OUR
OFFICE OF UTILITY REGULATION

Office of Utility Regulation

Guernsey Post's Tariff Changes

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Final Decision

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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 because of uncertainties around its new contract with Royal Mail (“RM”) for the delivery of mail to the UK and abroad.

Over the summer 2010, GPL undertook a far-reaching review of its operations and overhead activities with the intent of adapting its methods of working to a changing environment. Its objective is not simply to reduce its costs in line with the generalized traffic decline experienced in other developed countries, which is expected to continue, but also to increase the flexibility of its operations to take advantage of new opportunities for growth where they exist. After its April submission, it therefore submitted revised proposals in October 2010 for tariffs in the three years to April 2014. The OUR published a consultation on these proposals in October and the DG has considered all responses to this consultation carefully. This document records his final decision for postal tariffs in the next three years (details in Annex A).

The uncertainty arising out of the changes initiated by GPL has been compounded by proposals for changes in UK postal prices (consultation by the UK postal regulator announced on 8 November), which has the potential to affect the contract between RM and GPL and, thus, half of GPL’s costs. This uncertainty is unlikely to be removed until early in year 2011 at best, but GPL needs a decision on tariffs at this time if they are to come into effect on 1 April 2011. Moreover, beside the uncertainty due to the contract with RM, other significant uncertainties exist for Years 2 and 3 of this price control. The decision recorded in this document, therefore, contains a limited number of opportunities for a re-assessment of certain tariffs when uncertainties affecting them are sufficiently reduced.

In making his decision, the DG has been 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 in view of the competitive environment in which it operates. Therefore the DG has invested considerable effort in assessing the efficiency of GPL’s business with the aim of ensuring that postal customers are only asked to pay for efficiently incurred costs.

2. Structure of the Decision

This decision document sets out the DG's decision on postal tariffs for the next three years. It 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:	summarises the responses we have received and how they influenced the DG's decision;
Section 5:	discusses a number of specific issues and uncertainties which have an important bearing on the DG's decision;
Section 6 :	Summarises the DG's decision on the costs that GPL could recover from its customers through regulated prices (or controlled prices, to be worked out) and, thus, the total income that GPL will be allowed to recover from its customers in each of the three forthcoming years; it also presents the DG's decision on tariffs, which are stated in Annex A;
Annex A	Individual GPL tariffs for Year 1 and increases allowed for the basket of controlled prices in years 2 and 3

In accordance with the OUR's policy on consultation as set out in Document OUR 05/28 – "Regulation in Guernsey; Revised Consultation Procedures Information Paper" – all non-confidential responses to the consultation have been published on the OUR's website (www.regutil.gg) and are available for inspection at the OUR's office during normal working hours.

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 sets 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.

[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 delivery by a sender, or the delivery of court documents and banking instruments. In

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

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. In accordance with section 9 of the Postal 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.

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.

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

4. Responses to the Tariff Consultation

The OUR received three responses to its consultation, one from GPL and two from respondents writing from a customer perspective, PostWatch Guernsey and The Sigma Group. A summary of GPL's response is provided immediately below. A number of comments from GPL as well as the responses from PostWatch Guernsey and The Sigma Group are reported in the next two sections, in connection with the specific topics they address.

GPL's comments

GPL supported the proposal for greater flexibility in the form of the price control that the OUR would apply after March 2012. It said it would be happy to work with the OUR to take forward the necessary work associated with such a move and thought the OUR should set out a programme of work involving stakeholders which would result in a significant improvement in the price setting system. Among the topics to be considered, GPL included:

- A better method than now to take account of inflation;
- An automatic adjustment for certain costs over which GPL had no control. In particular, GPL commented that Royal Mail charges are either set by Postcomm (DownStream Access (DSA) charges) or must be the same as set for Jersey services (RM must not discriminate between Guernsey and Jersey) and, in either case, are outside GPL's control; and
- A revised business model with stronger features in modelling GPL financial parameters and forecasting demand in response to price changes.

GPL thought that the pricing flexibility associated with a new price control regime was welcome and essential in view of separate proposals to introduce a licensing regime for competitors to GPL and the possible further opening of the postal market to competition.

Process of tariff setting

The first issue on which views were invited was the proposal that the OUR should make a final decision on tariffs without a preliminary consultation on its draft decision. This proposal was driven by GPL's wish to have a decision in 2010 while its latest tariff proposals were made in October only, superseding those made in April 2010. GPL supported the proposal to skip the draft decision stage and the other two respondents did not comment on it.

The DG is therefore proceeding with a final decision now. In so doing, he will follow the general principles outlined in the consultation document, to which no one objected.

Scope of the Price Control

The issue of the scope of the price control is closely related to GPL's dominance of postal markets. In November 2005, the OUR concluded (OUR05/26) that GPL was dominant in Guernsey for the following markets:

- Regular letter and parcel services
- Priority (Special Delivery) letter and parcel services
- Outbound bulk mail services

At the same time, Condition 18 of GPL's licence, which defines the services that are regulated by the DG, was amended to reflect the OUR's dominance findings. This condition reads as follows:

"The Director General may determine the maximum level of charges the Licensee may apply for Licensed Services[4] 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 preparation of its price determination, the OUR consultation asked whether respondents believed that GPL's dominance had changed since the OUR conducted its 2004-05 dominance review. None of the respondents argued it had changed.

In its response, GPL said that there should be no price control for products which are outside the reserved area. In particular, GPL observed that competitors were active and taking market share in the packet market, which had been completely removed from the reserved area. GPL also noted that the OUR had agreed not to control the prices of priority services.

The DG believes that there has been no change to GPL's dominance since the OUR reviewed the postal market and, by virtue of GPL's licence, he must regulate

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[4] *Refers to services within the reserved area, as described above, while that of 'universal service' refers to the services defined in the OUR Order of September 2010 (see above).*

"licensed services and/or universal services" where GPL is dominant. This means he needs to regulate the reserved area and the universal services provided in the three main markets above. The DG also believes that competition is not sufficiently established to justify removing controls from all USO services outside the reserved area where GPL may still be dominant.

The situation is different for priority services: the DG accepted in his 2006 price review that GPL was unlikely to abuse its market dominance in the priority letter and parcel market. This is so because there are competing services provided by other postal service suppliers which constrain GPL in this market.

The DG is therefore intending to set prices for regular letter, packet, parcel and outbound bulk mail services only.

Proposed price changes

Postwatch was pleased that GPL was not proposing to increase the cost of posting a normal letter but thought GPL should do more to inform the public on how to avoid the higher-cost 'Large Letter' product. It thought the proposal to increase pricing flexibility by controlling the price of a 'basket' of products – not of each individual product - was very sensible. As noted above, GPL also favoured the move to a basket approach for price controls.

The Sigma Group was concerned that, with controls applied to a basket, individual prices for years 2 and 3 would not be determined now. Its preference was for a firm pricing structure and known prices for the next three years. However, it favoured the proposal of regulating a basket of products if it was accompanied by increased competition. It said increased competition should be achieved at the earliest opportunity if Guernsey was to avoid the risk of customers moving to other jurisdictions.

The DG believes that the GPL prices he has determined provide the best value for customers that is compatible with GPL's potential efficiency improvements. The move to a basket approach for years 2 and 3 strikes an appropriate balance between pricing flexibility for GPL and certainty for its customers. He notes that certainty of price or cost for more than one year is now a very rare occurrence anywhere.

5. Specific issues in setting prices

In its October consultation, the OUR identified a number of issues on which it sought views and which the DG would have to determine in order to set GPL tariffs. The main issues on which the DG had to make a decision were:

- Efficiency review
- Distinction between 'Large Letter' and 'Packet' products
- Choice of inflation rate
- Royal Mail charges
- Pension costs
- Capital investment and rate of return

Each issue is discussed below, referring to respondents' comments where appropriate.

Efficiency review

The main purpose of the form of price control commonly used for utilities is that, by setting prices in advance, it gives the controlled utility an incentive to do better than the regulator assumes. With an ex-ante fixed price control mechanism, the controlled entity may retain any reward from 'beating' a regulator's expectation until the next price review. In determining price controls, the regulator therefore needs to make assumptions about how efficient the controlled utility can become.

The Sigma Group thought it was essential that the DG should review GPL's operations to ensure that they are as efficient as possible.

The OUR commissioned an efficiency review of GPL for the 2009 price review, which it updated for the purpose of its 2010 price review. The OUR is grateful to GPL for the cooperation and constructive spirit shown in carrying out this review.

In his assessment of the costs of the controlled (or regulated) business, the DG has used GPL's own assessment of how its operations needed to change as well as the outcome of the efficiency review the OUR commissioned.

The two main factors affecting forecast operating costs for the next few years are Royal Mail charges, which have increased dramatically in the last few years, a trend which is forecast to continue except to the extent that they are reduced by the predicted decline in traffic sent by GPL to the UK. It is worth noting that, like the movement in operating costs, the overall cost of RM charges declines as traffic declines even if RM charges per postal item are expected to increase significantly. The other main factor affecting future operating costs is the deliberate steps GPL is now taking to reduce the costs over which it has control and discretion. By the end of 2013-14, and compared to 2009-10, the last full year for which actual data are available, GPL is planning to reduce its costs by around £3 million (assuming 3% annual inflation).

The DG's assessment – the details of which are confidential – is the proposed cost savings are a welcome strategic change in direction. His review of GPL's proposals has included an assessment of some of the assumptions inherent in the forecasts proposed by GPL (pension costs, inflation...), including revisions to some of them. Also, he has reviewed the extent to which various sectors of the postal market should benefit from GPL's increased efficiency. The DG is keen to ensure that the benefits of GPL's efficiency improvements are shared fairly between customers in those markets where GPL still retains a monopoly and the customers who could benefit from choosing a competing supplier.

The result of the DG's assessment, in the form of tariffs for the price controlled services only, is shown in Annex A. This assessment is open to revision in certain circumstances (described below) and reflects current traffic forecasts. The DG does not accept that productivity should go down – and costs rise – simply because external conditions have changed. However, he is not proposing to review the prices he has set if traffic proves different from that anticipated in Year 1.

The DG's assessment also enabled him to set the overall revenue that GPL is allowed to obtain from its price-controlled business in the years ending in March 2013 and 2014 if the current traffic and inflation forecasts for these years prove accurate. The OUR will work with GPL in 2011 to develop forms of control that are resilient even if these forecasts prove wide of the mark.

The next sub-sections discuss some of the decisions that the DG had to make to make an overall price determination.

Distinction between 'Large Letter' and 'Packet' products

The international norm for the 'Large Letter' product is more restrictive than the current 'Large Letter' definition in Guernsey – up to 25mm thick and with a weight limit of 750g. As RM charges GPL for any item larger than the international norm at the higher 'packet' rate, GPL had wanted to match the definition it uses to the international norm. However, the change affects some of its customers adversely and they need to be given time to change their operations.

In the October consultation, the DG announced his intention to restrict the 'Large Letter' product to the international norm (20mm thickness and maximum weight of 500g) as such a move brings charges in line with costs, which leads to more efficient decisions by customers. The DG consulted on when the change should be made. The Sigma Group asked for the change not to be made before 1 April 2012 at the earliest because it would not have time to make changes in packaging, IT systems and advertising before April 2011.

In its response, GPL noted that it had first drawn attention to the difficulty in its tariff submission to the OUR in May 2009, giving customers nearly two years' notice. The DG concurs that the definition of the 'Large letter' product was discussed in the OUR's 2009 consultation documents and customers have had the definite knowledge since October 2010 that they would need to adapt to the international norm for large letters. He believes that the principle of cost-reflectivity needs to be observed because it gives customers incentives to adapt their use of postal services to the cost of providing them. The DG has therefore decided that the change may take place on 1 April 2011.

Inflation and impact on costs

In its consultation document, the OUR invited views on GPL's assumption that many costs would increase by 3.5% per annum. It also invited comments on whether it should move to a form of price control that included an automatic adjustment for actual inflation, which is the form of price control most commonly used in the UK. In such a case, the control is applied to 'real prices', namely prices that would prevail if inflation was zero, to which a measure of actual inflation is automatically added every year. Such a method has the advantage that the inflation measures used are actual outcomes and there is no need to go through the unreliable exercise of forecasting inflation.

GPL supported a move to a form of price control where prices can be adjusted according to the most recently available data on general inflation. It thinks such a system would be logical and fairer, ensuring that risk is shared more evenly. There were other specific comment on these proposals. The DG has therefore concluded that:

- He will accept GPL's forecast of 3.5% inflation for its costs for the prices he sets for 2011-12, except for specific cases discussed below;
- As noted above, he will work with GPL in the course of 2011 to ensure that his determination of overall revenue for the GPL's price-controlled business in the years ending in 2013 and 2014 is resilient to differences between actual and forecast inflation
- He will move to a form of price control for the next price review for which he will invite GPL to submit its proposals for tariffs (and costs) in real terms, excluding general inflation.

Royal Mail charges

Royal Mail charges have increased significantly in the last decade as a proportion of GPL's costs and now account for more than half of these costs. GPL is dependent on Royal Mail for all traffic outside the Channel Islands – a dependence that The Sigma Group noted and which it thought GPL should correct. It believes that GPL should have incentives to use the most competitive postal services in the UK and in the rest of the world.

In its response, GPL states the charges it pays RM to deliver mail in the UK or send it to other countries are effectively set by RM 'on a take it or leave it basis'. The OUR believes that GPL should take steps to reduce its dependence on RM. Meanwhile, it is pleased that relationships with RM have been put on a more predictable basis with the signing of a new contract between GPL and RM, even if prices have to be agreed annually.

However, this contract links prices changes for GPL to certain price changes in the UK. There is now renewed uncertainty on UK prices and these depend on decisions made by Postcomm, the postal regulator in the UK, which announced early in November that it will rule on an application by RM for a significant increase in UK Mailsort[5] prices in February 2011. Such a decision may have a significant impact on the prices that RM will charge GPL from April 2011.

However, an increase in RM charges to GPL, and the extent of this increase, is not certain since Postcomm's decision has not been made and the link between UK prices and RM charges to GPL is not automatic. In view of this uncertainty, the DG believes it appropriate to:

- Set prices now on the assumption that RM charges will increase, on average, by 3.5% in the next three years (3.5% being the general inflation rate assumed in GPL's tariff submission);
- Set up a procedure whereby the GPL prices affected by RM charges may be reviewed on GPL's application or at the DG's discretion, taking account of GPL's financial overall position including greater certainty regarding its efficiency programme.

5 Mailsort prices are prices which RM charges large customers

Pension costs

The OUR consultation document contained a discussion of the extent to which customers should pay the full cost of the pension entitlements accumulated by GPL's employees or whether GPL's shareholder, namely the States, should bear some of this cost.

The reason for suggesting that GPL's shareholder should bear some of the cost of GPL's pension scheme is an analogy with private or privatised companies, where pension costs are the result of management decisions, of which shareholders bear the cost since they are ultimately responsible for a company stewardship. There also is the fact that some of GPL pension costs might result from a demand by the States pension scheme for a very swift correction of the current pension deficit (in ten years) while a company like RM has been given 38 years to correct its pension deficit.

The OUR is clear that GPL must honour its commitments to its staff. However, to the extent that some of the staff cost incurred by GPL would not have been incurred by a fully efficient postal operator, the consultation asked whether GPL's shareholder should not bear the cost of past inefficiencies, as would be the case in the private sector.

In its response, The Sigma Group said that GPL should be managing its own pension scheme and not rely on the scheme run the States. PostWatch noted that GPL has no control over the way its staff pension scheme is run, since it is run by the States, and, therefore, it should be up to the States to make good the pension deficit incurred on behalf of GPL's staff.

GPL confirmed that, in its view, its hands were tied by the rules of the States pension scheme. It also noted that if it decided to set up its own scheme, it would have to be similar to the one run by the States but GPL would incur additional administrative costs in running it. It did not agree that its pension liability would be smaller if it had managed its costs more efficiently in the past. It was concerned that its competitors did not have to bear the same costs as it did, which made it impossible, it said, to create a level playing field and enable it to compete fairly.

The DG believes that, over time, GPL needs to manage its operations as a commercial organisation increasingly subject to competition at home and internationally. GPL therefore needs to consider whether it is appropriate to provide pension benefits to its staff by means of the States pension scheme. The DG believes that GPL should be able to determine how it remunerates its staff and the appropriate remuneration mix of salary, benefits and pension entitlements, taking into consideration the remuneration schemes used by its customers and competitors.

At the moment, the only information on the future pension costs which may fall on GPL is an interim report produced in March 2010. This report identified that employer and employee pension contributions need to increase to maintain the same benefits as in the past for two reasons, namely that (1) the scheme is now estimated to be in deficit in view of its long term liabilities and (2) increased longevity and lower investment returns have increased any pension scheme net long term liabilities. A new fuller report, with up-to-date assumptions and forecasts, is expected in early 2011

For the next three years, on the assumption that GPL stayed with the States pension scheme, the DG has decided:

- he will allow – meaning customers will pay for - the increased contribution payments GPL needs to make on top of its future salary bill to cater for item (2) above; however, this amount is uncertain and depends on the forthcoming review of the pension scheme. The DG therefore assumes that this increased contribution will be 17.5% of salary instead of the current 15% and the near 25% that GPL originally proposed; the figure of 17.5% is in line with contributions considered by other organisations in a similar situation; it will not be applicable before year 2012;
- he will not allow any additional contribution to pay for the existing deficit, noting this deficit is an estimate dependent on various assumptions, some of which are now questionable. In any case, the assessment of the pension deficit will be made anew in the next schedule pension fund review scheduled for December 2010; and
- he is setting up a procedure whereby GPL prices may be reviewed on GPL’s application or at the DG’s discretion, taking account of GPL’s financial overall position including greater certainty regarding its efficiency programme.

Capital investment and rate of return

As we noted in the consultation, GPL proposed to spend around £1.2m in capital investment. The DG has accepted this proposal, which is reflected in the Regulatory Asset Base (“RAB”) on which GPL earns a return. At the time of the next price control, the starting point will be the efficient RAB agreed by the DG.

In its submission and its response to the OUR October consultation, GPL argued for a higher cost of capital than the DG had allowed when it set prices in 2006 (real pre-tax return of 7.11%). It repeated its argument in its response to the OUR’s consultation. In its response, The Sigma Group thought that the rate of return on capital was an issue which required agreement with the States.

The DG has not seen any evidence that could persuade him to change the cost of capital it set in 2006 and will therefore not change the rate of return allowed for GPL.

6. DG's Assessment of Costs and Tariffs

Annex A contains tables of the specific prices the DG is setting for Year 1 for the product prices which the OUR controls. These prices are maximum prices and, subject to the relevant conditions in its postal licence, GPL may choose to set lower prices.

The DG determination of prices also fixes the total expenditure which GPL is allowed to seek to recover from its customers in years 2 and 3 of the price control period (years 2012-13 and 2013-14), including an appropriate amount for profit and on the assumption that traffic and inflation are as forecast. During 2011, the DG will develop a basket pricing approach with GPL that results in appropriate changes in the total allowable expenditure as traffic and inflation forecasts are reviewed.

[END]

ANNEX A - DECISION ON PRICES AND BASKETS

See GPL’s Tariff Tables in a separate document.