



Office of Utility Regulation

Guernsey Post's Proposed Tariff Changes

Consultation Paper

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Office of Utility Regulation

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1. Introduction

In May 2009, the Director General of Utility Regulation (“DG”) received an application from Guernsey Post Limited (“GPL”) to change both the level and structure of its tariffs for the period April 2010 to April 2011. Whereas the OUR would normally determine the maximum tariffs for a longer period, in this specific case, the OUR has agreed, at the request of GPL, to determine the tariffs only for a one year period. GPL requested this one year price control due to uncertainty surrounding the new contract with Royal Mail for delivery of cross-border mail.

GPL has applied to the OUR to:

- revise its postal tariffs with effect from 1st April 2010;
- implement Size Based Pricing (“SBP”) from April 2010 onwards for all posting customers; and
- have an increase in the Reserved Area from the current £1.35 to £2.15. In the reserved area GPL has the exclusive right to provide postal services.

GPL’s proposal to implement SBP involves a radical restructuring of its tariffs for both social and business customers. Instead of prices being solely determined by the weight of a posted item, they would be determined both by weight and by which of the three sizes the posted item fell into:

- Letter (broadly speaking, thin items half of A4 size);
- Large Letter (broadly speaking, A4 size items up to an inch thick); and
- Packets (bulky items).

When SBP was introduced in the UK it did not lead to higher overall prices but it resulted in a ‘rebalancing’ of tariffs, Letters became cheaper and Packets more expensive. However, GPL is requesting a significant increase in tariffs across all formats. This means that if SBP is to be introduced in the Bailiwick, tariffs are likely to increase for almost all services. However, this increase would not be higher (and possibly a bit lower) than if SBP was not to be introduced. This is due to the fact that SBP might encourage some postal users to switch format to cheaper formats which would result in GPL facing slightly lower costs from Royal Mail. This reflects the fact that a large proportion of GPL’s total costs for a number of postal services (such as Bulk Mail, mail to the UK and international mail) consists of Royal Mail charges.

GPL states that the driving force behind its tariff proposals are the large increases in and the restructuring of Royal Mail charges. GPL has provided a non-confidential submission to the OUR which is available to download from the OUR’s website at www.regutil.gg. The DG is still reviewing the information submitted by GPL and is at present not able to comment in any detail on the figures and assumptions in GPL’s actual submission. The OUR and GPL are still in the process of resolving certain aspects of the submission before the OUR is able to conclude its efficiency review. This consultation therefore focuses on the principle of SBP. Stakeholders will be given a further opportunity to give their views on the detail of GPL’s proposals (especially the level of the tariffs) in the light of the OUR’s efficiency review which will be included in the draft decision document scheduled for Autumn 2009.

In addition, GPL has requested that the size of the Reserved Area (within which GPL has a monopoly) be increased from its current £1.35 limit to £2.15. This issue is further addressed in section 5.

The DG is aware of the impact that tariff changes may have on all users of postal services within the Bailiwick. He is also aware that for many businesses, particularly the bulk mail and fulfillment industry, the postal service is a significant input to their cost base. GPL's current weight based pricing structure has been in place for a long time and the DG recognizes that the introduction of SBP would have an adverse impact on some customers whilst benefiting others. As explained later in this paper, the DG, based on the information currently before him, is considering allowing the introduction of SBP in some form, although he has yet to form a view on the actual level of prices for the different categories of postal items.

In addition to postal users' views on GPL's proposals generally, he is particularly interested in detailed responses from postal users of the possible impact that a change to SBP might have on their use of postal services. The DG also seeks views on an appropriate timeline to introduce SBP which would give postal customers reasonable time to make necessary changes to their use of postal services if they desire to do so.

In order to consider the full impact of these proposals the DG is inviting interested parties to submit their written comments to the OUR so that they may be considered in full prior to both a draft decision scheduled for Autumn 2009 and a final decision in December 2009. The rest of this document sets out in more detail the consultation timetable and the background to the various issues that need to be considered before a final decision can be reached.

This document does not constitute legal, technical or commercial advice; the DG is not bound by this document and may amend it from time to time. This document is without prejudice to the legal position or the rights and duties of the DG to regulate the market generally.

2. Structure and Comments

2.1. Structure of the Consultation Paper

The rest of this paper is structured as follows:

- Section 3: describes the legislative framework and licensing arrangements which gives the DG power to price control certain areas of GPL's postal activities;
- Section 4: presents GPL's proposed restructuring of the tariffs and background to the introduction of SBP in the UK;
- Section 5: sets out GPL's request for a review of the Reserved Area and the DG's initial observations;
- Section 6: outlines the OUR's approach to reviewing GPL's tariff application and the next steps in the process which will culminate in the introduction of new prices in April 2010.

2.2. Comments

Interested parties are invited to submit comments in writing on the matters set out in this consultation to the following address:

Office of Utility Regulation
Suites B1& B2
Hirzel Court
St Peter Port
Guernsey
GY1 2NH

Email: info@regutil.gg

All comments should be clearly marked "**Comments on Guernsey Post's Proposed Tariff Changes**" and should arrive before **5pm on 11th September 2009**.

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", non-confidential responses to the consultation are available on the OUR's website (www.regutil.gg) and for inspection at the OUR's Office during normal working hours. Any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However the DG regrets that he is not in a position to respond individually to the responses to this consultation.

The DG would particularly welcome quantitative responses from interested parties that demonstrate how GPL's price changes would affect their demand for postal services (either as businesses or private individuals) in order to assess the impact of GPL's proposals.

For example, the DG would welcome information on issues such as:

- Demonstration of how a user's demand for postal services would be affected by the proposed changes both in terms of price and more generally in response to the proposal to adopt SBP (i.e. price elasticities of demand);
- Modelling results showing the impact of the proposed price changes on a company's financial performance;
- Explanation of the impact of the proposed price changes on the company's strategy (e.g. investment and employment levels);
- Historical actual mail volumes and average weights on a quarterly basis (disaggregated by types of products if considered helpful); and
- Projected mail volumes and average weights on a quarterly basis (again disaggregated by types of products, if demand for products are likely to vary i.e. total average weights may vary over time).

The DG would therefore encourage respondents to respond fully to the issues raised by GPL's proposed tariff changes and reiterates that any material that is confidential should be put in a separate Annex and clearly marked so that it can be kept confidential.

3. Legislative and Licensing Background

3.1. Legislation and States Directions

The Post Office (Bailiwick of Guernsey) Law, 2001 (the “Postal Law”) provides that a range of postal activities do not require licensing, ranging from personal private delivery to the delivery of court documents and banking instruments¹. 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 Law².

The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 (the “Regulation Law”) 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.

3.2. 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

¹ Section 1(2) of the Post Office (Bailiwick of Guernsey) Law, 2001

² The Post Office (Reserved Postal Services) Order, 2001

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 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”.

3.3. 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 objectives³:

- 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 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 Directions⁴ 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.

³ The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001

⁴ States Resolutions 2001, pages 78-80 (item no 14)

3.4. Licence Conditions

3.4.1. Reserved services

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 and 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 (see paragraph 3.2).

GPL was awarded a licence on 1st October 2001 in accordance with States Directions and the DG further determined that any postal services that are provided for a price of *less than £1.35* are deemed to be reserved services and this was set out in an Order made by the DG in accordance with section 9 of the Postal Law⁵.

3.4.2. Non-reserved services

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*.

In addition, 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 instruments⁶.

3.4.3. USO services outside the reserved area

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

⁵ The Post Office (Reserved Postal Services) Order, 2001

⁶ Section 1(2) of the Post Office (Bailiwick of Guernsey) Law, 2001

(c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.

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

In November 2005 the DG designated GPL as being dominant⁷ in the following markets:

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

For the purpose of the current price control the DG will determine the prices for all the above services as GPL has been found dominant in providing these services.

⁷ Document OUR 05/26 Review of Market Dominance in the Guernsey Postal Market – Report on the consultation and Decision Notice, November 2005

4. Size Based Pricing

Size Based Pricing has been introduced in a number of countries such as the UK (including Isle of Man), Denmark, Germany, Ireland, Australia, Japan and the United States.

In the UK, SBP was adopted in August 2006 and is generally known as Pricing in Proportion (“PiP”).

4.1. Background

Royal Mail has historically charged GPL primarily on a *weight* basis for handling its UK and International Mail. The format of the traffic, e.g. whether it is a letter or packet, has not formed a significant part of the price calculations. This was broadly consistent with Royal Mail’s pricing structure until 2006 when Royal Mail introduced SBP in the UK. Among the drivers for the introduction in the UK was that SBP would better reflect Royal Mail’s costs as it would cost Royal Mail more to sort, handle and deliver larger envelopes and items compared with smaller letters which are generally sorted by machine. Royal Mail argued that without SBP most light but bulky items were priced below their cost, whereas smaller, heavier items were generally overpriced.

With the expiry of the Royal Mail/GPL contract in 2009, Royal Mail has decided to bring the new contract with GPL into line with its UK pricing structure and introduce SBP for the charges it makes to GPL. SBP concerns the *structure of prices* rather than the overall or average level of prices. Therefore, Royal Mail’s introduction of SBP need not in principle cause a significant increase in the overall level of prices. However, it is the OUR’s understanding, that in addition to SBP, Royal Mail’s new contract also features a significant *increase in charges* for larger sizes, without an offsetting decrease in charges for smaller sizes.

According to GPL, based on the existing format profile of postings the expected cost increase in 2010/2011 as a result of this new contract could amount to approximately £8.2m (an increase of about 18% on GPL’s 2009/2010 total budgeted operating expenditure). However, GPL anticipates that, if it were to introduce SBP for all postal customers in the Bailiwick, some customers might switch the profile of their postings to minimise the impact of the price rises and in that case the increase would amount to £3.8m.

4.2. GPL’s Proposed Restructuring of Tariffs

In b wanting to adopt SBP is the change in structure and scale of the Royal Mail charges for UK and international mail.

4.3. SBP in the UK

The process to introduce SBP in the UK started with Royal Mail consulting with some of its customers about the potential change to SBP⁸. In August 2003 Royal Mail submitted its initial application to Postcomm. At the time, Postcomm had concerns about the underlying data used by Royal Mail and considered that more work needed to be done in order for Postcomm to approve SBP. In March 2005 Royal Mail published its revised SBP proposal. Postcomm announced its decision to approve SBP in August 2005, following two years of extensive consultation. Royal Mail introduced the changes in August 2006.

4.3.1. Rationale for introducing SBP

There have been four main reasons why Royal Mail and Postcomm decided to adopt SBP in the UK. Each of these reasons is set out below.

Better alignment of prices with cost

Royal Mail introduced SBP to bring its pricing structure more into line with its costs. Whereas UK mail prices had historically been set purely based on weight, the size and shape of items largely determined the costs of collecting, sorting and delivering letters and packets⁹. Royal Mail argued that different formats of mail (Letters, Large Letters, and Packets) incur significantly different handling costs. For example, items that cannot be easily machine sorted, usually take up more transportation capacity. Also items that cannot be delivered through letterboxes, incur higher costs than those items that can, for example, because several delivery attempts may have to be made. Whereas Letters (broadly speaking, thin items up to half of A4 size) are less costly, the items that tend to impose larger costs are Large Letters (broadly speaking, items up to A4 size and up to an inch thick, sometimes known as “Flats”) and Packets (bulky items). Royal Mail also argued that under purely weight based pricing the prices for heavier weight items were significantly in excess of the cost of handling these items.

Enabling sustainable and effective competition

Postcomm issued a consultation document on the Royal Mail proposals in April 2005¹⁰. The Postcomm consultation set out that there were a number of strategic reasons why Royal Mail wanted to better align its prices with costs. From 1 January 2006, Royal Mail lost its remaining monopoly within the UK postal services market. The market is now fully open to any licensed competitor wishing to provide customers with alternative products and services. Royal Mail believed that sustainable and effective competition would not be possible if its prices were significantly out of line with its costs.

⁸ <http://www.royalmailgroup.com/portal/rmg/content1?catId=23200532&mediaId=23700549>

⁹ Royal Mail News Release at

<http://www.royalmail.com/portal/rm/content1?catId=400126&mediaId=11000125>

¹⁰ <http://www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/pricing-in-proportion/141803120final.pdf>

Acting in a more commercial manner

Royal Mail was responding to increasing pressure from its shareholder (the Government) to act in a more commercial manner. In the past, Royal Mail focussed more on its overall profitability than on a commercial assessment of the margins earned on different types of mail items.

Fairer and more appropriate prices for customers

Finally, Royal Mail wished to continue to develop and encourage its customers to use efficient posting methods. This is only possible if customers pay the costs that Royal Mail reasonably incurs in providing services to them. Generally speaking, it can be considered fairer and more appropriate for customers to pay prices that reflect, as well as reasonably possible, the costs incurred in conveying their postal items.

4.3.2. Projected impact of SBP in the UK

The April 2005 Postcomm consultation explained that the pricing of about two thirds of the volume from products affected by SBP would not change. This would be due to Royal Mail's proposal to keep the standard letter price for all products unchanged. In addition, Royal Mail's proposal to extend the 0-60g weight step up to 100g would result in a price decrease for heavier letters within this step.

It was therefore envisaged that the '*rebalancing*' under SBP would affect about one third of the volume from all products affected by SBP. The consultation also pointed out that the general effect was to raise prices for relatively light but large or unusually shaped postal items, and to lower prices for relatively heavy postal items. Initially, Royal Mail did not propose to introduce SBP for international mail. It is important to note that Postcomm had already made clear that it would not allow Royal Mail to increase its overall revenue as a result of the introduction of SBP. Postcomm would as part of its assessment ensure that Royal Mail's proposals would be "revenue neutral".

Royal Mail also proposed a rebate scheme for some of the worst affected customers in the two years following the introduction of SBP. This was to be based on the increase in a customer's total postage bills following SBP and the total amount the customer spends with Royal Mail. In practice this only covered large businesses and it seems that only one customer benefited from this scheme¹¹.

4.3.3. Postcomm assessment criteria

After having received Royal Mail's proposals to adopt SBP, Postcomm raised a number of specific issues during the consultation process, such as:

¹¹ http://www.psc.gov.uk/postcomm/live/news-and-events/commentary/COMMentary_Issue_11.pdf

- the robustness of Royal Mail's cost data;
- the cost reflectivity of Royal Mail's proposals;
- the revenue neutrality of Royal Mail's proposals;
- the appropriate length of notice period before such a change in price structure could be introduced;
- Royal Mail's communication programme for informing postal users of such a change in price structure;
- Royal Mail's mitigation scheme; and
- the extent to which Royal Mail would be able to adjust the indicative prices it has proposed for PiP before final implementation.

These issues were addressed during a consultation process which took approximately two years in total. This process resulted in Postcomm developing a number of specific criteria to assess Royal Mail's proposals. Postcomm required Royal Mail to demonstrate that its proposals would:

- be revenue neutral (within the context of the wider price control);
- lead to prices for the service being more cost reflective than they would be if the existing pricing basis were retained;
- be introduced in a manner that avoids unreasonable changes for users of the service;
- not lead to a circumvention relating to non-price terms; and
- not lead to a failure to provide services priced in a manner referred to in the European Postal Services Directive (e.g. prices "geared to costs").

Postcomm also pointed out that in practice the first three criteria would be the most significant and be the primary focus of its review. Postcomm assessed cost reflectivity at an overall level as well as at the individual product level.

4.3.4. Advantages and disadvantages of SBP

The adoption of SBP in the UK involved a lengthy consultation process and resulted in the final plans being very different from the initial plans submitted by Royal Mail to Postcomm as set out in the April 2005 consultation document¹². The revised proposals involved:

- the introduction of further weight steps to reflect the fact that weight was more of an indicator of costs than suggested in Royal Mail's initial application;
- an increase in the maximum thickness of Large Letters from 10mm to 25mm;
- an increase in the maximum thickness of Large Letters from 25mm to 35mm for Response Services (these items are not delivered to residential letterboxes and hence the 25mm constraint was not relevant);
- an increase in the weight limit for Large Letters from 500g to 750g;
- removal of the requirement for Presstream Large Letters and A3 Packets to be of a uniform thickness;
- a general lowering of the price of 0-100g Large Letters (flats) to better reflect underlying costs; and
- allowing customers to present Royal Mail with bags of mail for delivery which, whilst needing to be of a single format, can contain items of mixed weight.

As part of its consultation process, Postcomm undertook an impact assessment, which concluded that¹³:

“Royal Mail’s revised SBP proposal is a price rebalancing exercise, which means that there are some prices that rise and others that fall. However, Postcomm believes that the potential benefits from improved cost reflectivity of pricing justify the change being proposed, particularly given the changes Royal Mail has made since its original proposal.”

4.3.5. Impact of SBP in the UK

In October 2007 Postcomm published a document assessing the impact of the introduction of SBP in the UK¹⁴. The report noted that a number of organisations had surveyed small business users about the impact of SBP. All of the surveys reported that business costs had risen as a result of SBP, or that SBP had a negative impact on businesses. Postcomm noted that the results of the surveys were of interest, but of limited validity due to survey techniques used and the risk of self-selection bias and the lack of precision in data collection.

¹² <http://www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/pricing-in-proportion/141803120final.pdf>, paragraph S.16

¹³ <http://www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/pricing-in-proportion/14473SBPAnnex.pdf>

¹⁴ http://www.psc.gov.uk/postcomm/live/policy-and-consultations/consultations/pricing-in-proportion/2007_10_22_PiP_Closure.pdf

Postcomm also asked Royal Mail to submit any analysis about the impact of SBP. Royal Mail responded that it had undertaken little analysis. Nevertheless, it was thought that the two main effects on the demand for postal services had been that (some) customers had:

- substituted one format for another, i.e. they were encouraged to switch to formats that were cheaper to mail; or
- abandoned postal services and moved to other forms of communication media, because SBP was too complicated.

The Postcomm report's main findings were as follows:

- Royal Mail implemented SBP well;
- the effects on the demand for postal services are difficult to track;
- suppliers to the postal industry were made aware of and responded to SBP;
- Post Offices responded well to SBP;
- Royal Mail's mitigation scheme had limited availability and only one customer benefited from it;
- The NAO complimented Postcomm's Impact Assessment; and
- Postwatch research has been invaluable in helping track the effects of SBP.

4.3.6. SBP of international mail products in the UK

Royal Mail's March 2005 revised application to Postcomm did not propose the introduction of SBP for any of its international products. However, at a later stage in the process Royal Mail notified Postcomm of its intention to extend SBP to its international products (e.g. retail, surface and airmail international products).

Postcomm stated in its August 2005 decision document¹⁵ that it would first need to assess whether international products have a higher proportion of their costs vary by weight. Postcomm noted that the cost structure for international mail is significantly different from that for inland mail, encompassing as it does both air freight charges and international contractual arrangements. Although, Postcomm did not rule out the possibility of extending SBP to include international products, it said it would expect Royal Mail to come forward with a justification for its proposal to extend SBP to these products.

¹⁵ http://www.psc.gov.uk/postcomm/live/policy-and-consultations/documents-by-date/2005/RM_proposals_for_PiP_-_Decision_Document_0805.pdf

4.4. Relevance of the UK experience for the Bailiwick

There are a number of similarities between the situation in the UK and the Bailiwick, which makes the UK experience especially relevant for the Bailiwick. However, there are also some clear differences.

4.4.1. Similarities between the UK and Bailiwick regulatory regimes

It could be argued that the regulatory regimes in the UK and the Bailiwick are broadly similar, including broadly speaking similar objectives. In both regimes it is recognised that cost reflectivity and competition can play key roles in protecting postal customers. As previously outlined, the main drivers to introduce SBP in the UK were:

- (1) opening up of the postal services market to competition; and
- (2) greater cost reflectivity.

In the Bailiwick the DG equally believes that these are two important tools in protecting postal customers. As long as the USO is being met, if an introduction of SBP can contribute to the introduction of competition and greater cost reflectivity, then the DG would expect this to have a beneficial impact on postal users through greater choice and fairer prices.

4.4.2. Difference between the UK and the Bailiwick: revenue neutrality

In the UK, Postcomm made clear at an early stage in the process, that any Royal Mail proposals to introduce SBP would have to be revenue neutral. The introduction of SBP in the UK therefore consisted of the ‘rebalancing’ of tariffs, with tariffs for relatively light but large or unusually shaped postal items going up and tariffs for small and thin, and relatively heavy postal items going down.

The DG is not able to put a similar condition on GPL. This is due to GPL’s cost structure. According to GPL, the main driver to introduce SBP are the large cost increases imposed on GPL and the way in which Royal Mail has restructured its charges as part of the new Royal Mail contract which has come into force since April 2009. Royal Mail charges form approximately 75% of GPL’s total costs for bulk mail. Conveyance contributes 10% and the remaining costs are pure GPL costs (e.g. processing, collection, overheads, etc.). The cost structure is slightly different for other services. For example, for social mail to the UK, 43% of the total costs can be attributed to Royal Mail, with conveyancing costs attributing 24% and the remainder being GPL costs (e.g. collection, processing, retail, overheads, etc.). In the case of International Mail, Royal Mail costs form 65% of GPL’s total costs, with conveyance costs contributing 11% and the remainder being GPL costs.

The DG notes that GPL has faced large Royal Mail costs increases before and that this did not result in a request to introduce SBP. The DG therefore considers that the main driver to introduce SBP at this time is more likely to be the large cost increases for larger postal items (i.e. Large Letters and Packets). If SBP was to be introduced it could shield smaller size postal items (Letters) from these large cost increases. Also, it

would enable postal users to mitigate the impact of large increases for larger items by switching some of their mailings to smaller sizes.

The DG considers that due to the large cost increases imposed by Royal Mail on GPL, it would not be possible to introduce SBP in a revenue neutral way. The DG also considers that not introducing SBP still involves the same significant cost increases; however, these cost increases would then be borne by all postal users. This would result in some postal users paying well in excess of cost reflective prices for the service they receive and this could be regarded as unfair treatment of these postal customers.

4.5. GPL's approach to pricing

At present, GPL does not make a distinction between the format of items and price increases from a base of 100gm in 50gm weight steps with no maximum weight. The maximum size is 610 x 460 x 460mm. For tubular or cylindrical packages, the maximum length is 900mm. In addition, the item's length when added to twice the diameter must not exceed 1,040mm.

4.5.1. Proposed formats under SBP

GPL's SBP proposal, which is available to download from the OUR website, was submitted in May 2009 and states that product prices will generally be based on three main formats with the following dimensions:

- **Letter** – a postal item that does not exceed 165mm by 240mm, with a maximum thickness of 5mm and maximum weight of 100g. There is one weight band (0-100g). The great majority of A5 sized mail will fall into this category;
- **Large Letter** – a postal item that does not exceed 250mm by 353mm, with a maximum thickness of 25mm and a maximum weight of 750g (with the exception of international post which has a maximum weight of 500g). The great majority of A4 sized mail will fall into this category; and
- **Packet** – a postal item that does not meet either of the other specifications with the only restriction being an upper maximum weight of 2 Kg placed upon international packets only.

Weight steps

The DG notes that the GPL proposals involve many more weight steps compared with the UK. In its submission GPL has not explained why it has decided to include all these extra weight steps and how this would benefit customers, given the additional complexity which this causes, nor has it explained why these particular weight bands incur the additional costs being proposed for such items.

GPL is proposing to introduce SBP for all intra-Bailiwick, Jersey, UK and international mail. GPL's main reasons to also introduce SBP for local and Jersey

mail seem that the same sort of cost differences exist and that adopting the same approach would result in a consistent pricing structure for all mail. However, GPL has not provided any data to support this view.

4.5.2. *International mail products*

Although Royal Mail has not so far adopted SBP for the international mail products it offers to its UK customers, it has introduced SBP for the charges it levies on GPL for delivery of international mail. GPL is proposing to introduce an adaptation of SBP for International mail, which mirrors the formats for the UK and the Bailiwick mail in terms of format. GPL wants to apply a maximum thickness of 20mm for the Large Letter format as this is the international standard for that format. GPL also wants to slightly reduce the length and width dimensions for both Letters and Large letters. GPL has argued that this is to ensure consistency with the UK formats.

The DG considers that it might not be appropriate to make such a change if the sole reason is to ensure greater consistency. The DG notes that GPL elsewhere has argued that one of the main drivers to introduce SBP in general is greater cost reflectivity. The key question is therefore whether any of the further changes proposed by GPL to the format for the international tariff are cost reflective or not.

In its tariff submission GPL has also informed the OUR that it has simplified international tariffs by collapsing the current three zones into two, namely 'Europe' and 'Rest of the World'. However, GPL has not provided the OUR with any information on how it expects this to affect its customers.

4.5.3. *Advantages and disadvantages of SBP in the Bailiwick*

The DG considers that in the light of the significant cost increases in the new Royal Mail contract, there are likely to be a number of advantages and disadvantages to SBP, compared with retaining the existing weight based structure. These are briefly described below.

Advantages

- More cost reflective prices, resulting in better price signals to customers and GPL alike;
- A fairer pricing structure, with customers facing prices that reflect, as well as reasonably possible, the costs incurred in conveying their postal items;
- Protection of mailers of smaller sizes from the cost increases associated with larger sizes;
- Provision of opportunities for mailers of larger sizes to mitigate the cost increases by switching to smaller sizes; and
- Removal of pricing distortions which would limit the scope for competition outside the 'reserved area'¹⁶

¹⁶The DG notes GPL's request to increase the reserved area, which would reduce the scope for competition. This issue is discussed in the next chapter.

Disadvantages

- Greater complexity - especially initially, it is likely to be more difficult for postal users to calculate the right postage as both the weight and size of the item have to be taken into account;
- Potentially higher cost to businesses in what is arguably already a difficult economic environment – for example changes to operational practices such as a slower mail run as items have to be sorted into size categories, mail might need to be redesigned to take advantage of lower price bands, new postage rates will be required for franking machines, equipment may need to be upgraded such as scales to help automate the process, etc.; and
- Potential additional costs of enforcement (e.g. additional costs to ensure that items have appropriate postage and recover any shortfall from addressee if appropriate).

4.5.4. Anticipated impact on postal users

GPL is expecting that 95% of all social mail would either face the same price or a lower price, with only 5% of social mail facing a higher tariff under GPL's proposals. GPL therefore anticipates that the main impact will be felt by large volume mailers and bulk mailers. This would especially be the case if these users are not able to change the format of their larger items to ensure that they fall into the large letter rather than packets category. Tables 1 to 5 give an indication of some of the proposed price increases. **Please note:** the full list of proposed tariffs can be found in GPL's non-confidential tariff submission, which can be downloaded from the OUR's website.

Table 1 - Local Mail

GPL – Intra-Bailiwick		
Product	Current Tariff (effective 1 st April 2009)	Proposed GPL Tariff (for 1 st April 2010)
Letter 100g max	£0.36	£0.36
Large Letter 100g	£0.36	£0.66
Large Letter 400g	£1.20	£1.38
Large Letter 750g max	£2.18	£2.22
Packet 100g	£0.36	£1.71
Packet 550g	£1.62	£3.24
Packet 1000g	£2.88	£4.77
Packet each 50g after 1000g	£0.14	£0.17

Table 2 - UK, Isle of Man, and other Channel Islands

GPL - Guernsey to UK, Jersey and Isle of Man		
Product	Current Tariff (effective 1st April 2009)	Proposed GPL Tariff (for 1st April 2010)
Letter 100g max	£0.43	£0.45
Large Letter 100g	£0.43	£0.75
Large Letter 400g	£1.84	£1.47
Large Letter 750g max	£2.89	£2.31
Packet 100g	£0.43	£1.80
Packet 550g	£2.29	£3.33
Packet 1000g	£3.64	£4.86
Packet each 50g after 1000g	£0.15	£0.17

Table 3 - International

GPL - International					
Product	Current Tariff (effective 1st April 2009)			Proposed GPL Tariff (for 1st April 2010)	
	Europe	World Zone 1	World Zone 2	Europe	Rest of the World
Letter 10g	£0.51	£0.56	£0.56	£0.56	£0.62
Letter 40g	£0.69	£1.14	£1.21	£0.70	£1.12
Letter 100g max	£1.23	£2.25	£2.53	£1.12	£1.97
Large Letter 10g	£0.51	£0.56	£0.56	£0.63	£0.69
Large Letter 240g	£2.49	£4.84	£5.61	£2.17	£4.03
Large Letter 500g max	£4.83	£9.65	£11.33	£3.99	£7.80
Packet 10g	£0.51	£0.56	£0.56	£0.93	£0.99
Packet 240g	£2.49	£4.84	£5.61	£2.47	£4.33
Packet 500g	£4.83	£9.65	£11.33	£4.29	£8.10
Packet each 20g to max of 2000g	£0.18	£0.37	£0.44	£0.14	£0.29

Table 4 – Local Franked mail

GPL Franked - Intra-Bailiwick		
Product	Current Tariff (effective 1st April 2009)	Proposed GPL Tariff (for 1st April 2010)
Letter 100g max	£0.36	£0.35
Large Letter 100g	£0.36	£0.64
Large Letter 400g	£1.20	£1.34
Large Letter 750g max	£2.18	£2.15
Packet 100g	£0.36	£1.66
Packet 550g	£1.62	£3.14
Packet 1000g	£2.88	£4.63
Packet each 50g after 1000g	£0.14	£0.16

Table 5 - UK, Isle of Man and other Channel Islands Franked Mail

GPL Franked – Guernsey to UK, Jersey & Isle of Man		
Product	Current Tariff (effective 1st April 2009)	Proposed GPL Tariff (for 1st April 2010)
Letter 100g max	£0.43	£0.44
Large Letter 100g	£0.43	£0.73
Large Letter 400g	£1.84	£1.43
Large Letter 750g max	£2.89	£2.24
Packet 100g	£0.43	£1.75
Packet 550g	£2.29	£3.23
Packet 1000g	£3.64	£4.71
Packet each 50g after 1000g	£0.15	£0.16

4.5.5. Implementation timeline

GPL is proposing to implement SBP by April 2010. In the DG's view, while GPL has informed bulk mail customers in general terms of its proposals, the company has so far been less pro-active in communicating this intention to ordinary business and individual customers. The DG also notes that there currently seems to be little information publicly available to enable GPL's customers to predict how they will be affected. The DG suggests GPL considers, as a matter of priority, developing and making available on its website an 'impact calculator' to enable customers to more fully understand the proposals it has submitted to the OUR. He expects GPL to make

this available by early August to facilitate interested parties making informed responses to this consultation.

5. The ‘Reserved Area’

On 1st October 2001 the DG made an Order in accordance with section 9(1) of the Postal Law designating certain postal services as reserved postal services. The effect of this Order is to reserve the right to provide postal services within the Reserved Area to GPL. This was designed to ensure that the universal postal services in the Bailiwick of Guernsey can be met.

The DG made an Order defining reserved postal services in Guernsey as those services provided for a consideration of less than £1.35. This price limit was arrived at by multiplying the standard tariff for letters to the UK (27p) by five, along the lines of the EU approach. The use of the standard UK tariff reflected the fact that a significant amount of the Bailiwick’s mail is to and from the UK. In practice this means that this area is ‘reserved’ for GPL and not currently open to competition.

In addition the States Direction to the DG requires him to review and revise the award of exclusive rights from time to time with a view to opening up the Bailiwick postal services market to competition, provided that any such opening up does not prejudice the continued provision of the universal postal service. Since 2001 no review of the reserved area has been undertaken.

5.1. GPL’s request to increase the Reserved Area

In its submission, GPL has asked the DG to review the Reserved Area and to increase it from £1.35 to £2.15. GPL states that it needs this increase:

“to ensure that it can continue to fund the Universal Service Obligation, to recognize the artificially low base line tariff, to recognize that it will be difficult for the Guernsey market to support more than one full-service postal operator and to compensate for the impact that inflation has had on the Reserved Area since 2001”.

GPL also argues that if the Reserved Area is not increased, it would potentially face competition on large letters above 350g and on all packets in the public tariff, and in all areas of the bulk tariff depending on the format and the weight step.

Since GPL’s request the DG has also been approached by a number of stakeholders who have asked for clarification on the extent of the ‘reserved area’.

5.2. Other jurisdictions

5.2.1. Europe

In Europe, efforts towards reforming the postal market began in the early 1990s, as part of the push to create a single European market. It was widely recognized that the postal sector is of major economic importance, affecting the competitiveness of other sectors, generating an annual turnover of approximately 1% of EU GDP, and providing employment to around 1.7 million people.

The aim of the reforms was to:

- get national monopolies to open up to competition in order to make postal services cheaper, faster, more efficient and more innovative – similarly to what was done in the telecom and energy sectors;
- harmonise performance across member states;
- improve the quality of cross-border services; and
- respond to the rise in electronic alternatives to mail, which many feared would lead to a decline in physical mail volumes.

The first Postal Services Directive was adopted in 1997 with the second one being adopted in 2002, which succeeded in opening up a number of postal services, including the delivery of parcels and express services, but stopped short of imposing competition for the delivery of letters weighing less than 50 grammes. Incumbent operators were entitled to hold onto this so-called “reserved area” – which is basically a legalised monopoly for certain services and which represents more than 70% of all letter post in the EU and around 60% of all revenues from postal services – in order to keep up their role of “universal service provider” (“USP”)¹⁷.

However, in 2006 the European Commission made clear through its proposed third Postal Services Directive that it intended to eliminate all remaining obstacles to a single postal market and to abolish this reserved area as of 2010. It was recognized that the reserved area enabled incumbents to maintain a lucrative monopoly over the delivery of letters weighing less than 50 grammes. It allowed the incumbents to offset losses made on high-cost postal users with profits made on low-cost postal users. This legally-protected monopoly over particular services or products remained the final obstacle to full liberalisation.

The European Commission’s approach¹⁸ has been to promote a gradual market opening, whilst maintaining the universal service. In 1999 the first reduction to the reserved area was made which was followed by further reductions in 2003 (to 100g and costing less than three times the basic tariff) and 2006 (to 50g and costing less than two-and-a-half times the basic tariff). By 2010/11 there will be full market opening for the 16 Member States (which represents 95% of the internal postal

¹⁷ Based on total local and outward mail, the reserved area accounted for 95% of volumes and 80% of revenues for the year 2008/09, but by 2010/11 this is expected to fall to 77% of volumes and 53% of revenues if the reserved area remains at £1.35. This is due to the proposed price rises taking volumes out of the reserved area.

¹⁸ http://ec.europa.eu/internal_market/post/legislation_en.htm#legislative

market). However, a number of member states have already fully liberalized their market ahead of this deadline, such as the UK, Finland, Sweden and the Netherlands. Furthermore, by 2012/13 there will be full liberalization for the remaining Member States (Greece, Luxembourg and Member States which joined the EU after 1 January 2004).

5.2.2. Jersey

In Jersey the approach has been in line with that taken by the European Commission. Although, the Law in Jersey provides for a reserved area to be licensed, the JCRA has stated that it does not believe that a reserved set of services or activities insulated from competition would encourage efficiency to the same extent as a free market¹⁹.

5.2.3. United Kingdom

In the UK the postal market has been fully liberalised since January 2006. As a result, there is no longer a reserved area for Royal Mail and there are now a number of providers of postal services operating in the UK market.

5.3. Reasons behind the introduction of a Reserved Area

In the past, it was normal practice for incumbent postal operators to use profits made on low-cost postal services to offset losses made on high-cost postal services. As a result, the charges faced by postal users were not very cost reflective. In practice this often resulted in one group of postal users cross-subsidizing another group of postal users in order to enable the postal operator to meet its USO.

In the Bailiwick it meant that bulk mailers cross-subsidised social mailers, resulting in artificially low stamp prices for social mail which did not cover the costs of providing the service. It also meant that certain groups of postal users paid prices which were arguably too high and this might have had an impact on the competitiveness of their businesses. However, historically, it was assumed that such an approach could ensure the provision of a universal service for all postal users at a reasonable cost and hence it enabled an incumbent postal operator to meet its USO.

One of the problems with this approach is that it severely limits the scope for competition and therefore consumer choice. Generally speaking, in a situation where the incumbent operator's prices are not cost reflective, there is scope for a new provider willing and able to provide services at true costs to enter the market. Customers who pay the inflated prices might switch to the new provider. This would leave the incumbent operator with a possible significant loss given that customers on subsidised services will keep using its services provided below their true cost. Such a business model is clearly not sustainable. The only way in which such a model could work is by providing protection to the incumbent operator from competition, i.e. by prohibiting new providers from entering the market or a certain part of the market (e.g 'reserved area').

¹⁹ <http://www.jcra.je/pdf/040929%20Info%20Paper%202004-1%20Regulating%20Postal%20Services%20In%20Jersey%20-%20An%20Overview.pdf>

There are a number of problems with this approach, such as:

- customers do not face ‘fair’ prices which reflect the cost of the services provided;
- customers who pay too little for the service provided might use more of the service than they would otherwise have done, further increasing the costs to the provider;
- customers who pay too much for the service provided might be at a competitive disadvantage especially compared with postal users in other jurisdictions;
- it severely limits the scope for competition, thus removing the incentives on the incumbent operator (which effectively is a monopolist) to become more efficient (which would benefit all its users through lower prices) and more customer responsive; and
- it limits postal users’ choice as there is little incentive for a monopoly provider to provide different price/quality trade offs.

It has therefore been a priority for the DG to remove cross-subsidies from one group of postal users to another group of postal users. As part of the last price control decision, cross-subsidies between different groups of postal users have been phased out. No new entrants have entered the postal market in the Bailiwick which might partly be due to the fact that GPL still has a reserved area of all items below £1.35.

Given the above, it could therefore be argued that the imposition of a reserved area has potential negative implications for postal users, especially if there is no clear need for a reserved area in order to fund the USO. As pointed out previously, as long as prices are cost reflective, the USO could be funded through the revenue obtained from postal users who use these services, i.e. it can be self-funding.

5.4. DG’s initial view on GPL’s request

The DG’s view is that in general terms consumers are usually best served where they have a choice of provider from whom to get their service. As mentioned above, most countries are now abolishing (or greatly reducing) those parts of the postal market which are solely to be met by the incumbent postal operator. Indeed the DG’s view is that the States also had an expectation that over time, as GPL increased its efficiency to meet competition, the size of the market over which it would retain a monopoly would reduce. As noted above the DG has, over previous price controls, been phasing out cross-subsidies between different groups of postal users.

Furthermore, the DG is aware from discussions with certain interested parties, that the large increases being proposed in postal rates will potentially have a significantly impact on certain postal users and that such customers are interested in exploring options that will mitigate these increases. This includes considering Downstream Access (“DSA”) providers in the UK. The DG has been made aware that one of the obstacles in seeking different postal solutions by these parties has been the imposition of the reserved area effectively prohibiting these parties from reducing costs to protect their competitive position. The DG has been told on a number of occasions that a further deterioration in their competitive position as a result of postage increases

would not be acceptable and that these companies may have to consider whether they could continue to be based in Guernsey.

The DG notes that GPL has provided a very limited argument in support of an increase in the Reserved Area and has provided no supporting cost information to support its proposed rate of £2.15. Given the scale of the tariff increases being proposed, the DG does not believe it is in consumers' interests to restrict further their choice of service provider. In fact, given the position being adopted elsewhere (including Jersey) of having no reserved area, the DG is minded to consider whether such an approach should be adopted in Guernsey. However, the DG would like to hear views from stakeholders including those who would be interested in providing alternative services to GPL to enable him to consider this matter further.

6. Approach to Reviewing the Tariff Change Application and next steps

The OUR needs to ensure that any major change to GPL's pricing structure, such as those that have been proposed, is cost reflective and is introduced in such a manner that minimises the impact on postal users and by ensuring that postal users have sufficient notice to make changes to their business processes if that is deemed necessary. The DG therefore wishes to seek every opportunity to consult with interested parties before reaching his final decision.

The DG has to exercise his functions (which have been set out in section 3.3) in the manner in which he considers is best calculated to ensure the provision of the universal service which has been imposed on GPL through its licence. In discharging his duties, the DG believes that it is appropriate for customers to pay prices that reflect, as well as reasonably possible, the costs incurred in conveying their postal items. This will help the DG to discharge his duty in relation to ensuring that utility activities are carried out in such a way as to best serve and contribute to the economic and social development and well-being of the Bailiwick.

Cost reflective pricing should encourage GPL to develop more efficient and reliable mail processes and encourage customers to choose between them and pay a reasonable price depending on the service they choose. It also helps to promote sustainable competition. With the removal of cross-subsidies from bulk mail services to social mail services, thus ensuring that the ordinary stamp price covers the cost of the service provided, there is no longer a need for a reserved area to enable GPL to fund its USO. Given the scale of the tariff increases being proposed, the DG does not believe it is in consumers' interests to further restrict their choice of service provider. The DG notes that elsewhere (including Jersey) the reserved area either has been abolished or is in the process of being abolished. The DG is minded to consider whether such an approach should be adopted in Guernsey.

Given the significant increases in Royal Mail costs, the DG considers that SBP would protect the mailers of smaller size items from the cost increases which are associated with larger sizes. It would also provide opportunities for mailers of larger sizes to mitigate the cost increases by switching to smaller sizes. The DG believes on balance that the introduction of SBP has the potential to be a positive development for postal users based on the information currently before him. However he believes significant further work is required before a view can be expressed on the level of tariffs GPL has requested. The DG is now seeking views from interested parties and especially any evidence of the impact on the demand for postal services by interested parties as a result of GPL's proposal to adopt SBP, before proposing a final decision.

At the end of this consultation, the DG will carefully consider the responses received and other available evidence, before deciding whether to accept GPL's proposal to adopt SBP and if so, whether to do so in its proposed form and to the timeline proposed by GPL. Given the implications for GPL's customers and the potential need for some customers to make changes to their operations, the DG believes that it is important that these customers are given sufficient notice if there was to be any move to SBP. The DG therefore intends to signal more clearly his intentions with regard to

SBP during Autumn 2009 as part of the overall draft decision. Interested parties who require further clarification on GPL's proposals are encouraged to contact GPL.

In order to assess whether tariffs are cost reflective or not, the DG needs to be sufficiently confident in the cost data on which GPL's proposals are based. Currently, there are still a number of outstanding issues which GPL and the OUR are trying to resolve before the DG can conclude his efficiency assessment, which forms a key input in the price control process. The DG notes that GPL wishes to implement new tariffs on 1st April 2010. In the DG's view the timetable for completing the review of GPL's tariff application is challenging but without any further delays in information provision by GPL it should be achievable.

The DG aims to publish a draft decision during Autumn 2009, which would incorporate the DG's view on the actual tariffs proposed by GPL for the April 2010-2011 period following the OUR's efficiency review. He intends to issue a final decision on GPL's proposals by mid-December 2009, which will include his decision on the Reserved Area and his final decision on SBP.

The DG looks forward to receiving feedback from interested parties to assist him with this review of GPL's tariff submission and more specifically any of the issues raised in this document.

ENDS/