GUERNSEY POST LIMITED

2011-12 TO 2013-2014 PRICE CONTROL APPLICATION

NARRATIVE SUBMISSION

NON CONFIDENTIAL VERSION

19 October 2010

1. INTRODUCTION

1.1 On 30 April Guernsey Post Limited (GPL) submitted a proposal to revise its regulated postal tariffs for a period of three years from 1st April 2011; the current price control period established by the Office of Utility Regulation (OUR) ceases on 31 March 2011. This proposal was based on there being no change to the current Reserved Area. In the light of the settlement recently agreed between GPL and the OUR and the DG's revised Final Decision retaining the £1.35 Reserved Area limit but excluding all packets GPL is submitting a revised proposal.

1.2 GPL has provided two key documents in order to inform its tariff increase request. These are:

- The financial model required by the Director General to model product revenues and costs and to assess the consequences of tariff structures. GPL has populated this model with historic numbers, budget figures and forecast data. GPL continues to believe that this model is a totally inappropriate tool to use for pricing decisions. We continue to have the same concerns that we have already expressed about this model regarding its fixation with the past, its complexity, the lack of flexibility, the inappropriate focus on very detailed numbers and the problems in sense checking inputs.

- A narrative that:

  - Identifies the key issues that underpin the need for tariff action
  - sets out the key assumptions that underpin the tariff proposals
  - sets out the tariff proposals for the three year period
  - provides a financial overview
  - identifies a number of key areas which impact in pricing decisions which need further discussion between GPL and the Regulator and where dialogue has already started.

1.3 The context for this submission is that it has been prepared against the background of significantly greater uncertainty than is normal – in addition to the usual commercial unknowns (volume forecasts, likely cost movements etc) the future direction of postal regulation in Guernsey is unclear.

1.4 GPL has prepared this tariff submission based on a number of key assumptions. Depending on the way in which issues are resolved over the coming months these assumptions may need to be revisited with consequential implications for pricing. It is essential that through the tariff review period GPL and the Regulator maintain and build on the ongoing dialogue recently started so that the implications of any decision can be jointly reviewed. GPL believes that it is vital to ensure that during the tariff review period attention is focussed on key strategic issues, so that valuable time and resource is only spent on issues that have a significant bearing on the price determination.

2. WHERE GPL IS NOW

2.2 Customer service (including Quality of Service)

In 2009-2010 GPL has once again met or exceeded all of the targets that were set by the OUR.

GPL has successfully implemented Pricing in Proportion for the financial year 2010-2011 - a further communications plan is scheduled for the run up to the Christmas posting period.

2.3 Mail volumes

2009-10 was a mixed year in terms of volume trends. Whilst there was a limited 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)at -12% and a reduction in local mail of -10%, with other public tariff or SME mail to the UK remaining static. Offsetting this we did see strong growth from one or two customers but even here volumes were not as great as we had anticipated at the time of the last tariff submission. This is not offset to any significant degree by the growth of on-line shopping.

There appears to be a general consensus amongst European postal administrations that, although the declines reflect in part the recent and current economic climate, there is now a significant, irreversible decline in traditional mail volumes - in particular with social and transactional mail.

2.4 Efficiency

GPL has reduced operational hours by 1.8% more than that forecast for the 2009/10 financial year. This performance supports the consolidation of operational changes made during the previous year, and the continued absorption of key account mail. most notably Moonpig.com.

Changes to despatch arrangements following the introduction of Pricing in Proportion have also been achieved at no extra cost.

GPL is also on course to achieve the changes described in the last tariff submission although this is somewhat insignificant given the stretching efficiency targets GPL has set itself for the next three years. These changes continue the focus 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.

2.5 Productivity

The following tables illustrate the improvements in productivity since the financial year 05/06.

Table 1

*Productivity Analysis – Total Weighted Volume **Including** Bulk Mail*

Financial Year	Actual Volume	Weighted Volume	Hours Worked	Items per Gross Hour	Base Year Efficiency Improvement %
2005/06	52,237,439	79,278,363	502,947	157	N/A
2006/07	57,004,975	81,563,175	506,320	161	2%
2007/08	59,286,300	80,122,122	491,321	163	4%
2008/09	63,177,470	82,332,826	475,001	173	10%
2009/10	63,992,701	82,623,224	453,095	182	16%

Table 2

Productivity Analysis – Total Weighted Volume ***Excluding*** *Bulk Mail*

Financial Year	Actual Volume	Weighted Volume	Hours Worked	Items per Gross Hour	Base Year Efficiency Improvement %
2005/06	34,526,955	70,216,931	502,947	139	N/A
2006/07	35,674,716	71,964,588	506,320	142	2%
2007/08	35,012,984	69,199,130	491,321	141	1%
2008/09	37,202,825	70,644,236	475,001	149	7%
2009/10	36,121,700	69,855,233	453,095	154	11%

2.6 People issues

The company has two strategic goals which relate directly to our people.

2.6.1 To recruit and retain the highest quality employees, consistent with the needs of their role and culture of the business

In our postal operation turnover of employees is very low with retirements or moving away from the Island generally being the only cause for someone leaving voluntarily. The postal workers job attracts a lot of interest when advertised and recruitment of good quality candidates is not particularly difficult.

In administrative and management roles we experience more difficulty. Competing with the Finance industry for the best quality candidates we do occasionally lose good people to other Island employers. To counter this we took a decision to invest in the development of our people creating career paths through the company.

After initial investment in courses bought in from the UK we are now delivering the majority of our training in house. Consequently we have been able to significantly reduce the training and development budget without stepping back in the commitment to supporting our people and our succession plan.

We have over the past 3 years completely refreshed our employment policies and we have revised our employment contracts. This work related directly to our Dignity at Work programme which supports our commitment to fair and equitable treatment in our workplace.

As a result of these initiatives we have achieved the following:-

- Shortlisted in both 2009 and 2010 for the Guernsey Awards for Achievement training award
- Placed second in the World Mail Awards (People Management category) 2009
- Achieved full Investors in People (IIP) accreditation at our first attempt
- Won the GOSHA Health and Safety award 2010

2.6.2 To have the best Industrial Relations in the mails industry

Tremendous progress has been made in this area over the past 3 years and this is evidenced by the following list:-

- New employment policies negotiated and agreed covering Health & Safety, Attendance Management, Discipline, Grievances, Dignity at Work, Voluntary Redundancy, Capability Management, Use of Safety equipment
- Establishment of partnership working with a monthly forum which discusses developments within the company
- Joint training initiatives with our Unions
- OUR Efficiency targets met by agreement (including a VR programme)

All of this has been achieved without any industrial unrest.

There is however no question that the external pressures building on the company around future profit/loss, changes to the service we provide, change driven by competition, future pension provision and speculation about our overhead costs is creating a level of tension which needs to be carefully managed
This has manifested itself in difficult pay negotiations with both the CMA (Communication Managers Association) and CWU (Communication Workers Association).

We envisage a different Industrial Relations environment going forward which will test how deeply we have been able to embed our transformational change in relationships

3. THE TARIFF PERIOD (2010-2011 TO 2013-2014)

3.1 Overview

3.1.1 There are four main factors underpinning the need to increase prices over the three year period:

- the need to put right some “structural” problems with the 2010-2011 tariff
- the impact of rising inflation on costs
- the continuing and apparently accelerating decline in traditional mail volumes which can not always be matched by commensurate reductions in operational costs thereby resulting in a loss of efficiency particularly on outdoor work such as collection and delivery
- the need to rebalance the relative contribution from bulk mail and public tariff mail to better reflect the level of overhead costs attributed to each

3.2 “Structural” pricing issues

This submission seeks to correct structural problems with the 2010-2011 tariff:

- the 20/25 problem – the decision taken by the Director General to price *International* items between 20 - 25mm thick and from 500-750 grams as large letters rather than packets means that the prices set for these items do not always cover even their Royal Mail charges. The international standard for large letters/flats is a thickness limit of 20mm and an upper weight limit of 500g and Royal Mail charges to GPL are based on that standard
- Following the final decision GPL has been able to re-negotiate the terms of the Royal Mail contract to slightly improve the situation, albeit at the cost of reducing margins elsewhere. The financial impact of the Director General’s decision is assessed as about £500k. To partially mitigate this GPL have introduced a new 20mm International Flat product with prices that reflect costs appropriately - despite this there is an ongoing hit in the region which is addressed by tariff action in this submission
- Bulk Priority products (air) are loss making – effectively those bulk mailers who use these products are being subsidised by other postal users. This issue is corrected with this tariff proposal. A phased approach has been taken to implementing the price increases necessary to restore profitability in order to provide those bulk mailers who use this service time to manage the impact of the increases.

3.3 Inflation assumptions

Based on the difference between index-linked and nominal government bonds, the financial markets are currently expecting UK inflation to reach about 2.5% in the 3 years ending 31 March 2014. Given that the average difference between inflation in the UK and Guernsey since 2002 has been 1.1%, it would seem reasonable to assume a Guernsey inflation rate of 3.5% for this period.

3.4 Mail volume forecasts

In common with other European postal administrations and as outlined at 2.3 above GPL is experiencing a significant decline in traditional mail volumes, in particular transactional mail and social mail. For GPL this decline has been offset by some growth in bulk mail.

Based on discussions with our large customers and the cap on bulk mail volumes applied by C&E in order to safeguard the LVCR we are significantly less optimistic about future bulk mail than at the time of the last submission and have reduced our growth forecasts for 2010-2011. We do not anticipate significant growth over the three years of this submission other than for very few bulk mailers. We expect the decline in traditional mail volumes to continue over the submission period.

3.5 Air conveyance

As indicated in 3.4 above our estimate of mail volumes is significantly lower than was assumed at the time of the last submission. This has resulted in insufficient revenue to fund the second plane from the beginning of 2010-2011. Given the uncertainty around volume forecasts, for the purposes of this submission we have assumed that any anticipated volume growth will be met by additional rotations rather than a second plane..

3.6 The key assumptions underpinning this tariff submission

The following assumptions have been made:

- bulk products will continue to make a contribution to the on-island USO although the size of this contribution is reduced compared to present levels

- there will be no change to the USO over the tariff period

- Fully inclusive DSA prices can not be set for a three year period as no operator is willing to confirm their prices for more than 12 months at the most and Royal Mail Wholesale (RMW) revise their prices annually. GPL's approach to pricing DSA products is that they will be priced on the basis of GPL costs and margin with all other charges (from RMW, from operators and for freight clearing/customs charges etc) flowed through. Any movement in these prices either upwards or downwards will be passed on to customers.

- there will be no step change in Royal Mail charges over the three year tariff period. The current contract covers the first two years of the tariff period and this restricts price increases to the average increase in Mailsort prices in the UK. These prices are regulated by Postcomm. There is a risk, however, that Royal Mail and Postcomm will at some stage determine that the current level of access price in the UK is too low – if so, we can expect Royal Mail charges to GPL to reflect this. This risk is not factored into this tariff proposal.

3.7 Cost of capital

Guernsey Post would like to discuss with the OUR the value of the risk free rate and the equity market risk premium, but is proposing an asset beta closer to 1 than the OUR has allowed in previous years for the following reasons:

  - Guernsey Post is a small company and lacks economies of scale
  - There is great uncertainty about future mail volumes given the impact of electronic substitution on the postal industry

- Electronic substitution is making it very difficult to estimate the price elasticity of demand
- Guernsey Post is dependent on the bulk mail industry and four or five key customers, which in turn depend on the existence of LVCR. The abolition of LVCR, which is a significant risk and much discussed by the UK government, will undermine GPL's sustainability
- Guernsey Post does not know what level of competition it will face given the uncertainty about the level of the reserved area, and has based its planning assumptions on a reserved area of £1.35
- Guernsey Post has no buying power in relation to its main supplier, Royal Mail, which represents over 50% of its costs
- Guernsey Post has a high and growing pension deficit
- Guernsey Post has high levels of operational gearing, which make it very difficult to reduce costs in line with volumes

3.8 Operational cost issues

3.8.1Capital expenditure programme and asset disposals - GPL has maintained a minimal capital expenditure programme with few large projects
In summary the capital expenditure for the 3 years of this tariff is:

2011/12	2012/13	2013/14
£	£	£
425,000	265,000	502,000

Further details are available if required.

3.8.2 Overhead costs

GPL has undertaken a fundamental review of costs and expects its overheads to be £4.5m in 2011/12 (before any restructuring costs) and then to increase by 3.5% in the following two years. In 2011/12, overhead costs will represent 10.7% of total costs.

Overhead costs can be broken down further into payroll and non-payroll costs. Payroll costs will be £2.8m in 2011/12 based on full time equivalents (FTEs) of 41.8, which represent 17% of total FTEs.

Non-payroll costs amount to £1.7m in 2011/12, of which £1.1m relates to fixed OUR licence fees and building and vehicle costs

3.8.3 Operations costs

Our tariff proposals are underpinned by cost reductions compared to 2009-2010 which amount to nearly £2m pa by the final year of the tariff period.

4. The proposed tariffs

4.1 Pricing principles

The pricing principles followed by GPL for this tariff submission reflect those which underpinned the last submission. They are that:

- 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
- 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

4.2 Public Tariff proposal

4.2.1 UK and Jersey

Pricing tables are attached. For 2011-12 the headline public tariff price remains unchanged at 45p with the Business tariff headline price being reduced by 1p to 43p. The structural pricing issues have been corrected

4.2.2 Intra Bailiwick

Pricing tables are attached. For 2011-12 the headline public tariff price remains unchanged at 36p with the Business tariff headline price being reduced by 1p to 34p. As with the UK tariff structural pricing issues have been corrected.

4.3 Bulk mail tariff proposal

4.3.1 Priority products

At the present time this product is loss making and the key priority is the need to get a positive contribution – inevitably this means a significant rise in prices. The impact will be felt mainly by flower exporters. GPL believes that this is an area for early discussion between the Regulator and GPL – in particular at some stage, although not necessarily for this price control period, we need to review the way in which air conveyance costs are allocated to products. At the present time conveyance costs are allocated on the basis of weight only. It might be more accurate to also reflect bulk (planes tend to “bulk out” rather than “weigh out”) but this will impact the flower exporters. Pricing tables are attached
A phased approach has been taken to implementing the price increases necessary to restore profitability in order to provide those bulk mailers who use this service time to manage the impact of the increases.

4.3.2 Economy products

For 2011-12 we have been able to freeze Economy 120 way sort packet prices – thereafter price increases here are driven mainly by the cost of inflation. Pricing tables are attached

Graphs are attached showing prices at different weight steps for all UK large letter and packet products.

4.3.3 International bulk products

We have taken the opportunity to collapse the Europe and Rest of World zones into one and to significantly reduce prices for bulk large letters and packets. For large letters we have recently introduced a new 20mm/500g International flat bulk mail product. As at present, if bulk mail customers wish to take advantage of the destination sort prices offered by Royal Mail we will pass on the full saving,
It should be noted that the prices quoted to us by Royal Mail are only ever for a 3 month period. Pricing tables are attached

4.3.4 Downstream access products (DSA)

DSA products cover both Sorted and Unsorted.

DSA Unsorted

This product provides our customers with the ability to present their items to GPL with the minimum amount of pre-work. The mail must be sorted by Format, Large Letter and Packet, but no further pre-sortation is required.

These items are then either sorted on island by GPL, or transported as freight to the UK where one of our UK DSA Partners sorts the mail and handles all the pre-advice and data provision that Royal Mail Wholesale require.

One of the pre-requisites of customers agreeing to use DSA is that it entails an additional day at the start of the processing over our standard Bulk Mail products. This may not always mean an extra day in delivery times for all of the mail as we have yet to see what the delivery “tail” is for items sent via DSA. The additional day applies whether GPL or one of our DSA partners in the UK sort the mail. Sorting is not the added factor, injection into the Royal Mail network is.

As the items bear indicia unique to GPL, HMRC have agreed to apply the terms of the MOU on customs clearance to both DSA Unsorted and Sorted mail posted through GPL. This also has the benefit of not requiring an electronic customs manifest to be provided, and means that the mail can be sent using a CN22.

GPL charges our posting customers a price based on the average weight of the consignment, or a unit price for items below 250g in weight.

DSA Sorted

This product requires the posting customer to pre-sort the mail to the Royal Mail inward mail centre selections, and for the customer to provide an electronic manifest detailing the contents of each bag sent in a consignment. The customer also has to attach a label to each bag which indicates to Royal Mail the contents of that bag for revenue protection purposes. The benefit of this pre-work is that the price is a significant saving per item, on both DSA Unsorted, and our standard Bulk Mail Products.

GPL have engaged the services of Mosaic to allow us and our customers to access DocketHub which is Royal Mail Wholesale approved software for accessing EPro, RMs revenue collection and protection system, and to produce compliant bag labels. GPL manage the contract with Mosaic and the interface with them on behalf of our posting customers.

Again as with DSA Unsorted as the items bear an indicia which is unique to GPL, HMRC have agreed to apply the terms of the MOU on customs clearance to DSA Sorted mail. Once transported by GPL to the UK the mail is handed to one of our DSA partners who then transport it to the RM inward mail centres.

As with DSA Unsorted GPL charges our posting customers a price based on the average weight of the consignment, or a unit price for items under 250g in weight.

There are three separate elements that comprise the price charged to a customer for DSA products:

1) GPL costs of handling – these include:
    - collection
    - container filling
    - conveyance charges (from Guernsey to the operator's facility)
    - GPL administration
    - Any appropriate contribution to overhead costs
    - GPL margin including contribution to the USO

2) DSA operator costs – these include:
    - operator's own costs
    - Royal Mail charges
    - Operator's margin

3) customs clearance charges

Of these, only the GPL element is controllable by GPL – DSA operators are not willing to provide forward prices for more than 12 months at the most. Royal Mail charges are price controlled by Postcomm, the UK postal regulatory body. GPL's pricing is, therefore, restricted solely to its own element of the costs – all other costs along with any future cost movements, either upwards on downwards, will be passed on to customers.

In pricing DSA products GPL has adopted the following principles and assumptions:

- the use of DSA results in at least one additional container being required each day. In practice, depending on whether or not the same operator is chosen to provide both DSA Sorted and Unsorted it may result in an additional 2 containers per day.
- Set against this, any volume switched into DSA from other Economy Bulk Mail products will clearly reduce that volume and it may be possible to reduce the size of one of the containers
- For the purpose of costing it is assumed that the net container efficiency resulting from the use of DSA will be that one existing 13m container will be converted into two 8m trailers (one DSA and one Economy Bulk Mail). Any costs resulting from container inefficiency will be borne by DSA users and not by other postal users
- GPL will look to make the same contribution margin on DSA products as it makes on Standard Bulk Mail products and will pass on to customers any savings from DSA compared to Economy Bulk Mail, net of any additional costs

- GPL’s administration costs are increased marginally because of the need to liaise both commercially and operationally with at least one additional service provider. For the purpose of pricing this cost is assessed at 1p per item
- GPL will select DSA operators based on a number of factors including cost and capability

Because GPL have negotiated advantageous rates with Royal Mail for Large Letters it is unlikely that DSA will be a viable proposition for this stream.

4.4 International Letters public tariff proposal

Pricing tables are attached. We have taken the opportunity to collapse the Europe and Rest of World zones into one and to reduce prices.

4.5 Parcels tariff proposal

4.5.1 UK parcels

Pricing tables are attached

4.5.2 International parcels tariff proposal

GPL’s prices have been unchanged for some time and are significantly below those of the UK and Jersey. This proposal brings GPL’s tariffs in line with the Parcelforce prices

Pricing tables are attached

4.6 Other products tariff proposals

Pricing tables are attached

5 Update on services not in the Reserved Area

5.1 Retail

GPL has 13 branches on the Island all operated all operated by Sub Postmasters except for two directly owned branches at Envoy House and Smith Street. The financial performance of the branches is affected by the general health of the postal market, the overall economic climate, and the non postal and retail product offering.

Sub Postmasters generally have a Post Office branch as an adjunct to a retail business bringing additional foot traffic for their core business and providing a service to their customers.

Directly owned branches are more focussed on providing a core distribution channel for postal services and traditional products. Without a strong related retail business to maintain or grow revenue, these branches need additional products such as financial services together with an expanded and more successful retail offering to prevent a decline in their financial performance.

The focus now is on improving the performance of the Smith Street branch through increased retail sales and reductions in labour costs. The retail strategy has included a change of range and display policy for retail featuring more impulse purchase items at lower price points.

5.2 Philatelic

The decline in the Philatelic market has been well documented but despite falling sales volumes the activity remains profitable and is likely to remain so for a least a few years to come. A profit of £300,000 has been delivered in 2009-10. The business will remain profitable in 2010-11. Please note – the profitability as shown in the tariff model is distorted by the way in which the model allocates overheads. We have flagged this as one of the key issues to be discussed during the tariff process.

A strategic review of the business has been carried out and in 2010 significant changes are to be made to the issuing and marketing policy which, together with systems and efficiency improvements, will see the business continuing to deliver profits in 2011-12 and in 2012-13.

5.3 Financial Services

Guernsey Post will continue to operate in the financial services market through the provision of foreign exchange and money transfer products and services. These areas have proven to be very successful and help to maximise the return on the company's retail infrastructure.

6 Risks

We have identified the following risks to the successful implementation of the tariff as proposed:

Market

- Mail volumes decline faster than expected
- Ecommerce growth stagnates
- Bulk mail volumes decline
- LVCR is removed or reduced
- Other jurisdictions start positively encourage bulk mailers to locate there
- Price elasticity of demand for postal services is higher than expected
- Philatelic market continues to decline

Customers

- Dependence on small number of key customers
- GPL cannot pursue new customers

Employees and Culture

- GPL cannot find the human resources to deliver the plan
- Loss of key personnel
- Costs of redundancy
- Lack of on-island skills

Business Development

- Conveyance to the UK is not cost-effective
- There are few practical diversification opportunities open to GPL

Royal Mail & Other Suppliers

- Dependence on RM
- No alternative to RM emerges
- RM imposes further, unsustainable price increases
- RM withdraws services to the Bailiwick
- RM goes out of business
- RM industrial action
- RM withdraws Skynet or joint relationship with Atlantic Airlines
- RM access prices increase with a knock-on impact on year 3 RM charges
- Increase in the oil price
- DSA service providers prove to be unreliable

Assets, Financials and Pension

- Envoy House cannot deliver a commercial return, but there is no buyer
- Low interest rates
- Pension deficiency is greater than currently forecast
- Terminal Dues charges are higher than assumed resulting in higher charges from Royal Mail for International mail

7 Other issues

There are a number of areas for discussion between GPL and the Regulator where issues need to be resolved as part of the tariff process and where discussions have commenced. These include:

- cost allocation – this subject has been discussed with the OUR but was not resolved in time for the submission of the model. For the purposes of this submission we have used the cost allocations assumed in the last model
- allocation of overhead costs – again, for this submission we have used the same basis as was used in the last model. However, this appears to allocate some costs inappropriately
- whether or not to incur the additional costs of a second plane
- the need for a more appropriate regulatory model allowing GPL to have greater commercial freedom to change prices and providing a mechanism which allows price changes in the event that key assumptions prove to be incorrect