Office of Utility Regulation

Guernsey Post's Proposed Tariff Changes

Decision Notice

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1. Introduction

This document sets out the Director General's ("DG") Decision on Guernsey Post Limited's ("GPL") proposed tariff increases taking into account detailed consideration of the responses to the Draft Decision which was published in November 2006. The DG's Decision covers the tariffs that is intended will apply to a range of postal services from April 2007 through to March 2010. The Decision is framed against a background of continuing change in the postal market, particularly with regard to the continuing liberalisation of the UK postal market and following a consideration of the scope of postal services Islanders wish to receive as highlighted from the review of the Universal Service Obligation carried out earlier this year.

The DG has set a three year price control to enable all postal users, in particular Bulk Mailers, to have greater certainty on tariffs for a sustained period and to enable GPL to focus on strategic issues facing its business. However there is scope for the Decision to be revisited should there be exogenous events that may have a significant impact on the postal service for Islanders that have not been taken into account in reaching this Decision.

The Draft Decision itself was based on an initial public consultation, a detailed efficiency review of the company and the Office's own modeling of GPL's business plan. Since the initial consultation in September 2006 the OUR and its consultants have been working closely with GPL's senior management and staff in order to allow the DG to meet the original deadline for the final Decision and so give both the company and its customers sufficient notice to prepare for the introduction of new prices. The DG would therefore like to express his thanks to GPL for the very constructive approach adopted to the Efficiency Review and the positive assistance that was provided to the OUR's consultants in performing that Review.

2. Structure and Comments

2.1. Structure the Decision Paper

The rest of this paper is structured as follows:

Section 3: presents the economic approach that has been taken to inform the DG's Decision;

Section 4: summarises the DG's calculation of GPL's Revenue Requirements including its operating costs informed by an efficiency review of GPL and its demand forecasts; and

Section 5: contains the DG's Decisions on each of the tariff changes sought by the company.

This Decision also contains a number of separate annexes, some of which are confidential to GPL.

Annex A describes the legislative framework and licensing arrangements which give the DG power to price control certain areas of GPL's postal activities.

Annex B sets out the DG's view on the appropriate cost of capital for GPL (i.e. the basis for determining a reasonable return for the shareholder, the States of Guernsey).

Annex C provides the OUR's specialist consultants' (Brockley Consulting and Sirius Solutions) assessment of GPL's response to the Efficiency Review provided in confidence to GPL during the consultation on the Draft Decision. Annex C is also commercially confidential and has been provided solely to GPL.

Annex D which is a confidential annex presents the demand assumptions the DG has used in coming to his Decision.

Annex E contains the formal price control that will apply to GPL in accordance with Licence condition 18.2 of its Postal Licence.

2.2. Responses to the Consultation Paper

The DG received responses to the Draft Decision from GPL and the Communications Workers Union ("CWU") and he wishes to thank the respondents for their contribution in assisting his consideration of this issue. In accordance with the OUR's policy on consultation set out in Document OUR 05/28 – "Regulation in Guernsey; the OUR Approach and Consultation Procedures", a non-confidential response to the Draft Decision is available on the OUR's website (www.regutil.gg) and for inspection at the OUR's offices during normal working hours.

3. OUR's Approach to Reviewing Tariff Change Application

3.1. Need for a Price Control

The DG believed that in order to protect consumers' interests, it is necessary to price control those areas of the postal market in GPL is dominant and invited views on this position.

GPL did not wish to make any comment with regard to this proposal. Therefore the DG maintains his view that it may be appropriate to price control those products where GPL has a dominant position.

Decision 1

The Director General will consider price controlling those areas of the postal market in which Guernsey Post Limited is dominant.

3.2. Scope for Price Control

In the draft decision the DG took the view that it is appropriate to price control GPL's products and services in those markets in which the company has been found as being dominant. In the DG's view price controls provide the means to protect customers' interests and prevent a dominant operator from abusing its market power by setting excessive prices. The DG was proposing to price control GPL's tariffs in the reserved area, the regular letter and parcel services, the priority letter and parcel services and the outbound bulk mail service markets.

In its response GPL commented that it believed that the DG had earlier indicated that he did not need to price control GPL's priority letters and parcels and that it should not be included in any price control. Whilst GPL might be dominant in this market, the DG recognized that there were real constraints on its ability to abuse such dominance. The DG therefore reaffirms that GPL's dominance in the priority letters and parcels market and that its market dominance is unlikely to be abused. Therefore the DG does not intend to price control GPL's tariffs in this market at the current time.

Decision 2

The Director General will price control Guernsey Post Limited's tariffs in the Reserved Area, the regular letter and parcel services and the outbound bulk mail service markets.

3.3. Form and Duration of Price Control

The DG believed setting prices for a three year period from April 2007 to March 2010 to be in the interest of the market and GPL and therefore intended to implement a three year price control for GPL on this occasion.

GPL responded to this issue by emphasizing that there were significant uncertainties in the postal environment in year three of the proposal that are outside the management influence or control of the company (including the air freight market, fuel costs and the impact of liberalization in the UK postal delivery market).

Consequently GPL believed it necessary for there to be a swift and agreed process enabling the Company to seek an interim decision on the tariffs for the final year of the price control should either the forecast volumes or the delivery charges used in the OUR's economic modeling are not realized. Hence GPL sought a formal understanding that it can submit an interim tariff application in 2008 for implementation from April 2009 should any of the external cost drivers or forecast volumes materially differ to those in the DG's final decision notice. However GPL emphasized that GPL has urgent business needs and the Company therefore seeks the most streamlined approach to such interim application as possible and therefore sought guidance on the expected procedure and timetable in the final decision notice.

The DG continues to believe that on this occasion a three year price control is appropriate for the Bailiwick's postal market as it provides certainty for both GPL and its customers. Price controls are a form of incentive regulation and as such provide an opportunity for the company and its shareholder to better the efficiency savings identified by the regulator. The DG acknowledges the uncertainty in the forecasts, in particular in 2009/10 and therefore has made conservative and prudent assumptions with regard to volumes and costs in order to share the risk between the company and its customers.

The price control decision in Annex E will continue until 31st March 2010 unless it is changed, amended, replaced or revoked by the DG. GPL may approach the Office at any time and seek an interim determination and a review of the price control decision. The DG would expect the trigger for an application for an interim determination to be, inter alia, significant changes in actual mail volumes compared to forecasts and significant changes in efficiently incurred cost inputs. The DG however would not envisage revisiting this determination on the basis of any difficulties experienced by the company in achieving the efficiency savings identified from the current review.

Decision 3

The Director General will apply a three year price control for Guernsey Post Limited from 1st April 2007 to 31st March 2010.

3.4. Criteria for Assessing GPL's Proposals

The DG intended to apply the standard regulatory approach to assessing Guernsey Post Limited's revenue requirements and invited views on allowing efficient operating costs, capital expenditure (through regulatory deprecation) and a return on the company's Regulatory Value.

GPL agreed that applying the Regulatory as opposed to any 'Pay as you go' approach is appropriate for a medium term duration determination with no exceptional capital programme.

The DG welcomes the support for this approach.

Decision 4

The Director General has applied the standard regulatory approach to assessing Guernsey Post Limited's revenue requirements under the price control.

3.5. OUR's Methodology

The Director General proposes to forecast efficient operating and capital expenditure and allow for a reasonable rate of return in determining GPL's prices. Interest earned by the company and apportioned to the price controlled business will be offset against the estimated revenue requirements.

Decision 5

The Director General has forecast efficient operating and capital expenditure and allowed for a reasonable rate of return in determining Guernsey Post Limited's prices. Interest earned by the company and apportioned to the price controlled business has been offset against the estimated revenue requirements.

The DG's consideration of GPL's response to the proposed rate of return is set out fully in Annex B. The DG has accepted GPL's arguments for a higher asset beta than was assumed in the Draft Decision. GPL's cost of capital has been derived assuming a gearing level of 0% and hence the Weighted Average Cost of Capital ("WACC") is simply derived from the cost of equity and level of taxation. Assuming a corporation tax rate of 20%, and the assumptions for inputs to the Capital Asset Pricing Model ("CAPM") given in Annex B generates a range of real pre-tax WACC results.

Table 3.1 GPL Real Pre-tax WACC

	Low Case	Middle Case	High Case
Risk Free Rate	2.5%	2.5%	2.5%
Gearing	0.0%	0.0%	0.0%
Equity Risk Premium	2.5%	4.25%	5.0%
Asset Beta	0.70	0.70	0.80
Equity Beta	0.70	0.70	0.80
Cost of Equity	4.25%	5.69%	6.50%
Corporation Tax	20%	20%	20%
WACC (real pre-tax)	**5.31%**	**7.11%**	**8.13%**

The DG proposes to take a mid-range value of 7.11% as the real pre-tax cost of capital for GPL for the duration of the price control period.

Decision 5

The DG has used a real pre-tax cost of capital of 7.11% in reviewing the company's tariff application.

Within the BPM itself the DG has used the latest inflation figures to derive the nominal pre-tax cost of capital.

3.6. Changes to GPL's Product Portfolio

In its response to the Draft Decision GPL highlighted changes to the company's product portfolio that it intended to make with effect from 1st April 2007.

In the first instance the company sought confirmation that the DG was content with the Bulk Mailer product specifications contained in its submission which GPL confirmed had been communicated by GPL to its bulk customers.

In the decision on Bulk Mail tariffs published in May 2006, the DG refused to allow the consignment limits proposed by GPL for the company's Bulk Sea Priority (4-way sort) product (referred to by GPL as its "We Sort" product). The DG was of the opinion that the consignment limits was in effect, through the non-price terms and conditions for this service, an attempt to circumvent the price control. Consequently the DG did not consider the consignment limits appropriate and directed GPL, under Condition 15.2 of its postal licence, to withdraw the Maximum Consignment limits from its Product specifications.

The DG notes that GPL has again sought to include Maximum Consignments in the Bulk Mail Product Specifications. The DG does note however that the proposed Maximum Consignment levels have been increased from the previous application as shown in Table 3.2.

Table 3.2 Comparison of Product Specifications: Consignment Limits

	SLP Air Unsorted	SLP Sea Priority Sorted ("We Sort")
2006/2007 Directed to withdraw Maximum Consignment Limits in OUR 06/12	Flower boxes minimum of 10 and all other mail minimum of 100 and maximum of 500.	Minimum of 500 with maximum of 2,000 per consignment or 50,000 per annum.
2007/2008	Flower boxes minimum of 10 and all other mail minimum of 100 and maximum of 1,000 day.	Minimum of 500 with maximum of 5,000 per consignment. 24 hours notification required. Collection slots 1100, 1200 and 1400 hrs.

The DG also notes that for the SLP Air Unsorted Product the consignment limits have increased from 500 to 1,000 day and that for the "We Sort" products the annual constraint has been removed and the maximum daily consignment increased from 2,000 to 5,000. In addition bulk mailers have been provided this information in advance of the draft decision and the DG has not received any representations or objections from the industry on this occasion. Therefore the DG is not proposing to amend the Bulk Mail Product Specifications as part of this decision. However he does expect GPL to ensure that the needs of customers are kept under review with regard to this product.

Secondly GPL had stated in its tariff submission its intention to remove surface mail options for international products from April 2007. In its response GPL sought confirmation that the DG was content for the removal of the product.

GPL's rationale for the removal of this product is that Royal Mail does not currently provide GPL with a surface rate and indeed it could not given the facilities available at Royal Mail's international distribution centre. In addition most mail regardless of air or surface specification goes by air as the extra logistics costs of separating traffic outweigh the savings. Consequently GPL believe that the provision of a surface mail tariff was an historic anomaly that is no longer justified with the removal of cross-subsidisation of products outside the reserved area. GPL maintain that Jersey Post, whom are in a similar position with respect to the commercial arrangements with Royal Mail, do not provide surface rates.

In terms of the volumes GPL estimate that currently there may be 30 surface mail items per week totaling 1,500 per year. This equates to less than 3% of GPL's non-bulk international packets. GPL further maintains that it is providing the international economy parcel for those large items where cost is more important than speed of delivery.

The DG is prepared therefore to allow GPL to withdraw this service on the basis that it is not cost reflective. He has however given further consideration to GPL's tariff proposals for its international standard and economy parcel product portfolios.

4. GPL's Revenue Requirements

4.1. *Efficiency Review*

As explained in the Draft Decision, Brockley Consulting Ltd was appointed by the DG to perform a detailed efficiency review of GPL. A confidential version of the resultant report was attached to the Draft Decision.

Brockley Consulting reviewed each major cost category in order to assess what opportunities exist for GPL to realise efficiency savings and outperform these forecasts. The consultant's approach involved identifying a level of operational performance and costs that was both challenging and also achievable. The consultants incorporated reasonable rather than extreme assumptions in their estimates upon which the DG's Draft Decision was based.

The total savings identified as a result of Brockley Consulting's review amounted to £5.3m over the price control period, with GPL forecasting total costs over the three year period amounting to £101.7m in their submission with the DG accepting Brockley Consulting's recommendation of £96.4m.

The DG invited comments on these proposals and the findings presented in the consultant's report. Comments were received from both GPL (a detailed response to the issues raised by GPL is provided in Annex C) and the CWU.

In light of the comments received Brockley Consulting continues to believe that the efficiencies identified in the original report in terms of postal operational savings are warranted and achievable. However they have accepted GPL's arguments in certain areas and have made some adjustments to the assumed efficiency savings.

The aggregate impact of these adjustments is to reduce the identified savings over the three year price control period in the Draft Decision from £5.3m to £5.0m.

Decision 6

The DG has assumed operating cost savings of £5.0m over the price control period for the purpose of determining Guernsey Post Limited's revenue requirements.

4.2. *Demand Forecasts*

In the Draft Decision the DG indicated that he intended to use the demand forecasts shown in Table 4.1 for the purposes of informing GPL's price control.

Table 4.1 Director General's Draft Decision Demand Forecasts

Volumes (m)	04/05	05/06	06/07	07/08	08/09	09/10
Total	44.3	49.5	50.2	50.3	50.7	51.3
Local	7.6	7.4	7.0	7.0	6.8	6.6
Inward	16.2	17.3	18.1	18.0	17.8	17.6
Outward	20.4	24.8	25.0	25.4	26.1	27.0

Based on the responses received to the Draft Decision, these forecasts have been modified slightly and having taken into account issues raised by GPL the DG has slightly modified the demand forecasts.

A more detailed breakdown and justification of the DG's forecasts summarized in Table 4.2 are shown in Annex D which has been provided on a confidential basis to GPL as it contains commercially sensitive information.

Table 4.2 Director General's Demand Forecasts

Volumes (m)	04/05	05/06	06/07	07/08	08/09	09/10
Total	44.3	49.5	50.2	50.3	50.7	51.1
Local	7.6	7.4	7.0	7.0	6.8	6.6
Inward	16.2	17.3	18.1	18.0	17.8	17.6
Outward	20.4	24.8	25.0	25.4	26.1	26.8

Decision 7

The DG will assume the demand forecasts shown in Table 4.2 for the purpose of informing Guernsey Post Limited's price control.

4.3. *Financial Forecasts*

The resultant financial forecasts for GPL's price controlled business based on the opex and demand forecasts given in this section and reflecting the prices set out in the Final Decision in section 5 are summarized in Table 4.3 for information.

Table 4.3 Financial Forecasts for GPL's Price Controlled Business

Nominal Prices (m)	04/05	05/06	06/07	07/08	08/09	09/10
Revenue	18.2	22.1	26.1	28.4	30.7	32.5
Opex	(17.8)	(21.4)	(25.3)	(27.5)	(29.1)	(30.5)
Depreciation	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)
Trading Profit	**(0.3)**	**(0)**	**0.1**	**0.1**	**0.9**	**1.3**
Interest	0.6	0.5	0.4	0.4	0.4	0.5
Profit/(Loss) before tax	**0.3**	**0.5**	**0.5**	**0.5**	**1.4**	**1.7**
Margin	**1%**	**2%**	**2%**	**2%**	**5%**	**6%**

5. Decision on GPL's Tariffs

As a consequence of the decisions presented in sections 3 and 4 of this document the DG intends to set tariffs for GPL's price controlled postal services through to 31st March 2010.

Decision 8

The DG has set the maximum prices at 1st April of each year for each of the postal services as shown in sections 5.1 to 5.12.

5.1. Local Letters

Weight (g)	2007	2008	2009
	£	**£**	**£**
60	0.32	0.34	0.36
100	0.32	0.34	0.36
150	0.46	0.48	0.50
200	0.60	0.62	0.64
Each additional 50g	0.14	0.14	0.14

5.2. Letters to UK & Jersey

Weight (g)	2007	2008	2009
	£	**£**	**£**
60	0.37	0.40	0.43
100	0.37	0.40	0.43
150	0.94	1.01	1.09
200	1.08	1.16	1.24
Each additional 50g	0.14	0.15	0.15

5.3. Local parcels

Weight (not over Kgs)	2007	2008	2009
	£	**£**	**£**
1	2.74	2.84	2.94
2	3.21	3.32	3.44
4	3.98	4.12	4.26
6	4.55	4.71	4.87
8	5.12	5.30	5.49
10	5.69	5.89	6.10
15	9.42	9.75	10.09
20	11.39	11.79	12.20
30 (max)	13.66	14.14	14.63

5.4. Parcels to UK & Jersey

Weight (not over Kgs)	2007	2008	2009
	£	£	£
1	4.45	4.61	4.77
2	5.43	5.62	5.82
4	7.40	7.66	7.93
6	8.90	9.21	9.53
8	10.35	10.71	11.08
10	11.75	12.16	12.59
15	13.71	14.19	14.69
20	15.21	15.74	16.29
30 (max)	16.30	16.87	17.46

5.5. Recorded Delivery

	2007	2008	2009
The fee for Recorded Delivery in addition to the appropriate postage	£1	£1	£1

5.6. Postcards

Location	2007	2008	2009
Europe (outside UK)	0.45	0.48	0.51
Worldwide	0.48	0.51	0.54

5.7. Airmail

	2007		
Weight (not over grams)	Europe (incl Eire)	Rest of World Zone 1	Rest of World Zone 2
	£	£	£
10	0.45	0.50	0.50
20	0.45	0.71	0.71
40	0.63	1.08	1.15
60	0.81	1.45	1.59
80	0.99	1.82	2.03
100	1.17	2.19	2.47
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

	2008		
Weight (not over grams)	**Europe (incl Eire)**	**Rest of World Zone 1**	**Rest of World Zone 2**
	£	£	£
10	0.48	0.53	0.54
20	0.48	0.74	0.74
40	0.66	1.11	1.18
60	0.84	1.48	1.62
80	1.02	1.85	2.06
100	1.20	2.22	2.50
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

	2009		
Weight (not over grams)	**Europe (incl Eire)**	**Rest of World Zone 1**	**Rest of World Zone 2**
	£	£	£
10	0.51	0.56	0.56
20	0.51	0.77	0.77
40	0.69	1.14	1.21
60	0.87	1.51	1.65
80	1.05	2.88	2.09
100	1.23	2.25	2.53
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

5.8. International Signed for

	2007	2008	2009
The fee for International Signed For service in addition to the appropriate postage	£3.42	£3.54	£3.66

5.9. Airsure

	2007	2008	2009
The fee for Airsure service in addition to the appropriate postage	£4.14	£4.28	£4.43

5.10. International Standard Parcel

Prices for international standard parcels shall remain at the existing levels for the duration of the price control.

5.11. International Economy Parcel

Prices for international economy parcels shall remain at the existing levels for the duration of the price control.

5.12. Logistics Tariffs

	Price per item at 60g (p)		
	2007	**2008**	**2009**
Bulk Air unsorted (flowers)	71.60	78.80	88.00
Bulk Air 120 way sort (flowers)	56.20	63.29	72.38
Bulk Sea Priority (4-way sort) <500g	43.60	46.16	48.07
Bulk Sea Priority (4-way sort) >500g	43.60	46.16	48.07
Bulk Sea Priority 120 way sort	30.10	32.93	34.04
Bulk Sea Economy 120 way sort	28.60	31.46	32.64
Bulk Sea Unsorted (non MOU)	37.16	39.58	42.94

	Price per g above 60g (p)		
	2007	**2008**	**2009**
Bulk Air unsorted (flowers)	0.260	0.280	0.300
Bulk Air 120 way sort (flowers)	0.237	0.255	0.273
Bulk Sea Priority (4-way sort) <500g	0.225	0.232	0.233
Bulk Sea Priority (4-way sort) >500g	0.225	0.232	0.233
Bulk Sea Priority 120 way sort	0.216	0.224	0.233
Bulk Sea Economy 120 way sort	0.216	0.224	0.233
Bulk Sea Unsorted (non MOU)	0.274	0.295	0.322

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Annex A: Legislative and Licensing Background

Legislation and States Directions

The Post Office (Bailiwick of Guernsey) Law, 2001 provides that a range of postal activities do not require licensing, ranging from personal private delivery to the delivery of court documents and banking instruments[1]. In addition, any postal services that are provided for a price greater than £1.35 (the "non-reserved services") can also be provided by any person or business without a licence. All services that are provided for a price of less than £1.35 are deemed to be reserved services and this is set out in an Order made by the DG in accordance with section 9 of the Postal Law[2].

The Regulation of Utilities (Bailiwick of Guernsey) Law 2001 provides for the States of Guernsey to issue States Directions to the DG in relation to:

- the scope of the universal service that should be provided in the postal sector in the Bailiwick;
- the extent of any exclusive privileges or rights in the postal sector;
- the identity of the first licensee in the postal sector; and
- any obligations arising from international agreements.

The Universal Service Obligation

In September 2001, the States issued Directions to the DG that required the DG to issue the first licence to provide universal services to GPL. At the same time the States set out the universal service obligation that should be imposed on GPL which is:

> *"… throughout the Bailiwick of Guernsey at uniform and affordable prices, except in circumstances or geographical conditions that the Director General of Utility Regulation agrees are exceptional:*
>
> - *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 (or other appropriate installations if agreed by the Director General of Utility Regulation) on six days each week including all working days;*
> - *Collections shall be for all postal items up to a weight of 20Kg;*
> - *Deliveries on a minimum of five working days shall be for all postal items up to a weight of 20Kg;*
> - *Services for registered and insured mail."*

Having defined the universal service, the States directed that GPL should be provided with the exclusive right to provide reserved services insofar as this is needed to enable and ensure the universal postal service is delivered. The relevant States Direction states:

> *"The Regulator shall reserve services to be exclusively provided by the Universal Service Provider to the extent necessary only to ensure the*

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[1] Section 1(2) of the Post Office (Bailiwick of Guernsey) Law, 2001
[2] The Post Office (Reserved Postal Services) Order, 2001

maintenance of universal service, and shall review and revise the reserved services from time to time with a view to opening up the Guernsey postal market to competition consistent with the need to maintain the Universal Service".

This legislative structure provides the DG, GPL and the States of Guernsey with a framework similar to that in neighbouring jurisdictions, within which:

- States policy can be articulated in more detail in the form of States Directions; and
- Licence conditions can be developed to provide more detail on the operation of the market.

Earlier in 2006, as recommended in the NAO report on Commercialisation[3], the OUR conducted a review of the original USO within the Bailiwick in light of the changes in the company's operating environment[4]. The DG recommended a number of changes in the USO in light of the responses to the consultation, the most significant being the reduction in the number of daily deliveries from six days a week to five days a week. The full set of recommendations are set out in Document OUR 06/11 which was been submitted to the Department of Commerce & Employment ("C&E").

In June 2006 C&E issued a Briefing Paper[5] with its views on the OUR recommendations. In short C&E found no compelling case to justify recommending to the States changes to the USO and therefore believed that there would be little purpose served by laying the matter before the States for debate. C&E invited views on this approach by 14th July and would take into account any feedback before coming to a final decision. However for the purposes of this consultation the OUR will assume no changes in the scope of the existing USO through to March 2010.

Statutory Functions and Powers

In exercising his functions and powers, the DG has a duty to promote (and, where they conflict, to balance) the following objectives[6]:

a. protect the interests of consumers and other users in the Bailiwick in respect of the prices charged for, and the quality, service levels, permanence and variety of, utility services;
b. secure, so far as practicable, the provision of utility services that satisfy all reasonable demands for such services within the Bailiwick, whether those services are supplied from, within or to the Bailiwick;
c. ensure that utility activities are carried out in such a way as best to serve and contribute to the economic and social development and well-being of the Bailiwick;
d. introduce, maintain and promote effective and sustainable competition in the provision of utility services in the Bailiwick, subject to any special or

[3] NAO Review of Commercialisation & Regulation in the States of Guernsey- September 2005, referred to in the Billet D'Etat X, 2006 Wednesday 31st May 2006
[4] OUR 06/06 Reviewing Guernsey Post's Universal Service Obligation – Consultation Document
[5] C&E Briefing Paper Guernsey Post Limited – Universal Service Obligation
[6] The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001

exclusive rights awarded to a licensee by the DG pursuant to States' Directions;

e. improve the quality and coverage of utility services and to facilitate the availability of new utility services within the Bailiwick; and
f. to lessen, where practicable, any adverse impact of utility activities on the environment;

States Directions[7] to the DG also require him:

- to ensure that the licensee (i.e. GPL) charged with providing the universal service in the postal sector does so throughout the Bailiwick of Guernsey at uniform and affordable prices; and
- to award the exclusive right to provide postal services in the Bailiwick to the extent that such exclusive right is necessary to ensure the maintenance of the universal postal service.

Licence Conditions

GPL was awarded a licence on 1st October 2001 in accordance with States Directions and was designated by the DG as being dominant in the market for reserved services in the Bailiwick of Guernsey[8].

Condition 18 of GPL's licence was amended early in 2005 to allow for the DG to price control GPL's USO services (outside the reserved area) where it has been found by the DG to be dominant.

Therefore in accordance with Condition 18.3 of GPL's postal licence, the DG may regulate the prices of a postal licensee where GPL is dominant. The relevant licence condition states:

> *"The Director General may determine the maximum level of charges the Licensee may apply for Licensed Services Services and/or Universal Services within a Relevant Market in which the Licensee has been found to be dominant. A determination may:*
>
> > *(a) provide for the overall limit to apply to such Licensed Services and/or Universal Services or categories of Licensed Services and/or Universal Services or any combination of Licensed Services and/or Universal Services;*
> >
> > *(b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or*
> >
> > *(c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.*

[7] States Resolutions 2001, pages 78-80 (item no 14)
[8] Document OUR 01/16 Decisions under the Post Office (Bailiwick of Guernsey) Law 2001 – Decision Notice and Report on the Consultation Paper.

In conclusion the DG has the power to directly regulate the prices that GPL charges for services provided within its USO.

In September 2005 the OUR published a draft decision[9] concerning market definitions, market power and dominance in the postal sector of the Bailiwick of Guernsey. In that Draft Decision, the DG set out his views on the nature of the postal sector in the Bailiwick, the degree to which clearly separate markets might be identified and the degree to which competition does, or is likely to, exist in those markets.

Following the consultation of the Draft Decision the DG designated GPL as being dominant[10] in the following markets:

- the market for regular letter and parcel services;
- the market for priority (SD) letter and parcel services; and
- the market for outbound bulk mail services.

[9] Document OUR 05//21 Review of Market Dominance in the Guernsey Postal Market – Proposed Decision: Statutory Invitation to Comment, September 2005

[10] Document OUR 05/26 Review of Market Dominance in the Guernsey Postal Market – Report on the consultation and Decision Notice, November 2005

Annex B GPL's Cost of Capital

Introduction

Capital is like any other scarce resource: where demand exceeds supply companies must compete for capital from shareholders (in the form of equity or retained profit) or in the form of debt. For an economic perspective, the cost of capital is in effect an "opportunity" cost i.e. the value that is foregone by the best alternative option. In practice, the best alternative option depends on the range of sources of capital from which a particular firm opts to chose (the "choice set")[11].

In general, the majority of companies adopt a wide choice set and obtain their capital from various sources including different types of debt and equity, as well as retained profits. In such instances, the cost of capital is considered to be the level of return required by the financial markets in order to provide capital to a firm. For a given level of return, rational investors will select the investment with the minimum risk; also for a given level of risk rational investors will select the project that maximises returns. Risk, in its simplest form, is caused by the possibility of different outcomes, which results in uncertainty. With regard to a specific business it is the risk element that cannot be diversified which is of significance.

By contrast, in other instances companies may choose to restrict their choice set for particular company specific reasons. For instance, rather than become involved in complex forms of financing, a company can place their retained profits in deposit accounts or provide them as loans rather than investing them in the business. In these circumstances the decision choice for that company has been deliberately simplified, with the cost of capital effectively being the interest received on a deposit or that received on the loan provided.

Given the wide range of uses to which capital can be put in modern markets, a sophisticated body of analysis has developed on methodologies for calculating the opportunity cost of capital when faced with a large choice of various alternative sources of capital. These methodologies rely on a large number of data inputs and assumptions that are designed to consider, inter alia, the economic conditions that prevail, the industry sector concerned and the company's position in that sector.

In the two previous price controls the OUR has taken GPL's cost of capital simply to be the interest that could be earned on States' Treasury Deposits. As a State owned enterprise funding its activities entirely through cash which was held on deposit by the States of Guernsey, the DG considered that GPL had chosen to restrict its choice set. In other words, the interest that the company could receive from the States was value that was foregone if GPL used the funds instead to invest in capital expenditure in the company. OUR was advised the interest rate earned on States Treasury Deposits was 3.8% which gave a pre-tax cost of capital of 4.75%. The OUR took this figure as the company's opportunity cost of capital with which to discount future cost and revenue streams.

[11] If a business consciously restricts its choice set for various reasons then the opportunity cost can be interpreted as relating to the set of alternatives considered, rather than the global set faced

However the cost of capital is a critical input to future capital investment decisions. Using a cost of capital that is too low will lead to excessively capital intensive expansion choices. It is therefore important from an investment perspective that the weighted average cost of capital ("WACC") is set at an appropriate level[12].

When considering the cost of capital that should apply to GPL, the OUR initially turned to the internationally accepted methodology of setting the cost of capital using the WACC approach. This is described in detail later in this section.

GPL have proposed a real pre-tax cost of capital of 7.5% assuming zero debt. In the following sections the DG sets out his views on the inputs to the WACC calculation in order to determine an appropriate cost of capital for GPL.

Weighted Average Cost of Capital

The WACC is the most commonly used approach for estimating a company's opportunity cost of capital.

Companies can raise capital either through equity or debt, both of which have a cost. The WACC therefore has two key components, the cost of equity and the cost of debt; the WACC is equal to the weighted average of the two components, based on the debt to equity ratio (known as the gearing). The WACC (pre-tax) equation is defined as follows:

$$WACC = (R_e * (1-g))/(1-T) + (g * R_d)$$

where:

- R_e = cost of equity;
- g = debt / (debt and equity);
- T is the tax rate; and
- R_d= cost of debt.

To calculate the WACC formula therefore requires the cost of equity, cost of debt, tax rate and capital structure as inputs. The traditional approach to estimating a company's cost of equity is to use the Capital Asset Pricing Model ("CAPM").

OUR 04/11 sets out a discussion of this area. Full descriptions of the WACC and CAPM used for estimating a company's cost of capital are provided in publicly available documents on other regulators' websites and respondents may also wish to refer to these for background information[13].

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[12] This point regarding investment decisions was contained in a report from an independent expert panel set up to examine a range of issues relating to the price control of Guernsey Electricity, including the appropriate cost of capital.

[13] The following two documents by Oftel and the Civil Aviation Authority in particular provide good introductions to the topic; www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/pri1997/contents.htmH and www.caa.co.uk/erg/ergdocs/annexcc.pdfH.

These components in the CAPM calculation are discussed in turn below.

Cost of Equity

The cost of equity term, Re, captures the returns shareholders would require in order to invest in a company. It is made of two components, the risk free rate, and the extra return above that risk free rate that is required to reflect the company risk, relative to the market.

$$R_e = R_f + \beta(R_m - R_f)$$

where:

R_e = the cost of equity;

R_f = the anticipated return available from risk free investment;

R_m = the anticipated returns available from risky investments in the market generally; and

β = the anticipated correlation between movements in the share price of the company concerned compared with movements in the

Risk free rate, R_f

The risk free rate is the rate of return that would be earned on an asset that carries no risk. Government bonds are considered to be the closest thing in practice to a risk free investment. In considering what the return is on government bonds, regulators typically look back at the average yield of such bonds over the medium and the long term, while also trying to identify if any fundamental changes in trends have taken place which would deem one approach preferable to the other. Bond yields are currently extremely low (below 2%), and may not be sustainable at such a rate in the longer term. Since 2004 UK regulators have estimated the risk free rate as lying between 2.25% - 3.0%, reflecting a view that current rates will rise slightly in the longer term.

Postcomm has recently used 2.5% as the risk free rate for Royal Mail's 2006 price control decision[14], and the DG therefore proposes to also use 2.5% as the risk free rate.

A more detailed discussion of the cost of capital prepared by Smithers & Co on behalf of the UK economic regulators and the Office of Fair Trading is available at www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2012_jointregscoc.pdfH

[14] Royal Mail Price and Service Quality Review, Final Proposals for Consultation, December 2006.

Equity Risk Premium, R_m - R_f

The equity risk premium reflects the difference between returns on equities in general and the risk free rate. This additional return reflects the additional risk of equities, above non-risk investments (i.e. bonds). Recent estimates for the equity risk premium from Ofgem, Ofwat, CAA (Civil Aviation Authority) and Postcomm range from 2.5% to 5.0%. This range was also proposed by the OUR as inputs for the WACC calculation for GEL; the OUR also now proposes this range for GPL.

Equity beta, β

The equity beta measures the relative "riskiness" of a company against the equity market as a whole, in terms of the variability in investment returns. If the value of beta is greater than 1, this means that returns for this company are more risky than those of the market. Conversely, a beta of less than 1 reflects less risk compared to the market as a whole. In simple terms, beta in effect captures the reliance of the company returns on the general market conditions. Typically, regulated utilities have low beta values, reflecting the fact that their size, monopoly status and provision of essential goods or services make them less vulnerable to market volatility than other businesses.

The level of financial risk associated with debt needs to be excluded when comparing the equity betas of different companies. Once this factor is removed, the remaining measure is known as the "asset beta":

$$\beta_e = \beta_a / (1 - g)$$

UK regulators have estimated asset betas for the regulated companies in the electricity, water, airports, telecoms, rail and postal sectors. Recent determinations for asset betas for regulated companies in these sectors have ranged from 0.5 to 0.65, if BAA is excluded (0.75).

Table B.1 Comparison of Asset Betas

National Reg. Authority or Competition Commission	Sector	Date	Equity Beta	Gearing	Asset beta
Ofgem	Electricity Distribution	2004	1.0	57.5%	0.43
Ofwat	Water & Sewerage	2004	1.0	55.0%	0.45
Comp. Commission	Airports	2002	1.0	25.0%	0.75
Ofcom	BT copper access	2005	0.9	35.0%	0.59
ORR	Rail	2000	1.3	50.0%	0.65
CAA	Air traffic control	2005	1.54	61.0%	0.60
Postcomm	Post	2006			0.65 – 0.75

In its recent consultation paper[15], Postcomm examined the asset betas of a number of listed UK companies, and specifically reviewed the asset betas of three delivery service companies.

Postcomm estimated an asset beta for Royal Mail of between 0.65 and 0.75. The OUR considers that a slightly lower range is appropriate for GPL, in light of the fact that the control period is for 3 years, and therefore suggested a range of 0.60 to 0.70. GPL however argued that the most applicable β_a was theRoyal Mail figure calculated by Postcomm and in fact could be higher due to the reliance on the bulk mail sector, lack of economies of scale and the skew of the non-bulk business customer base to the Financial Services sector. The DG is therefore prepared to adopt the 0.65 to 0.75 range for the company's β_a as proposed by the company to derive

The gearing levels on which the risk-based discount for GPL is derived is proposed as zero given the absence of debt by GPL. This is consistent with the OUR's proposals for calculating the WACC for GEL. The proposed equity beta is therefore simply equal to the asset beta, $\beta_e = \beta_a$.

Cost of Debt

The gearing levels on which the risk-based discount for GPL is derived is proposed as zero given the absence of debt by GPL. For the purpose of calculating the WACC the cost of debt term, R_d, is redundant and no further investigation into the cost of debt is required.

This reflects the States' policy with regard to the sources of funding adopted by the Bailiwick's State-Owned Enterprises ("SOE").

Summary

As outlined above, the OUR proposes to assume a gearing of 0% for GPL. The WACC is thereby simply equal to the cost of equity:

$$WACC = (R_e * (1-g))/(1-T) + (g * R_d)$$

and where g=0,

$$\Rightarrow WACC = R_e /(1-T)$$

and substituting for R_e

$$\Rightarrow WACC = \frac{(R_f + \beta_e (R_m - R_f))}{1-T}$$

[15] Royal Mail Price and Service Quality Review, Final Proposals for Consultation, December 2006.

Using this formula, and assuming a corporation tax rate of 20%, the following range of real pre-tax WACC results.

Table B.2 GPL Real Pre-tax WACC

	Low Case	Middle Case	High Case
Risk Free Rate	2.5%	2.5%	2.5%
Gearing	0.0%	0.0%	0.0%
Equity Risk Premium	2.5%	4.25%	5.0%
Asset Beta	0.70	0.75	0.80
Equity Beta	0.70	0.75	0.80
Cost of Equity	4.25%	5.69%	6.50%
Corporation Tax	20%	20%	20%
WACC (real pre-tax)	**5.31%**	**7.11%**	**8.13%**

The DG proposes to take a mid-range value of 7.11% as the real pre-tax cost of capital for GPL for the duration of the price control period. The DG has up-dated the inflation assumption within the BPM accordingly to derive the nominal pre-tax cost of capital for the company.

Annex C Assessment of Comments on Efficiency Review of GPL

This Supplementary Report has been provided to GPL in commercial confidence and addresses the comments received on Brockley Consulting's "Efficiency Review of Guernsey Post Limited" which was included as a confidential annex to Document OUR 06/18 "Guernsey Post's Proposed Tariff Changes Draft Decision and Report on the Consultation".

The Decision set out in section 4.1 of the report is based on both the original Efficiency Review of Guernsey Post Limited (Annex C of OUR 06/18) and the Supplementary Report (Annex C of this document).

Annex D Demand Forecasts

This information has been provided in commercial confidence to GPL.

Annex E Price Control Decision

Determination of the Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Postal Services in dominant markets

1. The Director General of Utility Regulation in accordance with:

   - condition 18 of the Postal Licence issued to issued to Guernsey Post Limited on 1st October 2001 (as amended); and
   - his duties, powers and functions, under the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 set out in sections 2, 4 and 5 respectively and in particular sections 2(a), 5(a), 5(e) and 5(g) of that law; and
   - section 5 of the Post Office (Bailiwick of Guernsey) Law 2001 and particular section 5(1)(d) thereof, and
   - his finding that Guernsey Post Limited has a dominant position in the market for outbound bulk mail services markets in the Bailiwick of Guernsey.

   hereby determines that the maximum levels of charges that Guernsey Post Limited may apply to the provision of Postal Services in those relevant markets specified above are those specified in paragraphs 4 to 16 below.

2. Unforeseen delays notwithstanding, it is expected that the maximum levels of charges which may be applied by Guernsey Post Limited, as set out in this Determination shall come into effect on 1st April 2007 and shall apply until 31st March 2010 subject to the provisions of paragraph 3 hereof.

3. This Determination is subject to review, either in whole or in part, by the Director General, where the Director General considers this necessary and/or appropriate or at the request of Guernsey Post Limited having regard to his duties and functions under Law, including the Regulation of Utilities (Bailiwick of Guernsey) Law, 2001, and the Post Office (Bailiwick of Guernsey) Law, 2001.

4. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Local to Local letter rates**

Guernsey Post Limited shall ensure that the charges which it applies to local to local letters shall not exceed the following rates:

Weight (g)	Local to local letter rates		
	1 April 2007	**1 April 2008**	**1 April 2009**
	£	**£**	**£**
60	0.32	0.34	0.36
100	0.32	0.34	0.36
150	0.46	0.48	0.50
200	0.60	0.62	0.64
Each additional 50g	0.14	0.14	0.14

5. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Local to Jersey and UK letter rates**

Guernsey Post Limited shall ensure that the charges which it applies to local to Jersey and UK letters shall not exceed the following rates:

Weight (g)	Local to UK/Jersey letter rates		
	1 April 2007	**1 April 2008**	**1 April 2009**
	£	**£**	**£**
60	0.37	0.40	0.43
100	0.37	0.40	0.43
150	0.94	1.01	1.09
200	1.08	1.16	1.24
Each additional 50g	0.14	0.15	0.15

6. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Local to Local parcel rates**

Guernsey Post Limited shall ensure that the charges which it applies to local to local parcels shall not exceed the following rates:

Weight (not over Kgs)	Local to local parcel rates		
	1 April 2007	**1 April 2008**	**1 April 2009**
	£	**£**	**£**
1	2.74	2.84	2.94
2	3.21	3.32	3.44
4	3.98	4.12	4.26
6	4.55	4.71	4.87
8	5.12	5.30	5.49
10	5.69	5.89	6.10
15	9.42	9.75	10.09
20	11.39	11.79	12.20
30 (max)	13.66	14.14	14.63

7. **<u>Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Local to Jersey and UK parcel rates</u>**

Guernsey Post Limited shall ensure that the charges which it applies to local to Jersey and UK parcels shall not exceed the following rates:

Weight (not over Kgs)	Local to UK/Jersey parcel rates		
	1 April 2007	1 April 2008	1 April 2009
	£	£	£
1	4.45	4.61	4.77
2	5.43	5.62	5.82
4	7.40	7.66	7.93
6	8.90	9.21	9.53
8	10.35	10.71	11.08
10	11.75	12.16	12.59
15	13.71	14.19	14.69
20	15.21	15.74	16.29
30 (max)	16.30	16.87	17.46

8. **<u>Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect Recorded Delivery rates</u>**

Guernsey Post Limited shall ensure that the charges which it applies to Recorded Delivery rates shall not exceed the following:

	Recorded Delivery		
	1 April 2007	1 April 2008	1 April 2009
	£	£	£
The fee for Recorded Delivery in addition to the appropriate postage	1.00	1.00	1.00

9. **<u>Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of postcard rates</u>**

Guernsey Post Limited shall ensure that the charges which it applies to postcard rates shall not exceed the following:

Location	Postcards		
	1 April 2007	1 April 2008	1 April 2009
	£	£	£
Europe (outside UK)	0.45	0.48	0.51
Worldwide	0.48	0.51	0.54

10. **<u>Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of airmail rates</u>**

Guernsey Post Limited shall ensure that the charges which it applies to airmail rates shall not exceed the following:

Weight (not over grams)	**Airmail 1 April 2007**		
	Europe (incl Eire)	**Rest of World Zone 1**	**Rest of World Zone 2**
	£	**£**	**£**
10	0.45	0.50	0.50
20	0.45	0.71	0.71
40	0.63	1.08	1.15
60	0.81	1.45	1.59
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

Weight (not over grams)	**Airmail 1 April 2008**		
	Europe (incl Eire)	**Rest of World Zone 1**	**Rest of World Zone 2**
	£	**£**	**£**
10	0.48	0.53	0.53
20	0.48	0.74	0.74
40	0.66	1.11	1.18
60	0.84	1.48	1.62
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

Weight (not over grams)	**Airmail 1 April 2009**		
	Europe (incl Eire)	**Rest of World Zone 1**	**Rest of World Zone 2**
	£	**£**	**£**
10	0.51	0.56	0.56
20	0.51	0.77	0.77
40	0.69	1.14	1.21
60	0.87	1.51	1.65
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

11. **<u>Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of International Signed For rates</u>**

Guernsey Post Limited shall ensure that the charges which it applies to International Signed For rates shall not exceed the following:

	International Signed for		
	1 April 2007	**1 April 2008**	**1 April 2009**
	£	**£**	**£**
The fee for International Signed For service in addition to the appropriate postage	3.42	3.54	3.66

12. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Airsure rates**

Guernsey Post Limited shall ensure that the charges which it applies to Airsure rates shall not exceed the following:

	Airsure		
	1 April 2007	**1 April 2008**	**1 April 2009**
	£	**£**	**£**
The fee for International Signed For service in addition to the appropriate postage	4.14	4.28	4.43

13. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of international standard parcel rates**

Guernsey Post Limited shall ensure that the charges which it applies to international standard parcel rates shall not exceed the charges it applies for each of these individual services in place on 31st March 2007.

14. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of international economy parcel rates**

Guernsey Post Limited shall ensure that the charges which it applies to international economy parcel rates shall not exceed exceed the charges it applies for each of these individual services in place on 31st March 2007.

15. **Maximum Levels of Charges which may be applied by Guernsey Post Limited in respect of Outbound Bulk Mail rates**

Guernsey Post Limited shall ensure that the charges which it applies to Outbound Bulk Mail shall not exceed the following rates:

	Price per item at 60g (p)		
	2007	**2008**	**2009**
Bulk Air unsorted (flowers)	71.60	78.80	88.00
Bulk Air 120 way sort (flowers)	56.20	63.29	72.38
Bulk Sea Priority (4-way sort) <500g	43.60	46.16	48.07
Bulk Sea Priority (4-way sort) >500g	43.60	46.16	48.07
Bulk Sea Priority 120 way sort	30.10	32.93	34.04
Bulk Sea Economy 120 way sort	28.60	31.46	32.64
Bulk Sea Unsorted (non MOU)	37.16	39.58	42.94

	Price per g above 60g (p)		
	2007	**2008**	**2009**
Bulk Air unsorted (flowers)	0.260	0.280	0.300
Bulk Air 120 way sort (flowers)	0.237	0.255	0.273
Bulk Sea Priority (4-way sort) <500g	0.225	0.232	0.233
Bulk Sea Priority (4-way sort) >500g	0.225	0.232	0.233
Bulk Sea Priority 120 way sort	0.216	0.224	0.233
Bulk Sea Economy 120 way sort	0.216	0.224	0.233
Bulk Sea Unsorted (non MOU)	0.274	0.295	0.322

16. This Determination shall come into effect on 1st April 2007 and shall continue in force until 31st March 2010 unless changed, amended, replaced or revoked, by the Director General.