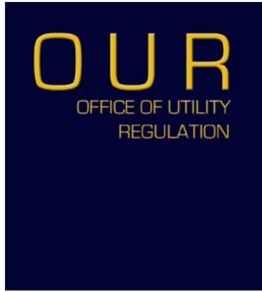


Office of Utility Regulation

# Guernsey Post's Proposed Tariff Changes

## Consultation Paper

**Document No:** OUR 10/12 **October 2010**

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# 1. Introduction

In December 2009, the Director General of Utility Regulation ("DG") determined the maximum tariffs that Guernsey Post (GPL) could charge its customers over the period 1 April 2010 to 31 March 2011. This one-year price control was undertaken at the request of GPL due to uncertainties around its new contract with Royal Mail for the delivery of mail to the UK and abroad.

GPL has now submitted an application for tariff changes coming into effect 1 April 2011 with, potentially, further changes in 2012 and 2013, covering the period to March 2014. A non-confidential submission accompanying GPL's proposed tariff changes is included as Annex A to this document. This Annex sets out the company's proposed price changes and the rationale for the price changes sought. The DG is now consulting on GPL's proposals and his initial assessment of those proposals.

In undertaking this consultation the DG is aware of the impact that tariff changes may have on all users of the postal service in Guernsey. For many residential and businesses customers the postal service remains a key service on which they rely. The service is of particular significance to the bulk mail industry in Guernsey given the nature of those businesses. The DG is therefore seeking, through this consultation, views on GPL's proposals, including the possible impact that changes of the type proposed by GPL may have on use of the postal service.

The DG also recognises that the commercial environment in which GPL and other postal service providers operate is continuously changing in significant ways. In particular, the demand for certain postal servicesis declining, while a significant proportion of GPL's costs is driven by factors such as the charging arrangements with Royal Mail and changes in transport costs. The DG notes that GPL has now commenced a series of initiatives and business changes given such challenges.

The DG's standard approach to consultation procedures is set out in document, OUR 05/28. It is however proposed that this consultative process is shortened for the purpose of this tariff review, by removing the draft decision phase. Unlike last year – where the DG's initial consultation was followed by a draft decision – the DG is minded to consult once only and issue a final decision in December 2010.

The reason for this is that since its original tariff submission at the end of April 2010, GPL has reviewed its submission for tariff changes and provided a substantially revised final submission in October. This submission reflects GPL's proposals to make substantive reductions in its costs in response to the introduction of competition in the mail market. These cost reductions are intended to improve GPL's efficiency. The DG therefore considered it appropriate to delay the OUR's consultation until now

to facilitate those initiatives and the business changes required. As the DG's decision is required in December 2010 if tariffs are to be implemented in April 2011, the opportunity to undertake a second consultation (the 'draft decision' phase) is constrained. Subject to any response to this consultation, the DG proposes to issue a final decision in late December.

*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

This consultation document sets out key aspects of GPL's submission and the DG's views on those. The OUR is therefore inviting comments from all interested parties on:

- the timetable and process proposed for price-setting;
- GPL's proposed price changes;
- the OUR's principles in determining prices; and
- the specific issues raised in this consultation document.

### Structure of the Consultation Paper

The rest of this document is structured as follows:

Section 3: discusses the legislative and licensing background for the DG's price review, the role of the States in providing a framework for his actions and the DG's powers and obligations;

Section 4: discusses GPL's present position and the proposals it has submitted, indicating the prices it would like to charge its customers in the period 2011-12. A non-confidential version of its submission is included in Annex A. Section 4 also outlines broad principles which the DG proposes to follow in assessing GPL's price submission;

Section 5: discusses a number of issues which have an important bearing on the DG's assessment of GPL's proposals. The section is focused on the approach that the DG should use to assess the total income that GPL will be allowed to collect from its customers in each of the three forthcoming years;

Section 6 :

discusses how the prices of some of the services supplied by GPL may or should move in relation to the prices of its other services;

Section 7: Outlines the next steps;

Annex A Price Control Application by Guernsey Post Ltd
Annex B Cost of Capital Determination in December 2006

Interested parties are invited to submit comments in writing or by email on the matters set out in this paper 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 "Guernsey Post's Proposed Tariff Changes" and should arrive before 5pm on Monday 22nd November 2010.

In line with OUR consultation policy, the DG intends to make responses to the consultation available on the OUR website. Any material that is confidential should be put in a separate Annex and clearly marked so it may be kept confidential. The DG regrets that he is not in a position to respond individually to the responses in this consultation.

# 3. Legislative and Licensing Background

## Legislation and States Directions

The main legislative provisions of relevance to this Decision are contained in two Laws, The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001 (the "Regulation Law") and The Post Office (Bailiwick of Guernsey) Law, 2001 (the "Postal Law").

The Regulation Law created the office of the DG and set out the DG's duties in section 2 of the Regulation Law. These include:

- the protection of the interests of consumers and other users in the Bailiwick in relation to the prices charged for utility services generally;
- securing the provision of utility services which satisfy all reasonable demands for such services within the Bailiwick;
- ensuring that services are carried out in such a way as to best serve and contribute to the economic well being of the Bailiwick;
- the introduction, maintenance and promotion of effective and sustainable competition in utility services; and,
- the improvement of quality and coverage of utility services.

The Regulation Law provides that the States of Guernsey may issue States' Directions to the DG[1] in relation to:

- the identity of the first licensee in a utility sector; the DG issued this first licence to Guernsey Post Limited in the postal sector;
- the extent of any special or exclusive rights to be awarded to a licensee;
- the scope of the universal service that should be provided; and
- any obligations arising from international agreements.

The Regulation Law further requires that the DG "shall comply" with States' Directions, except where to do so would be in contravention of the duty imposed on him under section 2 of the Law or any of his functions or powers.

Pursuant to section 2(1A) of the Regulation Law, the States may give the DG directions of a strategic or general nature by Ordinance.

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[1] *Section 3 of the Regulation Law*

## States' Direction: The Universal Service Obligation

In September 2001[2], the States issued a Direction to the DG requiring 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 ("USO") which should be imposed on GPL, namely:

> "… 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:
>
> 1. One collection from access points on six days each week;
> 2. 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;
> 3. Collections shall be for all postal items up to a weight of 20Kg;
> 4. Deliveries on a minimum of five working days shall be for all postal items up to a weight of 20Kg;
> 5. Services for registered and insured mail."

Having defined the USO, the States directed that GPL should be awarded the exclusive right to provide postal services in the Bailiwick, to the extent that such exclusive right is necessary to ensure maintenance of the USO. These exclusive services are termed the 'Reserved Area' (RA). The relevant States' Direction also requests the DG to "review and revise the award of exclusive services…with a view to opening up the Bailiwick postal service market to competition, provided that any such opening up does not prejudice the continued provision of the USO".

## States' Direction: The Reserved Area

The Postal Law prohibits the provision of postal services without a licence. However, section 1(2) contains a number of important exceptions to this provision, with the effect that a range of postal activities do not require licensing, such as personal

[2] *Billet D'Etat XXVIII of 2001, 26 September 2001, p.1259 onwards*

delivery by a sender, or the delivery of court documents and banking instruments. In addition, any postal services which are provided outside the reserved area can be provided without the need for a licence.

The reserved area is defined by the products and services which GPL has the exclusive right to provide. By law, the DG may define the reserved area by Order if, in particular, he believes that a reserved area is necessary to enable GPL to provide a universal postal service. The products for which GPL has a universal service obligation (USO) must be provided everywhere in the Bailiwick of Guernsey at a uniform tariff. It is this requirement that there should be a uniform tariff for a uniform quality of service which creates an obligation and which justifies a reserved area: a uniform tariff may result in postal services being provided at a cost – even a low and efficient cost – which is higher than the uniform tariff in certain circumstances or areas of the Bailiwick while the same services may be provided to other customers at a cost lower than the uniform price.

The extent of this transfer between customers is not quantified but it is generally believed that the obligation to provide a similar service at a uniform price creates differences in margin for the same products; the margin on the services where costs are below the uniform tariff compensates GPL for providing certain services at a higher cost than the uniform tariff. The rationale for the reserved area is that, if the profit-making services were not reserved to GPL, competitors would wish to take them away from GPL – since they are profitable – thereby depriving GPL of the revenue it has hitherto used to cover the costs of the more expensive services. By reserving the provision of the services in the reserved area to GPL, in the absence of an alternative funding mechanism, this ensures that GPL can finance the cost of providing the USO.

This rationale applies even to the most efficient of postal operators and explains the way the States set up the legislation relevant to the USO. Both the rationale for a reserved area and the scope of the universal obligation it is designed to support are being questioned in Jersey, in some other European countries and in European legislation (Directive 2008/6/EC). The Commerce & Employment Department intends to consult on the postal USO which Guernsey needs in the near future. For this reason, this consultation will not discuss the principles of a USO and the size of the reserved area further.

The reserved area has to be determined by the DG by Order, in accordance with section 9 of the Postal Law. Following the initial order made in 2001, the DG made a

new Order on the 14th of September 2010[3] that designates, as reserved postal services, the services which:

1) are provided in consideration of a payment of less than £1.35 made by or on behalf of the person to whom those services are provided; or

2) relate to postal items with a length equal to or less than 353mm and a width equal to or less than 250mm and a thickness equal to or less than 25mm and a weight equal to or less than 750g.

This effectively excludes all postal packets and all postal items costing £1.35 or more from the reserved area.

The DG had already taken steps to alter the sources of GPL's income in previous price reviews so as to ensure that as far as possible all products covered their costs and made an appropriate contribution to overheads. In effect, GPL's pricing regime is such that the USO is self-financing for the costs that can be attributed to it directly but there remains a continuing debate on the contribution which each type of product – in the reserved area or outside it – should properly make to GPL's overheads.

However, as the reserved area is reduced and as a greater share of the postal traffic becomes open to competition, there is a concern that the source of funding that supports the provision of the USO may be reduced below what is required. If the financing of the USO became a problem, the OUR is proposing, in a recent consultation, that there should be licensing provisions to ensure that competitors which compete with GPL make a contribution to USO funding. However, the DG also expects GPL to take action to reduce its costs and adapt to the challenges of a more competitive market. It therefore seems appropriate to the DG that explicit USO funding arrangements by competitors would be considered only where any potential USO funding shortfall is caused by competition. This is not considered a material risk at this stage of market opening.

## USO services outside the reserved area

Since GPL is a monopoly provider in the Reserved Area, the DG controls the prices that GPL charges in the reserved area. However, price controls need to extend beyond the reserved area. Condition 18 of GPL's licence was amended in 2005 to

[3] *The Post Office (Reserved Postal Services) Order, 2010 - S.I. 84 - http://www.regutil.gg/docs/Post%20Order%20Statutory%20Instrument84%20%202010FINAL.pdf*

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 licence, the DG may regulate the prices of GPL 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
>
> (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 control the prices that GPL charges for services provided within its USO even if outside the Reserved Area.

In November 2005 the DG designated GPL as being dominant[4] 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.

For the purpose of the current price control the DG's initial view is that the above services fall within its scope. The DG does however seek views on whether, since 2005, GPL has become dominant for other services or is no longer dominant for some of the above services.

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

# 4. Setting GPL's Prices

This section outlines the starting point of the OUR's tariff review, namely GPL's current position as described in its submission (Annex A). The section then discusses the OUR's principles in its response to this submission and its overall approach in determining the maximum prices that GPL charges its customers. The following section, Section 5, then discusses a number of issues in greater depth.

## Current Position

In its submission, GPL reports that it met or exceeded all of the targets that were set by the OUR for 2009-2010 and it successfully implemented a new charging basis - Pricing in Proportion – which it introduced for the financial year 2010-2011. GPL reports that, while there was growth in bulk mail (c5%), the picture for traditional mail streams was one of a significant drop in volumes, particularly with regard to Southbound mail (i.e. mail from the UK), which fell by 12%, and a reduction in local mail of 18%, with other public tariff or SME mail to the UK remaining static. Offsetting this was strong growth reported for a small number of customers but volumes were not as great as GPL had anticipated at the time of the last tariff submission. These trends are argued as consistent with the view of European postal administrations that while the declines reflect in part the recent and current economic climate, there is now a significant, irreversible decline in traditional mail volumes - in particular for social and transactional mail.

In terms of efficiency changes, GPL explains that its focus is on responding to the sustained decline of standard mail through better alignment of hours to workload and a rebalancing of the pay mix and, additionally, a reduction in overhead costs. GPL has now submitted an application for tariff changes coming into effect 1 April 2011 with, potentially, further changes in 2012 and 2013, covering the period to March 2014. GPL explains that its submission is informed by five main factors:

1. Differences between the OUR and GPL at the last decision;
2. Cost inflation;
3. Declines in traditional mail volumes;
4. Rebalancing the relative contributions from bulk mail and public tariff mail; and

5. Better reflection of the level of overhead costs attributed to different customer and product groups.

GPL's tariff submission is based on cost reductions compared to 2009-2010 which could amount to more than £3m annually by the final year of the tariff period, including sizeable reductions both in operations and in overhead costs. GPL explains that the following principles underpin its pricing:

- All products must make a positive contribution to overhead costs;
- All product prices must reflect their actual costs;
- The contribution from bulk mail products is set lower than that for public tariff products to reflect the low level of overhead costs attributed to bulk mail, which itself reflects the low staff costs associated with bulk mail services;
- Opportunities for arbitrage will be avoided by assessing all prices in relation to each other across the whole portfolio of products;
- The size of contribution for each product will be determined by the market opportunity.

GPL's proposed tariffs are set out in Annex A for the year 2011-12 only, given the DG's proposal – discussed below - of stepping away from regulating individual product prices and allowing GPL greater pricing flexibility. In the first year of its determination, the DG proposes to set maximum prices for individual products and, in later years, to control the overall average income that GPL can obtain from groups of products rather than the price of each product.

GPL proposals for 2011-12 include a freeze on local and UK public tariff letters, which stay at 36p and 45p respectively, a reduction of 1p for some business tariffs but significant increases for large letters. GPL also proposes the creation of a single international zone for letters, large letters and packets; in effect, all international traffic would be charged at the same rate, whether to Europe or elsewhere.

## Price Control Principles

The DG considers that in his review of GPL's pricing proposals, the protection of **consumer interests – in the short and long term –** is a key priority. His main objective is to determine prices that are as competitive as possible while sufficient to provide an income to allow an efficient postal operator to finance its activities and

invest adequately for the future. He also looks to ensure that tariffs are cost-reflective and encourage customers to make decisions that are well-informed and efficient.

The DG needs to exercise his powers to determine tariffs in the absence of effective competition. A better mechanism would be effective competition, namely where GPL does not have exclusive rights or is not dominant (see above). However, even where the DG has been able to introduce competition in the provision of postal packet services, it would appear that GPL remains dominant and the DG will need to determine prices for those services until competition acts as an effective 'regulator' of GPL's prices.

The DG's determination of GPL's maximum allowed prices will be such that, if GPL is managed efficiently, it can expect to cover all its costs, including the costs of its capital employed, over the period of the price control. The DG must determine both the overall income that GPL may obtain from its customers and the relative level of tariffs of the various products and services

***Overall Income***

Determination of the income that an efficient operator would need in the three years to March 2014 requires a number of forecasts and several regulatory decisions. The most important of these are set out in the next section (Section 5), the purpose of which is to invite comments on how realistic and well-evidenced they are (forecasts) and how appropriate they are for the purpose of achieving the objectives given to the DG by the Bailiwick's legislation.

***Relative Prices***

Concerning the determination of relative prices, the DG believes that the two essential principles are that:

- Where practicable, prices should reflect the cost of providing each service, including an adequate contribution to GPL's overheads; and
- GPL must be able to make commercial decisions on prices while abiding by applicable regulatory rules, including the obligation not to discriminate between customers where it is a dominant operator (licence condition 18.4).

The issues relevant to the implementation of these principles are discussed in Section 6 and the DG welcomes comments on these principles and the specific points raised in Sections 5 and 6.

## OUR’s Approach

The OUR is committed to adopting a rigorous, but proportionate approach to assessing GPL’s tariff change application, taking into account the statutory objectives set out in the Regulation Law. We recognize that GPL operates in a particularly uncertain environment, which makes forecasts of costs and activity more challenging. In view of this uncertainty, the DG believes that setting prices for three years strikes the right balance between conflicting objectives: keeping the price review long enough to create incentives for GPL to outperform regulatory expectations while keeping the review short enough so that the cost and traffic forecasts can be made with a reasonable degree of confidence. The DG would like comments on whether a three-year price review duration is appropriate.

A basis for the DG’s assessment of GPL’s tariff proposals is GPL’s confidential Business Plan as well as a model submitted in support of the tariff changes. The spreadsheet-based model has been developed jointly with GPL over a number of years and despite GPL’s concerns set out in its submission (which the DG does not accept) we believe such an approach enables us to share a basic understanding of data and forecasts with GPL while taking adequate account of the complexities of setting prices for some £40m of price-controlled postal business.

We have commissioned an efficiency review of GPL’s operations - which has included an overview of the efficiency of overhead costs. This review will report later this month and we will share its findings with GPL in preparation of the DG’s decision in December. We will also rely on other sources of information as appropriate, such as estimates and benchmarking studies.

We understand that uncertainty exists around Royal Mail’s future business model and its charges to GPL. We agree that the likely prospect of a decline in traffic other than certain forms of bulk traffic originating in Guernsey (which require minimal handling by GPL) present particular challenges to GPL. However, the DG will not accept that productivity should go down – and costs rise – simply because external conditions have changed. Past practices, that were appropriate to meet different challenges in different market conditions, must be changed to enable GPL to adjust its costs and activity to the environment in which it now operates.

A preliminary outcome of the efficiency review is that GPL is taking steps not only to adjust its operations to a decline in traffic but also to be ready to adapt to further changes as they arise. If this is so, we commend this approach.

## 5. Forecasts and Policies Relevant in Assessing GPL's Proposals

This section discusses the issues – forecasts and regulatory issues - the DG needs to consider when determining the overall income that GPL receives from its customers in the next three years. The forecasts – for the next three years - on which the DG is seeking comment are:

- Forecasts of postal traffic (customer demand);
- Inflation and impact on costs; and
- External costs such as Royal Mail charges and conveyance fees

The regulatory issues which the DG will be considering and on which he would like comments are:

- The range of GPL's activities for which the DG needs to set price controls;
- Whether GPL is running its operations efficiently and its proposed efficiency savings are sufficient and timely (operations and overhead costs);
- The extent to which GPL has control of certain elements of its cost base, e.g. Royal Mail charges, and whether customers must accept these costs;
- The extent to which all pension costs should be borne by current postal customers;
- How large GPL's capital investment should be and whether it is properly justified;
- What return on capital is appropriate for a States-owned entity; and
- Whether the DG needs to regulate the price of every product separately or whether it can group products, giving GPL some pricing flexibility within each product group.

### Forecasts of postal traffic (customer demand)

A decline in postal traffic has been predicted in most developed countries given developments in electronic communication. However, for a long time, postal traffic did not show an actual decline. In fact, GPL traffic (see Annex A) has been essentially static for the last few years – by some measures – and, when the bulk mailer traffic is included, continued to reflect healthy grow. However, GPL is now forecasting a continuing decline in certain traffic, like other postal authorities, for reasons that we have discussed in previous documents.

An environment of static or declining traffic poses particular challenges to maintaining or increasing efficiency. Table 1 below shows GPL's expectations of traffic volumes in the next few years.

**Table 1 - GPL Traffic – Past and Forecast (million items)**

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 |
|---|---|---|---|---|---|---|---|---|---|---|
| Local | 7.6 | 7.4 | 7.8 | 8.6 | 8.4 | 6.9 | 6.6 | 6.2 | 5.9 | 5.6 |
| Outward | 20.3 | 24.6 | 28.8 | 32.9 | 37.8 | 41.9 | 40.1 | 39.4 | 36.5 | 34.1 |
| Inward | 16.2 | 17.3 | 17.3 | 17.2 | 17.1 | 15.1 | 14.2 | 13.3 | 12.6 | 11.8 |
| Total | 44.1 | 49.3 | 53.8 | 58.6 | 63.3 | 63.9 | 60.8 | 59.0 | 54.9 | 51.5 |

By way of comparison, GPL's current price control anticipated that its overall traffic would be 64.2 million items for 2009-10 and 65.7 items for 2010-11 (BPM final – 21 Dec 2009).

When he determines the revenue that GPL may obtain from its customers, the DG takes account of forecasts of traffic volumes to assess potential productivity improvements and the margins that postal products provide so as to cover the fixed costs of GPL's business, including overheads. The DG therefore needs to be satisfied that the traffic forecasts proposed by GPL are reasonable. The OUR will seek to validate GPL's traffic assumptions in particular from discussions with a number of large mailers to ascertain their views in these areas.

## Inflation and impact on costs

In its submission, GPL assumes that inflation will be 3.5%, based on the assumptions that UK inflation will be 2.5% and Guernsey inflation 1.1% over UK inflation. The question is whether these assumptions are too high or too low, particularly as recent evidence for 2010 is that, in fact, Guernsey inflation is now below that in the UK. Also, it is worth noting that, at the moment, the target inflation rate in Guernsey is 3%.

Specialists believe that medium and long term inflation rates are particularly difficult to forecast now. The Bank of England quarterly inflation report (August 2010) believes that inflation is likely to stay above the 2% target (for the Consumer Price

Index, CPI) until the end of 2011, after which inflation is likely to fall back to target or below.

Aside from the question of general inflation, there is the separate question of whether the same rate of inflation can be assumed to apply to all types of GPL's costs. For instance, costs that have an origin outside the Island, such as Royal Mail charges and international conveyance costs, may increase at a different rate from that applicable to Guernsey-based costs, for instance at a rate linked to UK inflation or the performance of the dollar against the pound sterling.

In determining prices, the DG will always need to make a judgment on how certain costs and forms of income – if they are significant - are likely to behave compared to the movement in general inflation. It is therefore appropriate for the DG to consider whether larger items of cost such as RM charges, sea and air conveyancing, or salaries are likely to change at significantly different rates from general inflation. However, it is possible to insulate a price determination from the effect of general inflation by allowing prices to be adjusted for inflation every year, on the basis of the most recently available inflation data. So far, this is not a method that the OUR has used for postal prices but the DG believes that this approach to price setting is worth considering.

The DG would like to hear views on appropriate inflation forecasts for GPL's costs over the next few years and views on whether he should move to a form of price determination where prices are determined in real terms and actual prices consist of the price determined by the DG adjusted by a recent measure of inflation.

## External costs such as Royal Mail charges and conveyance fees – forecast and policy decision

Royal Mail charges and conveyance costs amount to more than 60% of GPL's costs, and more than 90% of GPL's costs for bulk mail**.** In negotiating contracts for these costs with RM, GPL argues that it is a relatively small buyer. GPL therefore suggests that the DG should allow GPL to recover its RM and conveyance costs fully and with no special scrutiny. Moreover, the current contract between RM and GPL will be in force until 2013.

However, if the DG treats RM costs as, in effect, 'pass-through' costs, there is less incentive on GPL to get the best possible deal in its negotiations with RM. GPL told us that they had been able to negotiate better rates for Large Letters, which indicates that it may have some ability to negotiate with RM.

Moreover, since RM is the only postal operator with which GPL has contracted for mail out of Guernsey, GPL does have incentives to develop relationships with other postal operators to reduce this reliance. In the UK, it could consider using DownStream Access operators for UK-bound mail and it could develop links with postal operators on the European continent. An active exploration of alternative routes for mail out of Guernsey would increase GPL's negotiating power with RM and could lead to reduced costs.

We are therefore asking for views on whether RM costs should be considered 'a given' or whether the DG should give GPL incentives to keep these costs low by not automatically allowing all of them to be recovered from customer tariffs.

## The range of GPL activities for which the DG needs to set price controls

In our comments in Section 3, we explained that the DG believes he needs to regulate prices in all markets in the absence of effective competition. The DG would like to hear views on whether prices in certain markets/products do not need to be regulated, and why it is so. He would also like to hear views on the criteria he should use to assess whether a market, now or in future, does not need price regulation anymore.

In particular, given the lowering of the Reserved Area, competitors might consider offering a level of competition that rapidly reduces GPL's dominance. This would of course depend on the extent to which customers are willing to shift supplier and the scale of remaining barriers to entry. Comments are sought on these aspects to inform the DG's views on the scope of price controls over the next three years.

## Proposed efficiency savings

As noted above, GPL has submitted measures of efficiency in support of its view that productivity gains have been made in the last few years despite its traffic being fairly static (Annex A). However, in assessing GPL's efficiency and its potential for improvement, the DG needs to distinguish between different types of traffic, namely:

- traffic that GPL actually handles – collecting, transporting, sorting, delivering – which incurs almost all of GPL's operational costs and which is in decline; and

- traffic for which GPL is, essentially, a broker between a large customer in Guernsey, on the one hand, and RM and the UK Customs on the other side, and which in fact accounts for a minority of its operational resources.

Decline in the former type of traffic now requires GPL to alter its operational model in ways that are more far-reaching and fundamental. The competition that exists for the latter type of traffic from other jurisdictions and, potentially, from other postal operators in Guernsey, requires GPL to reduce the costs it charges its large customers for its 'brokering' services. As bulk mailers cause GPL to incur little direct operational costs, the costs which are relevant in the competitive arena are RM and conveyancing charges – over which GPL argues it has limited, if any, control - and a share of GPL's overhead costs.

The DG acknowledges that GPL has now recognized that the situation requires leadership and an extensive change strategy. GPL is proposing, in the next three years:

- To reduce its overhead costs by more than £1m in 2013-14 (from more than £7m in 2009-10; and
- To reduce its operational costs by £2m by 2013-14 (from more than £9m in 2009-10).

In order to achieve these savings, GPL will incur re-structuring costs. These are likely to vary with the speed at which it implements its re-structuring. The benefit of a three-year price control is that GPL may retain the benefit of an early cost reduction and balance it against its re-structuring costs.

The DG is seeking views on GPL's efficiency proposals, including its proposals to reduce its overhead costs. These reductions imply overheads would be about 13% of GPL's total costs. It must be noted that this figure is not necessarily comparable with other postal operators as so much of GPL's costs are RM charges. However, the DG is minded to use a 'top-down' assessment of overhead costs – such as the percentage of applicable costs attributable to overheads – but would like views on whether such an approach is an appropriate way of assessing GPL's overhead costs.

## The extent to which Pension Costs should be borne by Current Postal Customers

The costs to an employer of providing pensions to its staff are an increasingly large component of staff costs throughout Europe in the public as in the private sector. The reasons are complex and include increased longevity before and beyond pension age

as well as reduced expected income from pension fund assets.  A recent interim report in the UK (the interim Hutton report) highlights some of these issues for public sector pensions.

GPL employees are included in the States pension scheme, which an interim review concludes is now in deficit and requires increased contributions from GPL. While the OUR has no remit regarding the States pension scheme, it must consider GPL's pension costs, identify those over which GPL has control, and determine the extent to which customers should bear them.

It is important to distinguish between different kinds of pension costs:

- The pension rights that past and present employees have already accrued, which are part of their remuneration contracts and over which GPL has now no control.  However, GPL may have in the past had some control on how a surplus or a deficit in its States pension scheme arose. For example, we understand it took a pension holiday in the 1990s when the States pension scheme was in surplus.  Looking to the future, as an organization owned by the States and with no likelihood of ceasing to trade, GPL may choose to repair its share of the States pension deficit over a longer timeframe.
- The future rights that present and future employees will accrue, over which GPL has some measure of control; and
- The rights to benefits other than pure pension, such as redundancy payments in the form of enhanced or earlier pension payments, over which GPL should have some control because it has control over when and to whom redundancy is offered and the discretionary elements of its redundancy offer.

These distinctions and these costs are separate from the question of whether certain pension costs, along with all other employment costs, were properly incurred in the past.  GPL has control over the first type of costs when it determines its staffing requirements and the OUR's responsibility in respect of these costs has been to put pressure on GPL to improve its efficiency.  A question the OUR wishes to consider is whether GPL could have implemented changes in its work practices sooner, in line with best practice elsewhere and as recommended by the OUR in 2006. Indeed, the OUR expected a marked efficiency improvement in the last four years.  This would have had the result that GPL's direct staff costs could have been lower in the last few years and its pension obligations now and in future would be correspondingly reduced, with a smaller GPL liability for pensions generally, and the States pension deficit in particular.

While the OUR is clear that GPL must honour its commitments to its staff incurred in the past, it questions whether customers now and in future should continue to pay for them.  In a privatized regulatory environment, it is the shareholders of a company that

fails to implement efficiency measures who pay the costs of this failure. By the same logic, the States, which are GPL's shareholders, should accept the burden of some of the costs of past inefficiencies. The DG would welcome views on the possibility that customers should not pay the cost of certain past decisions made by GPL with the approval of the States as shareholder but the cost of these decisions should fall on the States directly.

Concerning the deficit in the States pension, whether GPL's obligations have been incurred as a result of its efficient operations or not, the question is how quickly GPL and its customers should seek to remove this deficit. At the moment, GPL's contributions are assessed on the assumption that the deficit has to be made good in ten years. However, this period could be longer – we understand that Royal Mail in the UK has been given 38 years[5] to correct its pension deficit, which might be taken over by the Government in any case in its entirety. The DG would like views on an appropriate period over which a state-owned operator should fill a funding gap in a States pension scheme.

The DG also notes that the size of the pension deficit which GPL has to make good depends on a number of other factors such as the health of stock markets and the economy generally, as well as actual future salary increases within GPL. Pensionable salary increases, to some extent, are within GPL's control and, by extension, so is the size of the pension deficit which GPL needs to make good.

In relation to present and future employment, the question is about the right balance between the contributions that employees and employers make. Employer contributions, at the moment, are 15% of salaries and it is anticipated that GPL's contribution needs to rise to 25% of salaries. The Hutton report mentioned above refers to this question by suggesting that the balance (as it exists for large Government pension schemes in the UK) needs to change, whether staff contributions need to increase, or employees need to contribute for more years, or both.

One could argue that this question is one that touches the States pension scheme and is outside the OUR's remit. However the pension costs that fall on GPL are likely to affect its customers – to the extent that OUR determines that GPL should recover its pension costs from customers. It is a duty of the OUR, therefore, to question whether GPL customers, many of which operate in a tough commercial world, and GPL itself, which is in competition with postal operators in Guernsey, in Jersey and in other jurisdictions, should bear the same pension costs as the States themselves, where pension costs, ultimately, fall on tax payers and not on customers.

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[5] *Saving the royal Mail's universal postal service in the digital age – An Update of 2008 Report, Richard Hoper, CBE, September 2010*

Finally, concerning the third type of pension cost identified above, it must be noted that they are restructuring costs and these are often accounted for separately. Regulators have not always allowed re-structuring businesses to pass re-structuring costs to their customers. Regulated companies have recouped re-structuring costs through the efficiency savings that they have achieved or these costs have been borne by the regulated companies' shareholders, which have considered them as investments in anticipation of future efficiency savings. Such an approach has the benefit that regulated companies are free to judge the best balance between:

- Achieving early efficiency savings, allowing them to reap and retain the benefits of increased efficiency longer, before they are transferred to customers at the next price review; and
- Reducing re-structuring costs by adopting a slower approach to efficiency savings.

The practical impact of these general considerations for GPL are:

- Pension contributions are forecast to increase to make up for the relevant deficit in the States pension scheme. This results from the assumption that this deficit has to be made good in 10 years (but that could be extended to a duration closer to Royal Mail's 38 years); and
- GPL anticipates a £1m re-structuring cost, some of which is pension related, which we understand it is not necessarily seeking to recover from its customers.

## GPL's capital investment

GPL is proposing to spend around £1.2m on capital investment over the next 3 years (see Annex A). It is less than 1% of its annual turnover and is reflected in the prices customers pay through a depreciation charge that depends on the life of the assets in which GPL invests.

In view of the size of the proposed investment, the DG believes that the most appropriate way to regulate capital investment is to invite GPL to share with him the business cases it makes when assessing its investment so that a clearer view can be had on whether they should be allowed.

## What return on capital is appropriate for a States-owned entity

As GPL's activities demand capital that could be employed elsewhere if GPL did not use it, the DG needs to take account of the return that such capital could be expected to obtain in another use. Such consideration is automatic in the private sector – because funds are provided by investors who expect a return - but it applies to a state-owned organisation also. The reasoning is that funds employed by state-owned organizations have alternative uses in the public sector which would generate a return, financial or otherwise.

In its decision on postal tariffs in December 2006, the DG used a real rate of return – namely, a rate of return that does not take account of inflation – of 7.11%. This return reflects the cost of equity to GPL (not the cost of debt since it has no borrowing) and is based on the Capital Asset Pricing Model assumptions (see Annex B). This return of 7.11% is higher than the DG originally proposed because GPL argued then that it was operating in a risky environment that required higher returns. GPL is now asking that the DG further increases its allowed rate of return because its operating environment has become riskier than could be foreseen for the period 2006-10 (see Annex A for the detailed reasons put forward by GPL).

The DG is aware of the most recent regulatory decisions on cost of equity in the UK. However, comparisons must be made with caution because estimates of the cost of equity listed below usually apply to entities whose activities are partially or largely financed by debt. The result is that, by-and-large, the cost of equity reflects the full weight of the risk borne by the whole operations concerned even if equity capital finances a small part of the operations only.

**Table 2 Recent Regulatory Decisions on Cost of Equity (real pre-tax)***

| Date | Regulator | Cost of Equity(%) |
|---|---|---|
| Dec 2009 | Ofwat for 2010-15 | 7.1 |
| Oct 2008 | Competition Commission for 2009-14 (Stansted Airport) | 6.94 – 11.39 |
| Oct 2008 | Office of Rail Regulator for 2009-14 | 9.0 – 9.7 |
| March 2008 | Civil Aviation Authority for 2008-2013 | 10.2-10.9 |
| Dec 2009 | Ofgem for 2010-15 (electricity distribution)** | 9.3 |

* Source: Europe Economics – Cost of Capital and Financeability at PR09 – October 2009
** Source: Ofgem, Electricity Distribution Price Control Review – Final Proposals (Ref 144/09)

The DG is therefore asking for views on whether the real rate of return for GPL should be changed from the real 7.1% that he determined in 2005/06.

## 6. Determining Relative Tariffs

As stated above, once the DG has determine the total income that GPL should obtain, he also needs to determine the mechanisms by which this income will be obtained, namely product prices such that, taking account of traffic forecasts, GPL actually obtains its allowed income. The essential principles are:

- prices should reflect the cost of providing each service, including an adequate contribution to GPL's overheads; and
- GPL must be able to make commercial decisions on prices while abiding by applicable regulatory rules, including the obligation not to discriminate between customers where it is a dominant operator (licence condition 18).

### Cost-Reflectivity of Tariffs

An important element of the DG's decision in December 2009 was that GPL could proceed with the introduction of Pricing in Proportion (PiP), also known as 'size-based' pricing. GPL had proposed to move to this form of pricing so as to correlate the prices that it asks its customers to pay with the charges that RM levies for UK and international traffic. The DG agreed with GPL that this kind of cost-reflective pricing was creating incentives for customers to choose formats and weights which minimized not only their own costs but also the burden of RM charges for GPL. The DG is pleased to note that GPL has implemented size-based pricing with relative ease.

The introduction of PiP required the DG to determine the characteristics of different postal items and, in particular, the dimensions of the 'Large Letter' (LL) product for international services. GPL argued that LL for international services should not be thicker than 20 mm and that such an approach would reflect the way RM charged GPL. In principle, the DG supported – and still supports - this argument.

However, the question then was the extent to which GPL had actively prepared its customers for the change in the specification of its international Large Letter service by informing them and giving them a chance to adapt their assets, working methods and investment program to a 'thinner' LL product. The representations that the DG received from customers clearly indicated that communication by GPL had been lacking and, therefore, they were unprepared for a move to a 20mm LL international product.

The DG is now again consulting on the question of the thickness of Large Letters for international services. However, this consultation is not whether LLs should be limited to 20mm but when the limitation should come in force. The DG is persuaded

that, in view of international developments and, in particular, RM's charging structure, LLs will need to be no more than 20mm eventually. However, he is not convinced that now is an appropriate time for the move and welcomes comments from customers as well as GPL.

## Pricing Flexibility for GPL

The DG's previous price determinations specified the price of every product by type (ordinary letter, Large Letter, packet…), by destination (within the Bailiwick, to the UK, International…), and by weight step. This approach reduces GPL's ability to alter the relative price of its products from one year to the next in response, for instance, to changes in customer demand or in the cost of providing certain services.

The DG agrees that GPL should not be bound by unnecessary regulatory constraints in the way it can adjust its relative prices. It is therefore proposing to regulate the income that GPL may obtain from certain groups of products – referred to as 'baskets' of products – but not the price of every individual product. Within a basket, GPL may adjust prices according to its commercial judgment as long as it abides by its legal obligations.

The determinations of the 'baskets' to which price controls apply is an essential part of this form of regulation. Baskets should contain products which are supplied in the same markets. For example, the products which are in the Reserved Area, where GPL has full monopoly power, should not be in the same basket as products which can be offered by competitors. By separating both types of products, the DG can ensure that each group makes an adequate contribution to GPL's overheads and the products where GPL has a monopoly are not used, potentially, to finance the discounts that GPL may wish to grant customers that could otherwise move to competitors.

In the fullness of time, the DG anticipates that he will not need to control the prices of the services offered outside the reserved area, because prices will be constrained by the activity of competitors, or the mere threat of their entering the market and attracting customers away from GPL. As competition is not clearly established to GPL outside the reserved area, the DG is minded to set up one or several product baskets in the non-reserved area and control prices for each of these baskets.

The DG would like views on whether:

- There needs to be a price control in the non-reserved area and the criteria the DG would need to use to determine whether competition is established well enough so that price controls are not needed anymore; and

- There should be one basket for the products in the non-reserved area, or more than one.  And, similarly, whether there should be one or more than one basket in the reserved area.

## Next Steps

This consultation concludes on 22 November 2010. However, during the course of this consultation the DG intends to have a number of separate meetings with interested parties to discuss issues arising from this paper and GPL's proposed tariff changes. The DG anticipates further information requests and meetings with GPL to understand the underlying assumptions and rationale for its tariff change application fully.

The OUR is also mindful of the fact that the Commerce & Employment Department intends to review the scope of the USO imposed by the States on GPL. Such a review might lead to reduced costs for GPL in providing USO services in the future. If this were so, customers who would experience a reduction in the USO service they receive should be those who benefit from the cost saving arising out of a reduced USO. In such circumstances, the OUR might wish to review the prices it has determined for the products in the USO basket. Whether and how this price review takes place is something the DG will consider at the appropriate time.

## Annex A Price Control Application by Guernsey Post Ltd

This document is available as a separate annex which accompanies document OUR10/12 on the OUR website.

# Annex B GPL's Cost of Capital – Decision of December 2006

## 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")[6].

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

[6] *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*

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.

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[7].

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:

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[7] *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.*

- $R_e$ = 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[8].

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;

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[8] *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.*

*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*

$R_m$ = 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[9], and the DG therefore proposes to also use 2.5% as the risk free rate.

**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.

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

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[10], Postcomm examined the asset betas of a number of listed UK companies, and specifically reviewed the asset betas of three delivery service companies.

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

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 $\beta_a$ 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 $\beta_a$ 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 $R_e$

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

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.