its consultation procedures, moving to draft decisions before any final decision. The OUR has also proposed and subsequently engaged in mediation with Guernsey Post to resolve a dispute, resulting in the licensee agreeing to withdraw its appeal.

4.25 Given the limited resources of the OUR and the potential impact on consumers of an expensive tribunal case in the form of higher charges it is important that an appeals process should be in place which is efficient in terms of the time and cost of resolving disputes. The operation of the appeals process is currently under review by the Commerce and Employment Department. The OUR points to the expense of the Appeals process as one of the key drivers of its costs in 2002 and 2003. The OUR estimates that its costs in 2005 will be some 20 per cent lower than that of those in 2002.¹⁷

4.26 Separately, the OUR itself recognises that the current appeals process does place a level of time pressure on regulated companies that is not comparable with other jurisdictions. The OUR this year decided, in an effort to increase the transparency of the regulatory process and to reduce to some degree the time pressures felt by companies, to publish “Draft Decisions” on key regulatory issues. This allows the company sufficient time to consider and comment upon key decisions prior to the decision being formally adopted. The OUR intends to change its consultation process to build in draft decisions as a feature later this year. It hopes that this will alleviate to some degree the concerns that the regulated companies have with the current timelines in the Law, although it too would wish to see the appeals process modified.

Recommendation: Given the importance of the appeals mechanism as an integral part of the commercialisation and regulatory framework, the results of the review by the Commerce & Employment Department need to be dealt with alongside the other recommendations in this report.

There are alternative models that could be adopted for regulation in Guernsey

4.27 As noted earlier, we have concluded that an appropriate model was chosen for regulation of the utilities in Guernsey, but improvements could be made in the way the model is executed, particularly in terms of reducing the regulatory burden by adopting a more risk-based approach. This section of the Report briefly discusses other models of regulation that might be adopted in Guernsey. We consider that these other models have some significant attractions and may be worth exploring further in certain circumstances. However, in terms of the OUR’s current remit, we do not believe they are superior to the regulation model currently adopted.

A consumer approach

4.28 Consumer representation is now at the heart of utilities regulation in the UK. In 2000 the Government established independent statutory bodies to represent the consumer interest in the energy and postal markets. Energywatch replaced the Gas Consumers Council and the Electricity Consumers’ Committees; and Postwatch replaced the Post Office Users’ National Council. Energywatch and Postwatch were established to ensure that consumers have an effective and influential voice within the regulatory system. Their specific aims are to promote and protect the interests of consumers in their respective markets and their three key statutory tasks are to:

- investigate complaints referred by consumers who are not satisfied with a company’s response;
- represent the views of consumers; and,
- provide advice and information to consumers.

4.29 In Guernsey, the consumer representation aspect of regulation is a more recent introduction than in the UK and therefore at an earlier stage of development. Consumer representation in Guernsey in the three sectors is undertaken by Postwatch, the Electricity User Council and the Cable and Wireless user group. Each of these organisations is funded by, but independent of, the incumbent operator. Postwatch is the most developed of the three consumer bodies, primarily because there has been a higher level of customer service issues in post since commercialisation.

4.30 We believe that there may be scope in Guernsey for the statutory regulator to take a less traditional regulatory approach than one might see in similar sectors in the UK, and a more consumer oriented watchdog approach. In effect, the OUR would provide advice to consumers on getting the best deal from their utilities whilst also influencing the industries concerned to provide services that consumers want at reasonable prices. This approach would be supported by a complaints procedure that synthesises a regulatory direction. For example when a consumer or, more likely, consumers make complaints, the regulator would investigate the complaints and, if necessary, issue an enforceable direction to the companies involved.

¹⁷ The OUR’s costs in 2002 were £915,887 and the Director General estimates that in 2005 they will be in the region of £750,000.

4.31 This regulatory approach could substantially reduce the costs of the regulator and the costs of regulation on business. This is because the regulator would not be trying to address the information asymmetries discussed earlier; rather it would reactively address issues brought to its attention by consumers.

4.32 There are some significant risks inherent in this approach. Much of the activity performed by the consumer watchdog would be educational. Should it need to direct a market participant, this would take the form of ex-post regulation, i.e. after the damage is done. This could lead to a situation where the transgressor continues to conduct business in an anti-competitive manner in order to achieve short-term gains.

The secretariat model

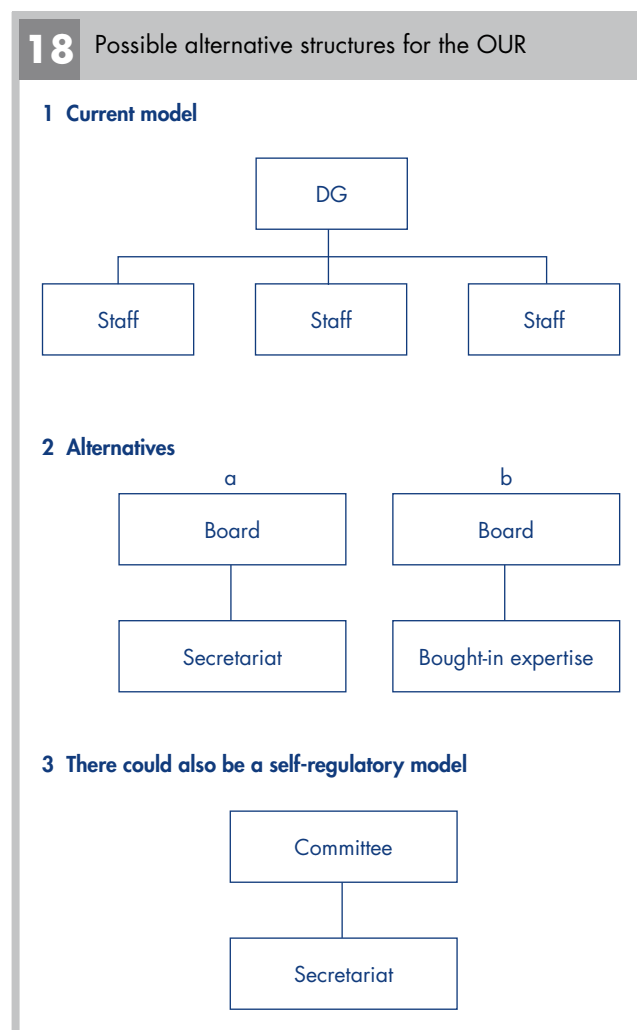
4.33 The current regulatory structure in Guernsey comprises a Director General with an office of supporting staff. The Director General is by law the regulatory authority, and the office provides the support enabling the Director General to discharge his or her duties. In the post privatisation era in the UK, this was the common regulatory structure, leading to National Regulatory Agencies such as OFTEL, OFWAT and OFGAS.

4.34 In the UK, with Office of Communications (OFCOM), there has been a move from individual-led regulation to a committee approach. This alternative structure sees the Director General replaced by a board which, in turn, is supported by a secretariat. OFCOM is the most recent and high profile example of this structure. In some instances, for example where the regulated industry is small, the secretariat function may be provided by a series of contracted services, or ‘bought-in’ expertise, such as consultants. This approach would have the advantage in Guernsey of overcoming the risks from succession planning; if one member of a committee leaves, a replacement is less time-critical than if a Director General were to depart.

The self-regulatory model

4.35 In some industries the regulatory function is performed by the industry itself through codes of practice. This approach is often called self-regulation or co-regulation. An example of such a regulatory body is The Independent Committee for the Supervision of Standards in Telephone Information Services (ICTSIS). In the UK this body is the industry funded regulator of premium rate telephone services. It has nine part-time committee members drawn from industry (but with no current connection to the premium rate industry). It is supported by a secretariat and regulates through a code of practice. However, it is clear there are risks with this model in an environment such as telecommunications where operators are dependant upon access to key services from their competitors, or in a monopoly market (such as electricity).

4.36 Possible alternative structures for the OUR are shown in **Figure 18** but, as noted above, we do not believe they are superior to the regulation model currently adopted.



APPENDIX 1

Terms of Reference

1 In October 2001/February 2002, the States of Guernsey agreed to transfer responsibility for the provision of postal, electricity and telecoms services from the existing political bodies to States Trading Companies (STCs) through a process of commercialisation that also involved the introduction of independent statutory regulation. The STC providing telecoms services was subsequently privatised.

2 The two States Departments which now have the primary responsibilities for the commercialised utilities; Treasury and Resources Department (T&R) and Commerce and Employment (C&E), have undertaken to review the outcomes of the commercialisation process and report back to the States on the results of the Review.

3 The objectives of the exercise are that the results of the Review will enable the States to consider in respect of each of the utilities:

- To what degree the process has achieved the objectives/expectations of commercialisation;
- Whether or not it wishes to completely abandon the commercialisation model and replace it with an alternative approach;
- Whether or not it wishes to revise any elements to the commercialisation model;
- Whether or not it wishes to revise any of the policies that have been adopted within the commercialisation model,

having been advised of the practicalities and implications of adopting various options.

4 The results of the review will need to present an assessment of:

- The political and business/economic situation prior to commercialisation and the objectives for/expectations of the process
- How effectively roles have been undertaken and policies been implemented for:
 - The Shareholder (including audit/scrutiny arrangements)
 - The Strategic Direction of utilities
 - The Strategic Direction for Regulation
 - The implementation of Regulation
 - The management of companies by the Boards of Directors
- The views and attitudes of the stakeholders in commercialisation including the public/consumers and States members.
- The current political and business/economic situation and how this might impact on the utilities.

5 The review will therefore need to be undertaken by a combination of:

- Examination of reports to the States and other documents
- A consultation process with stakeholders including
 - States Members
 - The bodies undertaking various roles within the commercialisation model
 - Various Interest Groups in the Community including businesses
 - The public
- The application of knowledge and experience of the operation of utilities and of regulatory regimes.

6 T&R and C&E have agreed that the research and consultation processes for the Review should be undertaken independently and is looking to commission an organisation that can demonstrate that it has, or has access to, the ability/experience necessary to:

- Understand the broad local and wider business/economic context of the three utilities
- Understand the broad local and wider regulatory context for the three utilities
- Understand the local political context.

7 The body undertaking the research and consultation will be required to submit a report setting out the results and any conclusions from the research and consultation process which T&R and C&E will then submit to the States along with a covering report and proposals.

APPENDIX 2

NAO Methodology

1 Our approach has been built around the “Issue Analysis and Dinner Party (IADP™)” technique pioneered by the NAO. This technique was developed by the NAO to ensure that investigations focused on the most important issues and that reports were logically structured and helped the reader readily to understand the key messages that were being put across.

2 The key elements of our study methodology are set out below.

Issue Analysis

3 We carried out a brief ‘Issue Analysis’ early in the assignment to confirm that the questions and tasks set out in the proposal were the ones that needed to be answered to enable us to form a view on the future direction of commercialisation and regulation. This process also enabled us to identify any emerging issues that we needed to consider.

4 The first object of issue analysis is to identify the key question that readers of the audit report would want answered. This is done by analysing the situation (i.e. what the subject is about) and identifying the complication (usually some problem) which has led to the subject being investigated. The key question will normally follow from this analysis. The technique then uses a top-down approach to identify all the questions that need to be answered before the key question itself can be answered.

5 The issue analysis technique helps to ensure that a study is properly focused on the issues that really matter and that sufficient evidence is collected to support the report’s conclusions and recommendations. It also helps reviewers to avoid getting side-tracked into areas that are not material or relevant. Finally, it ensures that reviewers evaluate situations rather than just describe them.

Evidence Collection

6 The NAO drew on a wide variety of sources to collect evidence for the review, as set out below.

File review and historical context

7 We undertook a detailed review of Departmental papers, States Billets D’Etats, and the legislation that set up the companies as States Trading Companies and the Office of Utility Regulation.

8 We also commissioned the local consultancy firm, Organization Development Ltd (ODL), to research and prepare a paper on the local context in which commercialisation took place in 2002 (see Appendix 4).

Semi-structured interviews with key stakeholders

9 We carried out a series of semi-structured interviews with:

- the Ministers and senior officials of the two Departments - Commerce & Employment and Treasury & Resources - that commissioned the review;
- senior officials at the Office of Utility Regulation, the three incumbent companies (Guernsey Electricity Limited, Guernsey Post Limited, and Cable & Wireless, Guernsey) and other companies that have entered the market;
- consumer groups, trade associations and other interested parties;
- the relevant department and utilities in Jersey.

Written comments

10 We wrote to all States Members asking for their views on commercialisation and regulation. We also wrote to over 40 organisations, including competitors and customers of the utility companies, consumer groups, business organisations, trade associations and unions.

11 We placed a series of advertisements in the Gazette Officielle inviting members of the public to give their views to us. The advertisement included an email address, states.review@nao.gsi.gov.uk, where readers could send their comments.

Focus groups

12 We commissioned ODL to convene two focus groups each containing 11 “opinion formers” drawn from commerce and industry. The groups were given a series of topics on commercialisation and regulation to discuss.

Telephone survey

13 We commissioned ODL to undertake a telephone survey of 200 randomly selected members of the public (see Appendix 5). It uncovered public views on the price, choice and quality of service offered by the commercialised utilities. It also investigated the views of the public on regulation.

Comparisons with the UK and elsewhere

14 We drew on the NAO’s extensive knowledge and many years’ research of the commercialisation and regulation models adopted in the UK and overseas.

Reporting

15 The draft report was prepared using the NAO’s “Dinner Party” technique referred to above. This technique aims to ensure that reports are logically structured, that findings are underpinned by solid and reliable evidence, and that the key messages and conclusions are readily understandable by the reader.

16 We showed our report in draft to senior officials of the Commerce & Employment and Treasury & Resources Departments. We also discussed our findings and conclusions with the Office of Utility Regulation, Cable & Wireless Guernsey, Guernsey Electricity and Guernsey Post. Where appropriate, we have included any comments on our findings and conclusions in the final report. The final report is the NAO’s.

APPENDIX 3

Principles for the States as Shareholder

1 There are in place corporate governance arrangements issued by the States of Guernsey via: States Trading Company Ordinance; and Shareholder Guidance, and which covers:

- a restriction on trading in shares of States Trading Companies without States approval;
- arrangements for the appointment by the States of non-executive directors on the nomination of the Treasury and Resources Department;
- arrangements for the Treasury and Resources Department to determine the remuneration of non-executive directors;
- provisions to avoid any clash of interests of non-executive directors;
- a requirement for the States Trading Companies to submit Strategic Plans to the Treasury and Resources Department;
- provisions for the States to issue guidance to the Treasury and Resources Department in the exercise of its role as shareholder on behalf of the States;
- a requirement for the annual publication of accounts and reports.

2 The States Trading Company Ordinance compels the Boards of Guernsey Post and Guernsey Electricity to submit a strategic plan outlining items such as mission and objectives, key issues, financial projections and future plans. This strategic plan is reviewed by the shareholder and forms part of the checks and balances imposed upon management.

3 A subset of this Ordinance is the Guidance issued by the States to the Treasury and Resources Department on the conduct of its role as Shareholder. This outlines: the activities that the States Trading Company is expected to undertake; financial performance indicators; the requirements to comply with policies set out in the strategic plan; and best practice in corporate governance and financial management. Appendices 3A and 3B set out the current guidance in respect of Post and Electricity as agreed by the States as part of the package of proposals for commercialisation.

4 Whilst we acknowledge that these documents go some way towards providing a suitable corporate governance environment, there are areas for improvement. This note sets out the principles by which we believe the States of Guernsey should operate in its role as shareholder, and its expectations for the businesses for which it is responsible. Although the States is referred to as the shareholder throughout this document, in practice the Treasury & Resources Department would undertake this role on behalf of the States.

5 The underlying principles advocated are as follows:

- **Clarity and transparency of objectives** – for the business; and an approach which ensures greater clarity between the trade-offs in policy, regulation, customer and shareholder interests.
- **A shared vision** for the business, based on agreed objectives, which are explicitly agreed by the shareholder, the Board and the management team.
- **An engaged and informed shareholder**, exercising its key levers of influence (i.e. governance, appointments, strategy, incentivisation and performance monitoring).
- **An incentive framework** that links rewards explicitly to profit and value performance over the long term.

6 The remainder of this document sets out more specific principles to guide behaviour of the States as shareholder. It is divided into two parts: what the States should expect of its businesses, and how the States itself should expect to operate as shareholder – in effect what businesses can expect of the States.

What the States should expect of its businesses

7 The over-riding objective for the businesses should be to ensure that they deliver sustained, positive returns and return their cost of capital over time within the policy, regulatory and customer parameters set by the States.

8 The constraint within which positive returns are to be made is important and in many cases can be the distinguishing feature of operation in the public sector. However, the more that policy and other requirements can be made clear and explicit, the easier it becomes for public sector businesses to focus on adding value, with performance more readily measurable. In this context, the States as shareholder can then seek to replicate the disciplines of the capital markets with its own shareholder function.

9 In framing principles for business operation in the public sector, we have turned to best practice in the private sector. In particular, we believe the so-called “Hermes Principles” offer a good framework for the public sector, with some adaptation.

10 Hermes Investment Management Limited is a major UK fund manager. It has placed emphasis on the exercising of good stewardship, and has published a comprehensive list of business principles which set out its expectations of the businesses in which it might choose to invest.

11 We set out below nine key principles which we would expect to govern the behaviour of businesses in the public sector.

Communication

Principle 1 Businesses should seek an honest, open and ongoing dialogue with the States as shareholder. They should clearly communicate the plans they are pursuing and the likely financial and wider consequences of those plans. Goals, overall plans and progress should also be made public and discussed in the annual report and accounts.

Principle 2 Businesses should operate a “no surprises” policy ensuring that the States as shareholder is informed well in advance of anything potentially contentious in the public arena.

Financial

Principle 3 Businesses should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to shareholder objectives and maximising shareholder value.

Shareholder value

Principle 4 Businesses should ensure that all investment plans have been honestly and critically tested in terms of their ability to deliver long-term shareholder value.

Principle 5 Businesses should have performance evaluation and incentive systems designed cost effectively to incentivise managers to deliver long term shareholder objectives and shareholder value.

Principle 6 Companies should have a capital structure which is appropriate for the nature of the business and ensures that incentives are not distorted, for example by the existence of cash on the balance sheet.

Strategic

Principle 7 Businesses should have and continue to develop coherent strategies for each business unit. The approach to reviewing strategy should be a dialogue between the Board and the shareholder. The focus of the dialogue should be set by the primary goal of the Board to deliver the business’s objectives, which will include key financial and non-commercial goals, including the maximisation of shareholder value consistent with these non-commercial objectives. Strategies should include a market and risk analysis, benchmarking, relevant sensitivity analysis, contingency plans and an outline of how the proposed strategy takes account of lessons learned from previous performance.

Principle 8 Businesses should have a clear rationale as to why they are conducting each of their activities and why they are the appropriate organisation to conduct such an activity.

Social, ethical and environmental

Principle 9 Businesses should manage effectively relationships with their employees, suppliers, customers, and other stakeholders who have a legitimate interest in the business’s activities. Businesses should behave ethically and have regard for the environment and society as a whole.

Principles by which the States should operate as shareholder

12 We consider that the States should follow these principles as far as is possible under the current law. Where appropriate it may be necessary to consider changing the law.

13 Subject to these constraints, we propose that the basic shareholder model should work as follows:

- the Shareholder appoints the Board, and agrees the terms on which the Directors are appointed and incentivised (annually and for the longer term);
- the Shareholder sets overall objectives for the business;
- the Shareholder agrees the business's strategic plan with the Board;
- the Board is accountable to the Shareholder for delivering the agreed Plan;
- the Shareholder gives the Board the operational freedom to take the action necessary to deliver the Strategic Plan;
- the Shareholder monitors the performance of the business to satisfy itself that the Strategic Plan is on track.

14 In operating this model the key points are as follows:

Governance framework

- a The Shareholder should set out, for each business, a single document (the "governance letter") describing the rights and levers held by the shareholder, and how it intends to use them.
- b The Shareholder should adopt a systematic approach to applying best practice corporate governance.

Setting objectives

- c The Shareholder should systematically, and in consultation with management, identify and, where possible, publish objectives for each business.
- d The Shareholder should take responsibility for resolving any conflicts and trade-offs between the States' objectives.

Approving strategy

- e The Shareholder should formally approve strategy. The Shareholder should ensure that it has the necessary capability to scrutinise the strategy proposed by the Board and should ensure that targets are both realistic and challenging.

Making appointments to the Board

- f The starting point for Board appointments should be an agreed vision between the Shareholder and Chairman of the Board of the mix of skills and experience for the Board as a whole.
- g Chairman and senior non-executives should share the Shareholder's view about the objectives for the company. Incoming chairmen (and if appropriate non-executives) should meet the Shareholder to discuss these objectives before taking up their appointments.
- h The relationship with the Chairman and non-executives should be managed at a senior level in the shareholding team;
- i There should be a systematic approach to assessing performance of boards as a whole and of individual board members.

Setting pay and incentive structures

- j Pay and incentives should be set at an appropriate level to attract the right talent, with pay for executives closely tied to performance over the longer term.

Monitoring and intervention

- k Monitoring should be seen not as an end in itself but forming the basis for effective intervention and, if appropriate, the use of formal shareholder rights and levers.
- l The Shareholder should agree its monitoring requirements with the company, including agreement on the frequency of monitoring and the type of information required. Monitoring should be conducted in a systematic manner.

Providing finance

- m The Shareholder should regularly review the capital structure of the company to ensure it is appropriate for the nature of the company.
- n The Shareholder should set clear dividend policies for the companies. The presumption should be that equity is fully remunerated.
- o Businesses that borrow from the States should be subject to commercial borrowing terms and disciplines.

APPENDIX 3A

States Guidance in exercising on behalf of the States the Role of Shareholder of Guernsey Post Limited

- 1 The extent of the activities of Guernsey Post Limited shall generally be:
 - To carry on business as a provider of postal services together with any other services which are ancillary related to or may be conveniently combined with the operation of postal services in the Bailiwick of Guernsey and elsewhere.
 - To act as distributors' freight and forwarding agents and carriers and suppliers of all related services and to enter into arrangements with contractors or sub-contractors for the provision of such services in the Bailiwick of Guernsey and elsewhere.
- 2 Financial performance targets for Guernsey Post Limited shall be set so as to:
 - deliver improved efficiency in fulfilling the requirements of the Universal Service Obligation imposed under the regulatory regime by drawing a balance between seeking a commercial return on the resources employed and the resultant effect on the community of any increase in charges which may result; and
 - achieve as soon as is practicable an appropriate commercial return on the resources employed in the provision of other services.
- 3 Without an express resolution of the States no property or buildings that are essential to fulfilling the Universal Service Obligation imposed under the regulatory regime shall be disposed of except by acquisition by the States under appropriate terms.
- 4 Policies for the provision of services and other activities of Guernsey Post Limited shall have regard to the Economic, Social and Environmental policies adopted by the States and set out in the Strategic and Corporate Plan.
- 5 Guernsey Post Limited shall be required to comply with best practice on corporate governance, financial management and controls.

APPENDIX 3B

States Guidance in exercising on behalf of the States the Role of Shareholder of Guernsey Electricity Limited

1 The extent of the activities of Guernsey Electricity Limited shall be to carry on business as a producer, generator, supplier, marketing agent and distributor of electrical energy together with any other services that are ancillary related to or may be conveniently combined with such electrical energy services in the Bailiwick of Guernsey and elsewhere.

2 Guernsey Electricity Limited shall not be permitted to apply for any licence for the provision of telecommunications services under the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001.

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

- 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
- achieve as soon as is practicable an appropriate commercial return on the resources employed in the provision of other services.

4 Without an express resolution of the States, no property or buildings which are essential to fulfilling the Public Supply Obligation imposed under the regulatory regime shall be disposed of except by acquisition by the States under appropriate terms.

5 Policies for the provision of services and other activities of Guernsey Electricity Limited shall have regard to the Economic, Social and Environmental policies adopted by the States and set out in this Strategic and Corporate Plan.

6 Guernsey Electricity Limited shall be required to comply with best practice on corporate governance, financial management and controls.

APPENDIX 4

The Commercialisation context in Guernsey

Introduction

1 This paper summarises the context in which commercialisation took place in 2001 and 2002 and was prepared for the NAO by Organization Development Ltd (ODL).

2 ODL drew the information on which the commentary is based from two sources:

- the policy letter debated by the States in March 2000 setting out the recommendations for commercialisation and planned time-table together with the Advisory and Finance Committee's 1998 policy letter that set the scene and the KPMG Economic Impact report that followed it;
- conversations with some eleven people who were actively involved with the process either as Senior Politicians or as Senior Managers. A list of those consulted is shown at the end of the paper.

The official context

3 The ownership and governance position of the three utilities had been the subject of States consideration for some years before commercialisation finally took place. The principal source of information regarding the official and public domain view of how the debate unfolded is a policy letter presented by the Advisory and Finance Committee in the Billet d'Etat of March 2000. It was the vote on this policy letter that determined the future of the commercialised utilities.

4 The March 2000 policy letter makes extensive reference to an earlier policy letter of June 1998 presented to the States by the Advisory and Finance Committee together with a joint submission from the States Committees controlling each of the three utilities. This 1998 Policy letter, that had taken some 18 months to prepare, began with a recognition of technological changes that would have to be faced by each of the utilities and led to the proposition that maintaining the existing ownership and governance structure would make it difficult for the utilities to deal with those changes.

5 The policy letter suggested that it was possible to identify the core strategic activities of each utility and to separate that core from any complementary or fringe activities that the organisations might undertake now or in the future. It expressed a need for the separation of ownership, regulation and management functions to ensure that the Island would be well served for the future.

6 As early as the 1998 policy letter, opposition was expressed by the Civil Service Board who maintained that the States owed a duty of care towards the employees of the three utilities that must be carefully protected during a commercialisation process. The Board also expressed significant concern about pension arrangements for existing and future employees. In order to satisfy these needs the policy letter proposed the creation of unique arrangements similar to the UK TUPE legislation to be applied to States Electricity Board and States Post Office Board employees.

7 In January 2000 the States considered a report from the Advisory and Finance Committee on the future provision of telecoms services for the Island. This report recognised the strategic importance of those services and consequently, from that point onwards, commercialisation of telecoms proceeded somewhat differently.

8 By March 2000 the Advisory and Finance Committee were in a position to recommend a commercialisation of the States Electricity Board and the Post Office Board supported by evidence from the KPMG assessment of economic impact. That assessment revealed that the likely impact of commercialisation was believed to be small. Nevertheless, the policy letter emphasised that the management teams of the utilities needed the freedom to react to commercial imperatives in order to compete effectively in a modern business environment.

9 The policy letter placed heavy emphasis on the asset management responsibilities of the utilities and the implications of those responsibilities for the positioning of the ownership role. Partly for this reason it recommended total control over the appointment of Directors and Chairman should be in the hands of the Advisory and Finance Committee who would also have powers of intervention when it was considered necessary to exert “strategic influence”.

10 Alongside principal recommendations of the January 2000 policy letter and the creation of interim Board arrangements for Guernsey Telecoms, the Advisory and Finance Committee recommended commercialisation of Guernsey Electricity and Guernsey Post and set up a timetable for implementation by July 2001. In reality, various practical barriers emerged to cause the implementation to be delayed until October 2001 for Telecoms and Post and February 2002 for Electricity.

Memories of the background and atmosphere

11 The remaining paragraphs set out a summary of the views expressed by those contributing to this pen portrait of the events that surrounded the commercialisation process. They are not expressed in any particular order of importance, but are rather intended to indicate the factors which key players in the process considered to have been important at that time.

12 It should be noted that these memories represent people’s understanding of the intentions and expectations perceived at the time. Even if some of these views can be seen as mis-informed or contradictory with interpretation of States resolutions with the benefit of hindsight, the views themselves will undoubtedly have influenced the original decision making.

The telecoms threat to the Island infrastructure

13 People recall clearly that concerns about future provision of telecom services for the Island were a main driver for the commercialisation process. A number of influential customer organisations, especially in the financial services sector, had signalled their intention to consider reducing operations in Guernsey if the Island did not keep pace with telecoms and data communications technology.

14 This was also taking place against the background of the dot-com boom and technological advances that were being led by major world players. Thus, although there had been a groundswell of support for commercialisation of all three utilities for some time, people clearly remember that the pace of decision-making was influenced by the telecoms threat.

Management effectiveness and commercial freedom

15 It should also be remembered that consideration of a change of status for these utilities was taking place in the context of similar operations having been privatised in the UK over 10 years earlier. Many changes had been observed and not least the changes in management approach that resulted from the movement of these services into the private sector. People remember that observation of privatised developments in the UK struck a marked contrast with the management structure in Guernsey that enabled local politicians to become involved at the most detailed level without necessarily being able to lay claim to either the business or technical skills needed to carry out that role effectively. There were also mixed views regarding the technical expertise of the senior management teams in each organisation and their ability to keep pace with complex technical and market developments.

Capital investment and sustainability

16 It is generally recognised that a key issue relating to the maintenance of sustainable utility services is that of generating appropriate reserves to maintain investment patterns. A monopoly position means that this balance can be unsettled in either direction since the organisation has the power to generate and retain excessive reserves or, through cross subsidy and emphasis on public services, to rely on being bailed out if large investment needs appear. The achievement of this balance was seen as a central factor driving the debate during the commercialisation process. However, the extent of investment needs was agreed to vary significantly between the three utilities.

17 Post Office services were moving towards automation although the capital injection involved in this was seen as relatively modest. Electricity services demanded significant long-term investment but the States Electricity Board was seen as having been extremely prudent in terms of amassing reserves and treating long-term investment in an extremely conservative manner by always heading for high quality, long life engineering solutions. The States Telecommunications Board had limited reserves and predicted needs already far outweighed what would be available in the short-term.

Technology and the pace of change

18 There is general agreement that commercialisation took place at a point of time when each of the utilities was facing technological change. The pressures on the telecoms world tended to dominate thinking and it was certainly the case that the States Telecommunications Board was facing much faster change than the other two utilities. However, Guernsey Electricity had only just connected to the European grid with a large investment in the cable link. The States had instructed Guernsey Electricity that capacity must be maintained to generate full demand on-island and this was confirmed as policy through an amendment to the commercialisation debate. In the case of the Post Office, Guernsey had maintained manual sorting systems long after most similar operations had been automated. Nevertheless, both of these utilities were more able to control the pace of change than telecoms.

The people dimension

19 The Civil Service Board mounted significant opposition to the commercialisation process both because of the duty of care owed to employees and because of a fear of the effect of commercialisation on the Staff Number Limitation Policy. In addition, the removal of negotiating rights from the Civil Service Board to the individual utilities created a concern that pay rates would fail to stay in line with the public sector and would put pressure on Civil Service Board negotiators. These concerns were regarded by many involved in the process as being unreasonable and as displaying the principal reason why managers of the utilities were deprived of some of the key tools needed for effective strategic management.

20 A further human resource issue related to the position of the unions. The Post Office unions wielded significant power and had affected management decisions for some time. Whilst the union position inherited by Guernsey Electricity was less extreme, the Company was put in a position quite early of being able to challenge certain restrictive practices that had been maintained in the past. Some 70 per cent of Cable and Wireless's staff are union members.

Fear of privatisation

21 Some consideration was given to partial or full privatisation of Guernsey Electricity and Guernsey Post. However, there was known to be considerable opposition to this in the States and so the States ownership commercialisation model was preferred. It is believed that concern about the possibility of ultimate full privatisation removed the possibility of partial privatisation similar to the Jersey Electricity model. However, some of those involved at the time now believe that participation by private shareholders could make a valuable contribution to the regulatory pressure felt by Directors and Managers.

One commercialisation or three?

22 It was felt politically expedient to conduct the debate about the principle of commercialisation with all three utilities being dealt with simultaneously. However, there was general recognition amongst those involved that in practical terms the three represented very different cases. The driving force behind telecoms commercialisation was seen to be world markets and the need for competition. The driving force relating to the creation of Guernsey Electricity was seen to be a need to achieve an appropriate long-term balance between revenue generation and reinvestment. The driving force behind the creation of Guernsey Post was an overriding need to seek improvements in service levels. Many of those involved at the time now express concern that the single model, especially relating to regulation, is inappropriate and consequently that the current review should be welcomed. The level, style and method of regulation needed is believed to be very different for each of the utilities.

Expectations of regulation

23 Guernsey had no experience of the independent regulation of utilities prior to the commercialisation debate. Consequently the States decision to set up a regulatory framework was limited to setting out broad principles and an undertaking that regulation would be effected with "a light hand on the tiller". The general expectation amongst those involved was that the licensing process would be just demanding enough to ensure that the utilities had reviewed their positions and that subsequent regulation would be supportive and undemanding.

24 The details of the model were to be strongly influenced by the regulator when appointed but it was expected that the wishes and opinions of the utilities would be taken into account. Those asked to comment were keen to point out these expectations and to draw attention to the apparent contrast with the model that has actually emerged.

Consultees

25 The following people were consulted about the political and economic climates that prevailed during the commercialisation process. They were assured that comments made were non-attributable and would be used only to contribute to an overview of the period.

- Deputy Bill Bell - Former President of the States Electricity Board and now Minister for Public Services.
- Peter Bougourd - Former Vice-President of the States Electricity Board, opponent of commercialisation for that organisation and now no longer in the States.
- Deputy Mike Burbridge - Former President of the States Telecommunications Board and now Deputy Minister for Public Services.
- Jane Langlois - Former Finance Director of the States Telecommunications Board and now Regulatory Advisor to Cable and Wireless (Guernsey).
- Stuart Le Maitre - Former Senior Commercial Officer of the Board of Industry and now Director of Resources, Commerce and Employment Department.
- Nigel Lewis - Former Chief Executive of the Board of Industry and now Chief Officer of the Commerce and Employment Department.
- Steve Morris - Former Senior Electrical Division Manager of the States Electricity Board and now Engineering Director of Guernsey Electricity.
- John Roper - Former President of the Board of Industry and now retired from the States.
- Deputy Mike Torode - Former President of the States Post Office Board and now Minister for the Home Department.
- Ian Watson - Former Chief Executive of the States Electricity Board and now Managing Director of Guernsey Electricity.

APPENDIX 5

Public perception of Commercialisation and Regulation in Guernsey

Introduction

1 This paper summarises the results of a telephone survey to gauge public perceptions of commercialisation and regulation. The survey was undertaken for the NAO by Organization Development Ltd (ODL) and this summary paper was prepared by ODL.

2 The telephone survey was carried out mainly during the week beginning 4 April 2005. The survey consisted of 200 calls to a random stratified sample of residential numbers in all parishes of the Island. The summary of results is based on 194 responses as the other 6 respondents had come to Guernsey since commercialisation took effect in January 2002.

Guernsey Electricity

3 The perception of Guernsey Electricity is that it is the organisation that has shown least change as a result of commercialisation. A statistical summary of opinions is shown below.

	Better		About the same		Worse		Don't know	
	No	%	No	%	No	%	No	%
Customer service	21	10.8	153	78.9	9	4.6	11	5.7
Value for money	18	9.3	141	72.7	21	10.8	14	7.2
Reliability	53	27.3	125	64.4	8	4.1	8	4.1
Range of services	18	9.3	158	81.4	4	2.1	14	7.2

4 A significant number of those called stated that they had little contact with the organisation and hence did not feel that any changes had affected them significantly. The results show that only a small proportion of respondents believed that there has been a worsening of performance and a slightly larger proportion commented on improved performance.

5 The feature of performance which was an exception to this pattern is value for money. There is significant irony in this given that the Company has held its prices for some 14 years and that the price of electricity has fallen significantly in real terms during that period. A further irony in this perception appears when people are asked why they feel that value for money has worsened. Measures taken to adjust the monthly direct debit or standing order payments made by the majority of customers have meant that many people now pay a higher monthly charge and then receive quarterly refunds rather than being asked for a balancing payment at quarter end. This appears to have resulted in a perception that prices have risen.

6 Nevertheless, on balance Guernsey Electricity is seen as the organisation for which commercialisation has been most successful.

Guernsey Post

7 The survey was held at a time when there was considerable local publicity and press debate about difficulties being faced by Guernsey Post. A statistical summary of opinions is shown below.

	Better		About the same		Worse		Don't know	
	No	%	No	%	No	%	No	%
Customer service	21	10.8	86	44.3	81	41.8	6	3.1
Value for money	2	1.0	96	49.5	87	44.8	9	4.6
Reliability	15	7.7	99	51.0	73	37.6	7	3.6
Range of services	9	4.6	156	80.4	16	8.2	13	6.7

8 Many respondents recognised the difficulty of distinguishing between changes in performance that have taken place since commercialisation and changes that have taken place since the serious disruption in service around Christmas 2002. If the latter is taken as the benchmark people report significant improvement. However, if the former is taken as the benchmark, opinion is split between those who believe that performance has substantially returned to normal and those who believe that commercialisation has not been a success for the organisation.

9 Two major causes for concern stand out in the more general discontent that is expressed. Firstly, recent rises in the cost of sending small packages overseas are seen as having been very fast and having resulted in particularly poor value for money. Comparisons with Royal Mail rates for the same service are particularly unfavourable.¹⁸ Secondly, there is widespread reporting of mis-delivery of both business and residential post. The frequency and extent of such mis-delivery is seen to have increased in the recent past and complaints or requests for action are believed to be ineffective.

10 In addition to these major concerns, the survey took place in the wake of a series of price rises. There was significant discontent expressed regarding the customer service, value for money and reliability of Guernsey Post.

Telecoms services

11 The added complication of the sale of Guernsey Telecoms to Cable and Wireless since commercialisation once again provided two different bases for comparisons to be made. It was also noticeable that most respondents related their answers to Cable and Wireless and that the apparent competition represented by current aggressive advertising campaigns is seen as illusory. A statistical summary of opinions is shown below.

	Better		About the same		Worse		Don't know	
	No	%	No	%	No	%	No	%
Customer service	14	7.2	115	59.3	55	28.4	10	5.2
Value for money	14	7.2	88	45.4	83	42.8	9	4.6
Reliability	20	10.3	152	78.4	15	7.7	7	3.6
Range of services	41	21.1	134	69.1	6	3.1	13	6.7

12 The principal areas of discontent relate to value for money and customer service. Rises in standing quarterly charges on land lines, mobile charges in general and broadband fees all contribute to the perception of rising prices. However, concerns about prices and customer service levels both appear to be influenced by a different discontent that is not directly expressed in the figures. A significant number of respondents expressed concern about the sale of Guernsey Telecoms and indicated that they had disapproved of it from the outset. This feeling of 'selling the family silver' clearly affected the judgement of many people regarding the performance of Cable and Wireless. Other specific concerns relate to line installation charges and difficulties with the billing process.

13 However, these criticisms are balanced by a significant body of opinion that paints a different picture. A significant number of respondents with somewhat closer knowledge of the Company's operations stated that Cable and Wireless had introduced more customer focus than could have been achieved as Guernsey Telecoms. In addition, there is wider recognition of the increasing range of services and also acknowledgement that waiting lists for installations had been very significantly reduced.

¹⁸ Guernsey Post observes that whilst this is fair comment in terms of public relations, it considers that this was the correct commercial decision.

Office of Utility Regulation (OUR)

14 Compared with answers relating to the three utilities, the most marked contrast regarding opinions of the OUR was that very few people indeed feel confident of being able to comment with any authority. Many respondents had little or no idea of the purpose of the OUR and even those who could describe some purpose did so with very limited confidence.

15 A statistical summary of opinions is shown below.

	Number of mentions	%
Keep prices down	72	22.4
Represent customers	42	13.1
Manage the utilities	12	3.7
Set service standards	50	15.6
Handle complaints	23	7.2
Represent the States	0	0.0
Raise efficiency	22	6.9
Impose international standards	2	0.6
Don't know	84	26.2
Other	14	4.4
Total	321	
Doing a good job	41	21.1
Not doing a good job	54	27.8
Don't know	99	51.0
Total	194	

16 These opinions were collected as the outcome of open questions and the responses classified by the interviewers. They show that those willing to express an opinion did show a broad understanding of the purpose of the OUR. However, the most striking issue for the OUR could be seen as its anonymous image set alongside considerable publicity regarding its high cost base. Many unsolicited comments were made about the cost of the OUR and those were linked with a general feeling of uncertainty regarding what value was added by it.

Conclusions

17 In the opinion of the two researchers who made all of the calls, the principal value of the results lies in the comparison between perceptions of each of the three utilities and perceptions of the OUR. Many respondents found it difficult to focus on differences before and after commercialisation and expressed views about the current levels of service rated on a sliding scale.

18 It was also clear that many people rapidly realise that changes which they do observe may not be the result of commercialisation but rather changes that have taken place coincidentally during the same period. However, as a broad indicator of public opinion at the point in time when the NAO is being asked to evaluate the effects of commercialisation and regulation, the survey results can be regarded as substantially reliable.

APPENDIX 6A

Telecoms Case Study

The development of broadband in the Guernsey telecoms market

1 Broadband services have been identified by most telecoms companies now as a key driver for future growth and revenues. Whilst the provision of broadband services commenced later in Guernsey than elsewhere, penetration levels are now on a par with those in other markets. This case study looks at the way in which broadband services were launched in Guernsey.

2 Prior to the commercialisation of Guernsey Telecoms in October 2001, the former States Telecommunications Board commenced a project to introduce ADSL services on its network in Guernsey. This project encountered some difficulties and was delayed on a number of occasions. Trials were initially commenced by Guernsey Telecoms in August 2001. In February 2002 Guernsey Telecoms informed the OUR of the abandonment of initial trials and made a public announcement on the matter. Then in July 2002 the company notified its intention to restart trials following further technical work that had been carried out.

Launch of broadband

3 On 17 September 2002, Cable & Wireless Guernsey¹⁹ announced its proposal to launch a range of ADSL network products in early October. The service had been trialed with its own ISP and the pricing for retail services set by the company and published. As required under its licence Cable & Wireless notified both the Office of Utility Regulation (OUR) and the market 21 days in advance of the proposed launch of the service (Cable & Wireless is not required to seek approval for its pricing but is required to ensure its pricing complies with its obligations under the Telecoms Law and its licence conditions).

4 On 30 September 2002, the OUR launched a formal investigation into a number of issues associated with the proposed launch of broadband. Among the issues of concern to the OUR was the pricing of the service to retail customers and to ISPs and whether the company had discriminated against competing ISPs during the development and launch of the service.

How did Cable and Wireless respond?

5 On 7 October 2002, Cable & Wireless Guernsey announced a delay of seven days in the introduction of its ADSL network products and provided additional information to independent ISPs to facilitate them in preparing and launching ISP services over the ADSL network. The launch of the ADSL product took place on 15 October 2002 at which time two ISPs, Cable & Wireless and Guernsey.Net (now Newtel Solutions), entered the market. Since then Itex has also offered broadband services.

6 Separate to the investigation into the launch of the service was a confidential investigation by the OUR into the pricing structure of the ADSL service. Following the launch of this investigation, Cable & Wireless announced reductions in the prices for the ADSL network services to end users, including services to retail users (purchasers of ADSL connect products) and ISPs who purchased connectivity to the ADSL network. The revised pricing represented a 33 per cent drop in the retail price for residential customers from the initial pricing announced by Cable & Wireless.

¹⁹ On 1 October Guernsey Telecoms Limited changed its name to Cable & Wireless Guernsey Limited.

Developments in the broadband market since 2002

7 Despite the initial difficulties in getting broadband services launched in Guernsey and a relatively slow start to the take up of the service, penetration levels now are comparable with that in most developed countries. However, concerns exist with regard to the range and pricing of services, with comparisons being made with the offerings available in the UK. As noted in the main report, such comparisons are not entirely helpful and may in fact be misleading. However, the OUR's audit of broadband services in 2005 did identify a number of issues with which it has concerns. These centred on the range of services available to residential users and the range of wholesale broadband services available.

8 Cable and Wireless has announced that it is upgrading the broadband service for all users (its Double Broadband promotion) which it believes responds to certain issues identified in the OUR report. In conjunction with this launch the OUR has announced that it is carrying out a detailed study of broadband pricing in Guernsey. This is in response to concerns identified in its own report and following concerns expressed by ISPs that the level of wholesale charges for broadband services is a barrier to the further development of the market and to innovation by independent ISPs.

APPENDIX 6B

Post Case Study

Quality of Service

1 This case study examines the quality of service provided by Guernsey Post Limited. It identifies reasons why quality of service was lower than expected immediately after commercialisation and what has since been done to improve performance.

2 Guernsey Post Limited became a commercialised entity on 1 October 2001. It currently delivers to over 27,000 addresses across the Bailiwick six days a week.

3 Guernsey Post has been set some universal service obligations:

- One collection from access points on six days each week.
- One delivery of letter mail to the home or premises of every natural or legal person in the Bailiwick on six days each week, including all working days.
- Collection shall be for all postal items up to a weight of 20 kgs.
- Deliveries on a minimum of five working days, for all postal items up to a weight of 20 kgs.
- Services for registered and insured mail.

The Problems of Christmas 2002

4 The management that was in place prior to commercialisation had decided to invest in automated machinery to help improve performance, to reduce the dependency on staff to sort mail and to reduce the amount of overtime worked. At the same time the management decided to move operations to a new location, Envoy House. In normal circumstances these would have been prudent moves for any postal operator trying to improve efficiency and drive down costs. However, serious problems arose because of poor project management and the implementation of wide scale changes just before Christmas, which is historically the busiest time of year for the business.

5 As a result there was a complete collapse in the service provided during this period. The new mechanised systems were unable to perform the functions they were purchased for and post was badly delayed.

Move to automated systems

6 Two automated systems had been purchased. There were, and in one case still is, teething problems with these machines. Because of these problems post could not be processed properly during the Christmas period.

Overtime

7 The difficulties were worsened by management's decision to reduce overtime just before the Christmas period as it was felt that the machines would be able to cope with the mail. Because of the problems with the machines, numerous items of post required manual sorting. However, employees were reluctant to perform overtime and as a result a huge backlog of post built up.

Move to Envoy House

8 The move to Envoy House was intended to provide Guernsey Post with a state of the art modern location from which to operate. The timing of the move was again during Christmas 2002 and the transition from one location to another exacerbated the other problems that had arisen.

Knock-on effects

9 In seeking to resolve these difficulties and to clear the substantial backlog of undelivered post, Guernsey Post incurred substantial extra costs. The company's reputation was badly damaged because of the collapse in quality of service. The knock on effect is still being felt today. The feeling amongst consumers in the Bailiwick is that Guernsey Post charges too much and provides a poor service.

10 The events of Christmas 2002 appear to have left a sour taste with residents on the Island and they are still holding this against the company. This was evidenced during Christmas 2004. Following the poor quality of service in 2002, the Office of Utility Regulation made Guernsey Post lower its postal charges for two weeks before Christmas 2003 to 10 pence. This move ensured that instead of just penalising Guernsey Post the public was given something back. This initiative was a great success as it ensured that people posted their Christmas post early to take advantage of the offer and lessened the burden on Guernsey Post. As a gesture of goodwill, Guernsey Post also reduced the postal charge during Christmas 2004, this time to 20 pence. But there was a feeling on the Island that the company had doubled the charge compared with the previous year, not recognising that under the previous regime before commercialisation, the Christmas discount had been 2p only.

Current Issues affecting Guernsey Post

11 Guernsey Post is currently going through a turbulent transition following the problems immediately after commercialisation.

New management board

12 Following the events of Christmas 2002, a new management team is in place with greater depth and experience of the postal industry. The new team has begun to make changes and to put right the reputation of the company.

Changes in staff pay and conditions

13 The new management has been active in rebuilding the company's reputation not only to the public but to its employees. It has introduced performance related pay and improved communication through working in partnership with employee and customer representatives. These measures have led to an improvement in industrial relations and, additionally, a reduction in the amount of overtime worked.

Increase in licence fee

14 The Office of Utility Regulation increased the licence fee from £120,000 to £180,000 from 2004.

Increase in Royal Mail costs

15 One of the most significant changes that has affected Guernsey Post is its contract with Royal Mail. Previously the company had a favourable deal with Royal Mail where it effectively received subsidised prices for post sent to the UK. Royal Mail decided that it was not benefiting from

this arrangement as Guernsey sends out far more post than it receives. It therefore terminated the agreement. This has resulted in a large increase in postal costs for post sent from Guernsey to the UK.

Increase in postal charges

16 Because of increased costs Guernsey Post applied to the Office of Utility Regulation to increase the standard postal rate in Guernsey. This application was granted, albeit at lower tariffs than sought, and in 2004 Guernsey Post increased postal charges.

External postal operators

17 Guernsey Post is reliant on external providers such as Royal Mail and Aurigny for post moving off the Island. Royal Mail provides postal services between Guernsey and the UK and Aurigny provides services to Alderney. Guernsey Post has little control over the performance or charges made by these providers.

Bulk mailers

18 Bulk mailers are responsible for a significant proportion of the post that goes out of Guernsey and are a major income provider for Guernsey Post. These bulk mailers are trying to negotiate better deals with Guernsey Post and have the ability to move their business elsewhere, such as to Jersey, if they are not satisfied with the service provided or the charges made.

Quality of Service targets

19 Guernsey Post did not have any quality of service targets before commercialisation in 2001. There is therefore no objective way of comparing the company's performance before and after commercialisation. Before the business was commercialised there was an impression that quality of service by the organisation was low. The business was however operating at a profit at the time of commercialisation.

20 The Office of Utility Regulation has set 23 quality of service targets for Guernsey Post. These targets need to be met to ensure that Guernsey Post is providing the Bailiwick with a good service and meeting its universal service obligations. Guernsey Post is enthusiastic about these targets as it believes they are a good indication of how the business is performing. The company is currently exceeding 18 of the targets.

21 A comparison of postal tariffs in Guernsey with those in Jersey (see Appendix 7) shows that in most instances Guernsey Post provides a service at lower cost.

APPENDIX 6C

Electricity Case Study

The Potential for Competition in the Electricity Market

1 The laws governing the Commercialisation and Regulation of Guernsey Electricity have been drafted to allow scope for competition in the electricity market.

2 Although in theory it is reasonable to allow scope for competition in electricity, in reality the NAO believes it very unlikely that Guernsey Electricity will face competition in a relatively small market of some 28,000 customers. Similarly, the size of the market makes it unlikely that a competitor would invest in another cable link. Although Guernsey Electricity faces some minor competition from unregulated gas it seems unlikely that this will significantly affect the company.

3 Guernsey Electricity could realistically be treated as a natural monopoly that is unlikely ever to be open to significant competition due to: the small island economy, which will probably not attract new entrants; and the restrictive planning rules on the Island which will prevent the building of a new electricity plant. The Office of Utility Regulation therefore attempts to mimic competition in the interests of consumers.

4 There is potential for competition amongst electricity generators as Guernsey Electricity negotiates a new contract for electricity from France as part of the Channel Islands Electricity Grid (CIEG). Electricity prices are likely to increase under the new agreement as world energy prices have risen and Guernsey Electricity achieved relatively favourable price terms under the original contract. Guernsey Electricity also has the potential to produce all the electricity for Guernsey rather than import it from France. However, this would rely on imported oil and it is likely that this would be more expensive than imported electricity.

APPENDIX 7

Price Comparisons

1 This Appendix compares telecoms prices between Guernsey, Jersey and the UK for a variety of telecoms services, and post prices between Guernsey and Jersey for a variety of destinations and weights. All prices are in effect at March 2005.

Telecoms Prices

Line Rental

Company	Monthly Price (£)	Quarterly Price (£)
Cable and Wireless Guernsey	5.72	17.16
Jersey Telecom	13.99	41.97
BT UK	10.50	31.50

Notes:

- Jersey Telecom is the HomeStyle tariff – the most popular option for residential consumers.
- BT is the Option 1 tariff. For those not paying by direct debit, the monthly charge rises by £1.

Local Calls

Company	Peak	Off Peak
Cable and Wireless Guernsey ⁽¹⁾	6p per call	6p per call
Cable and Wireless Guernsey – timed call tariff ⁽¹⁾	1.7p per minute	1.7p per minute
Jersey Telecom ⁽²⁾	0.023p per minute	0.023p per minute
BT UK ⁽³⁾	3p per minute	5p for up to an hour

Notes:

- Minimum call charge of 2 pence.
- Minimum call charge of 7 pence.
- Minimum call charge of 5 pence.

Broadband

Company	Monthly Price (£)
Cable and Wireless Guernsey	26.99 for a 1/2 MB connection
BT UK	17.99 for a 1 MB connection

International calls

The cost of calling a selection of countries, in pence per minute, at the weekend.

Company	USA	France	Portugal	Cayman Islands	Jamaica
Cable and Wireless Guernsey	4.9p	6.3p	6.3p	20p	37p
BT UK	8.99p	8.99p	16p	53p	22p
Jersey Telecom	6.2p	6.2p	8.8p	45p	45p

Notes:

- For weekday and evening calls BT charges a higher rate than those shown here.
- There are cheaper alternatives to BT. However, it is the incumbent operator and a close approximation to the situation in Guernsey.
- Their data available from Jersey Telecom applies to the HomeStyle tariff

Calls to mobiles

Company	Calls to	Prices (pence per minute)		
		Day	Evening	Weekend
Cable and Wireless	Local mobiles	14.8	14.8	11.8
Wireless	UK mobiles	25	20	10
Guernsey ⁽¹⁾	Jersey Mobiles	14.8	14.8	14.8
Jersey Telecom ⁽²⁾	Local Mobiles	12	10	9
	UK Mobiles	28	18	16.2
	Guernsey Mobiles	20	15	13.5
BT UK	O2 mobiles	12.6	11.81	3.61
	T-Mobile	14.91	8.4	7
	Orange mobiles	13.6	11.4	6
	Vodafone mobiles	15.61	6.31	3.70

Notes:

- 1 Cable and Wireless Guernsey has standard, cheap and Sunday as its charging periods. In keeping with Jersey Telecom and BT, we have translated this into day, evening and weekend charge periods for comparison.
- 2 This is the cost of calls to mobiles made from the HomeStyle tariff.

Post Prices

Cost of Postage – Letter Rates

From Jersey

To	Jersey only	UK, IoM & other Channel Islands
Weight Under	Tariff	Tariff
100g	£0.32	£0.33
200g	£0.55	£0.68
300g	£0.84	£1.01
400g	£1.10	£1.29
500g	£1.35	£1.68
600g	£1.65	£2.04
700g	£2.06	£2.40
800g	£2.39	£2.79
900g	£2.64	£3.08
1000g	£2.87	£3.41
	*£0.69	*£0.85
	†£13.95	†£17.13

* Each additional 250g (or part thereof)
 † Exceeding 5kg but not exceeding 10kg

From Guernsey

To	Guernsey only	UK, IoM & other Channel Islands
Weight Under	Tariff	Tariff
60g		£0.32
100g	£0.26	£0.46
150g	£0.38	£0.60
200g	£0.50	£0.74
250g	£0.62	£0.88
300g	£0.74	£1.02
350g	£0.86	£1.16
400g	£0.98	£1.30
450g	£1.10	£1.44
500g	£1.22	£1.58
550g	£1.34	£1.72
600g	£1.46	£1.86
650g	£1.58	£2.00
700g	£1.70	£2.14
750g	£1.82	£2.28
800g	£1.94	£2.42
900g	£2.18	£2.70
1000g	£2.42	£2.98

Price Difference

Weight	Price difference between Jersey and Guernsey		Cheapest Channel Island	
	Local Delivery	To UK, IoM and Other Channel Islands	Local Delivery	To UK, IoM and Other Channel Islands
100g	£0.06	-£0.13	Guernsey	Jersey
150g	£0.17	£0.08	Guernsey	Guernsey
200g	£0.05	-£0.06	Guernsey	Jersey
250g	£0.22	£0.13	Guernsey	Guernsey
300g	£0.10	-£0.01	Guernsey	Jersey
350g	£0.24	£0.13	Guernsey	Guernsey
400g	£0.12	-£0.01	Guernsey	Jersey
450g	£0.25	£0.24	Guernsey	Guernsey
500g	£0.13	£0.10	Guernsey	Guernsey
550g	£0.31	£0.32	Guernsey	Guernsey
600g	£0.19	£0.18	Guernsey	Guernsey
650g	£0.48	£0.40	Guernsey	Guernsey
700g	£0.36	£0.26	Guernsey	Guernsey
750g	£0.57	£0.51	Guernsey	Guernsey
800g	£0.45	£0.37	Guernsey	Guernsey
900g	£0.46	£0.38	Guernsey	Guernsey
1000g	£0.45	£0.43	Guernsey	Guernsey

Cost of Postage – Parcel Rates

From Jersey

To	Jersey only	UK, IoM & other Channel Islands
Weight Under	Tariff	Tariff
Initial 1kg	£4.40	£10.60
2kg	£4.40	£10.90
3kg	£4.40	£11.20
4kg	£4.75	£11.50
5kg	£5.10	£11.80
6kg	£5.44	£12.05
7kg	£5.78	£12.30
8kg	£6.12	£12.55
9kg	£6.46	£12.80
10kg	£6.80	£13.05
15kg	£7.80	£13.55
20kg	£8.70	£14.00
30kg	£9.60	£14.90

From Guernsey

To	Guernsey only	UK, IoM & other Channel Islands
Weight Under	Tariff	Tariff
1kg	£2.40	£4.10
2kg	£2.80	£5.00
4kg	£3.50	£6.80
6kg	£4.00	£8.20
8kg	£4.50	£9.50
10kg	£5.00	£10.80
15kg	£8.25	£12.60
20kg	£10.00	£14.00
30kg (max)	£12.00	£15.00

Price Difference

Weight	Price difference between Jersey and Guernsey		Cheapest Channel Island	
	Local Delivery	To UK, IoM and Other Channel Islands	Local Delivery	To UK, IoM and Other Channel Islands
Initial 1kg	£2.00	£6.50	Guernsey	Guernsey
2kg	£1.60	£5.90	Guernsey	Guernsey
3kg	£0.90	£4.40	Guernsey	Guernsey
4kg	£1.25	£4.70	Guernsey	Guernsey
5kg	£1.10	£3.60	Guernsey	Guernsey
6kg	£1.44	£3.85	Guernsey	Guernsey
7kg	£1.78	£4.10	Guernsey	Guernsey
8kg	£1.62	£3.05	Guernsey	Guernsey
9kg	£1.46	£2.00	Guernsey	Guernsey
10kg	£1.80	£2.25	Guernsey	Guernsey
15kg	-£0.45	£0.95	Jersey	Guernsey
20kg	-£1.30	£0.00	Jersey	-
30kg	-£2.40	-£0.10	Jersey	Jersey

Cost of Postage – International Surface Mail

Weight Under	Jersey tariff	Guernsey tariff	Difference	Cheapest Channel Island
20g	£0.39	£0.36	£0.03	Guernsey
60g	£0.62	£0.58	£0.04	Guernsey
100g	£0.91	£0.83	£0.08	Guernsey
150g	£1.27	£1.16	£0.11	Guernsey
200g	£1.62	£1.49	£0.13	Guernsey
250g	£1.99	£1.82	£0.17	Guernsey
300g	£2.35	£2.15	£0.20	Guernsey
350g	£2.72	£2.48	£0.24	Guernsey
400g	£3.09	£2.81	£0.28	Guernsey
450g	£3.45	£3.14	£0.31	Guernsey
500g	£3.82	£3.47	£0.35	Guernsey
550g	£4.18	£3.80	£0.38	Guernsey
600g	£4.55	£4.13	£0.42	Guernsey
650g	£4.90	£4.46	£0.44	Guernsey
700g	£5.26	£4.79	£0.47	Guernsey
750g	£5.63	£5.12	£0.51	Guernsey
800g	£6.00	£5.45	£0.55	Guernsey
850g	£6.37	£5.78	£0.59	Guernsey
900g	£6.74	£6.11	£0.63	Guernsey
950g	£7.00	£6.44	£0.56	Guernsey
1000g	£7.45	£6.77	£0.68	Guernsey

Cost of Postage – Airmail Letters Zone 1 & 2
Jersey

Weight Under	Zone 1 Tariff	Zone 2 Tariff
10g	£0.49	£0.49
20g	£0.70	£0.70
40g	£1.09	£1.16
60g	£1.47	£1.62
80g	£1.86	£2.10
100g	£2.25	£2.56
120g	£2.64	£3.02
140g	£3.02	£3.48
160g	£3.41	£3.94
180g	£3.80	£4.41
200g	£4.18	£4.87
220g	£4.57	£5.34
240g	£4.95	£5.80
260g	£5.34	£6.26
280g	£5.72	£6.73
300g	£6.10	£7.20
320g	£6.49	£7.66
340g	£6.88	£8.12
360g	£7.27	£8.58
380g	£7.66	£9.05
400g	£8.05	£9.51
420g	£8.44	£9.97
440g	£8.83	£10.43
460g	£9.18	£10.89
480g	£9.58	£11.36
500g	£9.97	£11.82

Guernsey

Price Difference - Air Mail Letters Zone 1 & 2

Weight Under	Zone 1 Tariff	Zone 2 Tariff
10g	£0.45	£0.45
20g	£0.65	£0.65
40g	£1.00	£1.07
60g	£1.35	£1.49
80g	£1.70	£1.91
100g	£2.05	£2.33
120g	£2.40	£2.75
140g	£2.75	£3.17
160g	£3.10	£3.59
180g	£3.45	£4.01
200g	£3.80	£4.43
220g	£4.15	£4.85
240g	£4.50	£5.27
260g	£4.85	£5.69
280g	£5.20	£6.11
300g	£5.55	£6.53
320g	£5.90	£6.95
340g	£6.25	£7.37
360g	£6.60	£7.79
380g	£6.95	£8.21
400g	£7.30	£8.63
420g	£7.65	£9.05
440g	£8.00	£9.47
460g	£8.35	£9.89
480g	£8.70	£10.31
500g	£9.05	£10.73

Price difference between Jersey and Guernsey			Cheapest Channel Island	
Weight	Zone 1	Zone 2	Zone 1	Zone 2
10g	£0.04	£0.04	Guernsey	Guernsey
20g	£0.05	£0.05	Guernsey	Guernsey
40g	£0.09	£0.09	Guernsey	Guernsey
60g	£0.12	£0.13	Guernsey	Guernsey
80g	£0.16	£0.19	Guernsey	Guernsey
100g	£0.20	£0.23	Guernsey	Guernsey
120g	£0.24	£0.27	Guernsey	Guernsey
140g	£0.27	£0.31	Guernsey	Guernsey
160g	£0.31	£0.35	Guernsey	Guernsey
180g	£0.35	£0.40	Guernsey	Guernsey
200g	£0.38	£0.44	Guernsey	Guernsey
220g	£0.42	£0.49	Guernsey	Guernsey
240g	£0.45	£0.53	Guernsey	Guernsey
260g	£0.49	£0.57	Guernsey	Guernsey
280g	£0.52	£0.62	Guernsey	Guernsey
300g	£0.55	£0.67	Guernsey	Guernsey
320g	£0.59	£0.71	Guernsey	Guernsey
340g	£0.63	£0.75	Guernsey	Guernsey
360g	£0.67	£0.79	Guernsey	Guernsey
380g	£0.71	£0.84	Guernsey	Guernsey
400g	£0.75	£0.88	Guernsey	Guernsey
420g	£0.79	£0.92	Guernsey	Guernsey
440g	£0.83	£0.96	Guernsey	Guernsey
460g	£0.83	£1.00	Guernsey	Guernsey
480g	£0.88	£1.05	Guernsey	Guernsey
500g	£0.92	£1.09	Guernsey	Guernsey

Cost of Postage – International Standard Parcel

Country	Jersey tariff	Guernsey tariff	Difference	Cheaper Channel Island
Republic of Ireland	£17.50	£6.55	£10.95	Guernsey
Belgium	£23.60	£17.70	£5.90	Guernsey
Netherlands	£17.50	£17.70	-£0.20	Jersey
Luxembourg	£17.50	£17.70	-£0.20	Jersey
France	£17.50	£17.70	-£0.20	Jersey
Denmark	£17.50	£17.70	-£0.20	Jersey
Germany	£17.50	£17.70	-£0.20	Jersey
Italy	£17.50	£17.70	-£0.20	Jersey
Spain	£17.50	£17.70	-£0.20	Jersey
Portugal	£18.50	£17.70	£0.80	Guernsey
Greece	£18.50	£17.70	£0.80	Guernsey
USA	£15.00	£18.70	-£3.70	Jersey
Canada	£15.00	£18.70	-£3.70	Jersey
Australia	£15.00	£24.35	-£9.35	Jersey
China	£15.00	£24.35	-£9.35	Jersey
Barbados	£14.30	£25.60	-£11.30	Jersey
Saudi Arabia	£14.30	£25.60	-£11.30	Jersey

Notes:

- 1 The costs reflected in this area are not defined by country. Both Islands have a structure based on groupings; although the cost to the Republic of Ireland may seem higher in one instance the cost to another country in the same grouping may be cheaper i.e. Germany.
- 2 Differences in prices are based on Jersey as the primary value.
- 3 The information used in this summary was obtained from the Jersey Post and Guernsey Post websites on 25/02/2005.

