GUERNSEY POST

Response to the Office of Utility Regulation's Draft Decision and Report on the Consultation to Guernsey Post's Proposed Tariff Changes (OUR 06/18A)

November 2006

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1. Introduction

1.1 Guernsey Post Limited (GPL) submitted a tariff proposal to the Office of Utility Regulation (OUR) on 6th September 2006. The proposal covered the three-year period from April 2007 – March 2010.

1.2 The proposal included an increase in the basic stamp price for intra Bailiwick mail by 4p (to 33p) from April 2007 rising to 39p by April 2009.UK and Jersey basic letters would increase by 5p (to 39p) from April 2007 rising to 49p by April 2009. Increases of between 8% and 10% per annum were proposed for international mail prices with bulk mail prices increasing by about 7% per annum.

1.3 These increases were largely caused by significant increases in delivery charges by Royal Mail in the UK of 26% from April 2007 and a further 10% the following year. These costs have been ameliorated by efficiency measures planned by GPL over the next three years amounting to £1.2m.

1.4 The OUR published its consultation document on GPL's proposals on 8th September. Following the consultation period, the OUR published its Draft Decision and Report on the Consultation on 8th November, requesting responses by 1st December.

1.5 This document represents GPL's formal response to the OUR's Draft Decision

2. GPL's Response to the OUR's Draft Decision

Draft Decision 1

The Director General proposes to price control those areas of the postal market in which Guernsey Post Limited is dominant.

GPL does not wish to make any comment with regard to this proposal.

Draft Decision 2

The Director General proposes to price control Guernsey Post Limited'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.

GPL is unclear why priority letter and parcel services are included in the price control. In the OUR's market dominance decision document OUR 05/26 the DG (Director General) clearly indicated that he did not need to price control this identified market – "the DG concluded that, while GPL is dominant in the market for priority postal services, there are real constraints on its ability to abuse such dominance. The DG therefore regards GPL's dominance as having a relatively low risk of being abused and concludes, in line with the principles of better regulation, that such an eventuality poses a low regulatory risk".

GPL is developing revised pricing for RMSD (Royal Mail Special Delivery) for the three-year period relative to this price control reflecting the cost of service provision plus market tolerant profit. These will be published annually to customers.

Draft Decision 3

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

GPL notes the three year duration of the price-control period proposed by OUR, which is consistent with the GPL tariff submission, which was in turn based on a request for a submission covering three years by the OUR.

There are significant uncertainties in the postal environment in year three of the proposal that are outside the management influence or control of GPL. These include the airfreight market, fuel costs and the impact of liberalisation in the UK postal delivery market. GPL has commented during the process of its tariff submission on the speculative nature of modelled figures used by both GPL and OUR in the activity that has led to this draft decision. Because of the subjective nature of any assumptions for year three GPL has significant reservations as to the validity and risks associated with them. Indeed GPL cannot provide any further evidence to support its position, just as it contends that the OUR cannot further support its own.

The most significant cost associated with the forecasting regards possible contract options and prices for mail leaving Guernsey for delivery in UK on the following day- the J+1 service - in the period April 2009-March 2010. The number of variables with regard to pricing, contractors and acceptance constraints has resulted in a difference in UK market development expectation between GPL and the DG.

What is of very great importance to GPL is that there is a swift and pre-agreed process enabling the Company to seek an interim decision on the tariffs for this final year of the price control should either the forecast volumes or the delivery charges used in the OUR updated finance model not come to pass. These are the two levers that will most influence the viability of the service, assuming that the Company has achieved forecast disallowed costs.

Guernsey Post therefore seeks a formal understanding through this tariff determination 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. GPL recognises that it would have to evidence its efforts made to achieve the best possible UK delivery costs. It may also have had to consider the provision of alternative services in the product mix to ameliorate further significant increases in postal charges for Bailiwick residents and businesses.

However as the DG has noted, GPL has urgent business needs, which demand time from the Management Team, and the Company therefore seeks the most streamlined approach to such interim application as possible. Guidance on the expected procedure and timetable in the final decision notice would be most helpful.

Draft Decision 4

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

GPL agrees 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.

Draft Decision 5 (part 1)

> The Director General proposes to forecast efficient operating and capital expenditure and allow 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 will be offset against the estimated revenue requirements.

GPL does not wish to make any comment with regard to this proposal.

Draft Decision 5 (part 2)

> The DG intends to use pre-tax cost of capital of 6.58% in reviewing the company's tariff application.

GPL does not accept the basis for the 6.58% and so cannot agree with the DG's proposal following the Annex B data.

1. The most applicable □ (and most current) to compare against is Postcomm's calculated □ for Royal Mail, i.e. 0.65-0.75 range
2. This is then reduced to a range 0.6-0.7 based on a different risk associated with a control period of three years.

However there are additional real factors to suggest a higher level of risk existing for GPL:

1. The risk of the bulk mail sector declining from Guernsey (consider the real VAT de minimis removal threat, the impact of minimum wage legislation on an industry that typically relies on low cost labour, the threat of limiting housing licences). This risk is not mirrored in the UK where the bulk mail sector is a very different: far less transient and not likely to act as a single entity.
2. The risk associated with lack of economies of scale.

3. The skew of the non-bulk business customer to a single industry (Financial Services).

On these bases GPL believes a downward move in the □ compared to Royal Mail is neither appropriate nor logical. In fact a higher □ or at least the highest point in Royal Mail's range is appropriate (in the absence of objective and substantive evidence of risk by either GPL or OUR).

Conclusion: the appropriate □ to apply is 0.75. Additionally the inflation factor used in the BPM of 3.1% to arrive at the nominal cost of capital is now inconsistent with the inflation rate accepted elsewhere and hence should be revised upwards to 3.5%

Draft Decision 6

> The DG intends to assume the operating cost forecasts in Table 4.2 prior to any demand forecast changes for the purposes of determining Guernsey Post Limited's revenue requirements.

GPL's response to Draft Decision 6 is contained in a confidential appendix to this document (Appendix A).

Draft Decision 7

> The DG intends to assume the demand forecasts shown in Table 4.3 for the purpose of informing Guernsey Post Limited's price control

GPL's response to Draft Decision 7 is contained in a confidential appendix to this document (Appendix B)

Draft Decision 8

> The DG proposes to set the maximum prices at 1st April of each year for each of the postal services set out in sections 5.1 to 5.12

Given the comments to the other Draft Decisions, GPL awaits a revised set of tariffs. However GPL wishes to advise OUR of a number of factors of which it believes OUR needs to be aware and respond to before making its final decision. GPL staff would be happy to discuss these points further if required. These are set out in Appendix A to this document.

GPL has also some specific concerns relating to the OUR's proposals for Logistics Tariffs (section 5.12 of the Draft Decision refers) which are outlined as a confidential appendix to this document (Appendix C).

3. Additional Issues Raised by Respondents

3.1 Respondents to the OUR's consultation document raised a number of issues which are worthy of comment. The comments are all contained in paragraph 3.6 of the Draft Decision report.

3.2 Pricing in Proportion (PiP)

Some respondents felt that GPL's failure to introduce PiP may have the effect of reducing customers' confidence in GPL's ability to compete in the market place. This was considered prior to developing the products within the submission. It was determined that there was currently limited benefit to customers given the profile of mail from Guernsey. GPL did increase the basic weight step on letters to the UK and Jersey from 60g to 100g however, benefiting customers who post items in the 61g-99g range with lower prices and making any subsequent move to PiP easier to achieve in future. Where there is potential benefit GPL has already started product development work with its customer base; this has been shared with the OUR in confidence and GPL believes it pulls together all the current benefits for those customers that could benefit from PiP pricing.

3.3 Insurance for Bulk Mail

One respondent complained about the lack of insurance for bulk mail. As the DG indicated, the pricing of bulk services is very keen and any insurance for bulk mail products would necessitate an additional premium. As competition increases, the opportunity to pressure service delivery competitors in the UK for a better deal may develop and these benefits can flow through to GPL's customer base. Currently with UK delivery charges still subsidised by RM, this situation is not possible. It remains under scrutiny. In the meantime, customers always have the choice of insuring against loss or damage of their products independently.

3.4 2nd Class Mail

Postwatch Guernsey considered that there might be interest in creating a second class service to the UK as a cheaper alternative. The DG is well informed on the issues that effect product pricing and correctly indicated that a second class service may not actually generate savings that would flow through to the retail tariff; indeed costs may increase. Additionally transfer of traffic to a second stream has the potential to cannibalise the main standard class of traffic, leaving its fixed costs to be covered by a reduced level of traffic – no customers win in this scenario. If the fixed costs remain shared (i.e. conveyance), there is limited scope to find savings as RM does not offer a second class tariff to GPL.

3.5 Volume Discounts

One respondent felt that GPL should offer volume discounts providing these were cost justified. GPL is permitted to develop a discount structure and has done so where product margins permit, for example the unregulated RMSD product was re-launched in April 2006 with a transparent discount structure. This demonstrates that GPL is alive to opportunities but these are always studied in commercial terms. Cost savings are very difficult to achieve in volume growth where margins are small, as in the standard and bulk services.

4. GPL's Product Portfolio

4.1 GPL assumes that the OUR is content with the Bulk Mailer product specifications contained in its submission (Annex 11 to Appendix B refers). These have already been communicated by GPL to its bulk customers.

4.2 GPL stated its intention to remove surface mail options for international products from April 2007 in its tariff submission (para 7.4 refers). GPL has assumed that the OUR is content with this and has included this change in its own consultation.