GUERNSEY POST LIMITED

RESPONSE TO OUR CONSULTATION PAPER (OUR 10/12)

Non confidential version
Version 1.1

1. Introduction

This document provides Guernsey Post's response to Consultation Paper OUR 10/12. Since the Consultation Paper was received a report on the regulation of Guernsey Post has been issued – this report suggests possible changes to the regulatory framework applied to Guernsey Post over and above those suggested in the Consultation Paper. Guernsey Post believes that such changes require serious consideration and debate but that the timescale for doing this will stretch beyond the deadline for responses to the Consultation Paper. This response, therefore, addresses only those issues raised in the Consultation Paper.

2. Consultation process

Although it would be financially viable for Guernsey Post to freeze prices into 2011-12 and thus defer the implementation date for the new tariffs this would not address the structural issues with the current tariff. Guernsey Post believes that ideally these issues should be addressed as soon as possible and on that basis supports the DG's proposal to shorten the consultation process this time with a final decision to be issued in December. However, we have only recently been made aware of the proposal by Postcomm to allow Royal Mail to significantly increase prices for 2011-12. At the time of writing this response it is not clear what the impact of these increases will be on the charges Royal Mail makes to Guernsey Post – it is possible that charges may increase by up to 12%. Although Guernsey Post will seek to agree acceptable charges prior to the proposed date for a final decision by the DG there is a very real possibility that we will not know the final level of charges until Postcomm makes a final decision sometime in February 2011.
This issue has already been raised with the DG and will be kept under review in the run up to his final decision.

3 Legislative and licensing background

3.1 States' Direction: The Reserved Area

Guernsey Post responded in detail to the recent consultation on licensing in May 2010. The arguments put forward then are not repeated here in detail but in summary Guernsey Post's position is that:

- Any licensing approach should ensure fair competition which will offer protection to all postal operators, including Guernsey Post, and their customers.
- Guernsey Post supports the idea of a licensing regime requiring any licensed postal operator to contribute to support the provision of the

Universal Service Obligation (“USO”) in the event that the provision of the USO became an unfair burden on Guernsey Post
- Whilst Guernsey Post would be supportive of an appropriate licensing regime such a regime would not of itself be sufficient to manage adequately the risks to providing the USO and other “flanking measures” would be needed, for example increased price flexibility within price cap regimes would allow Guernsey Post to more dynamically respond to changes in a competitive market place

It is absolutely essential that the necessary flanking measures are put in place before any further opening of the postal market in Guernsey.

3.2 USO Services outside the Reserved Area

Guernsey Post notes, with reference to a determination made in November 2005, that the DG views “priority (SD) letter and parcel services” as falling within the scope of the current price control. Guernsey Post believes that this is in conflict with the DG’s decision (OUR 06/21R) in December 2006 (which followed an appeal by Guernsey Post against the November determination subsequently resolved by mediation) that he did not intend to price control tariffs in this market. The exclusion of priority letters and parcels from price control has been accepted by the DG in subsequent price controls and that position is reflected in the current BPM.
GPL is strongly of the view that priority letters and parcels should continue to be excluded from price control.

Guernsey Post believes that, since 2005, it has not become dominant in services other than those where it was then dominant. It is the view of Guernsey Post that it is not dominant in the area of packet delivery where there are a number of competitors with between them a significant and possibly dominant market share.

4. Future Price Controls

4.1 Guernsey Post welcomes the DG’s proposal to provide greater pricing flexibility in future years - this is a fundamental and positive change to the structure of Guernsey Post's price control. Guernsey Post is fully supportive of the need to move quickly to a more standard incentive regulation framework whereby Guernsey Post determines individual prices within the regulation framework. Such systems have been put in place widely in other jurisdictions in the postal sector both where universal service providers are privately owned and publicly owned. This issue is of particular importance in the postal sector given the large number of postal prices arising from the extensive range of products and associated formats and weights and the requirement to set large, detailed price plans each year. It is also noteworthy that the controls on the overall level of prices typically operate on an annual basis, with prices reconsidered each year relative to general consumer price inflation. In this way, the risks arising from general inflation, over which Guernsey Post clearly has no control, are managed actively through the price control regime. This is an example of a wider point—that such regimes can be designed to help manage risks that arise from circumstances outside the control of a regulated company in a transparent and pre-announced manner.

4.2 Guernsey Post believes that there are significant advantages in developing the control framework so that the OUR no longer sets the price of each of GPL's products - ie, one of the main differences between GPL's current price control and a standard price control framework. Both the UK and Jersey, among others, have moved significantly in this direction by adopting RPI – X controls for the regulation of postal prices.

The development of such a control framework requires analysis and testing of a number of key areas. These include the following.

– The UK and Jersey have both adopted weighted average or disaggregated revenue yield forms of control which use forecast volumes for the current year as weights to calculate the allowed revenue for that year. It would be possible for GPL to use such an approach, but it would also be possible to adopt other, perhaps simpler, forms of average revenue type control or, alternatively, a tariff basket structure which uses the most recent year's historical volumes as weights, more akin to the system in France.

– The calculation of the allowed revenue itself rests primarily, as under the current system, on the OUR's assessment of allowed operating expenditure (OPEX) costs in the light of its efficiency review. However, the treatment of capital expenditure (CAPEX) and the return GPL earns on its postal operations could either follow a RAB/WACC approach, as applied in the UK, or a Pay As You Go approach, which has been adopted in Jersey.[1]

– There are other significant elements that require determination including, for example, the measure of inflation to be used and the historical values to be applied (period average or single month), and the relevant measures of volumes and prices to be used in constructing the control.

– Testing, validating and confirming the functionality of the operational model put in place to implement the selected characteristics of the price control.

Guernsey Post would like to work with the OUR to take forward such work. Although, in principle, there could be a large programme of work, it should be possible to make use of the experience and evidence available from other jurisdictions, particularly in the postal sector, so that the programme remains proportionate, low cost and is completed over a comparatively short space of time. As part of its leadership role in this area, it would be beneficial to all for the OUR to set out such a programme and process to undertake and complete it which fully involves stakeholders. That should enable significant

[1] The OUR's BPM model includes RAB and WACC items but their effect is unclear as there is no explicit allowed revenue of the form normally found in RPI – X calculations.

improvements to the system of controlling prices to be brought into effect for price changes in 2012.

4.3 The issues of coverage and possible product groups relate, first, to which of GPL's products should be price-controlled and, second, to whether the products that are price-controlled should be in a single group or basket. In the UK and Jersey, most products are included within those jurisdictions' respective price controls. There are two baskets in the UK (with additional constraints on the pricing of access but not within a separate basket)[2] and a single basket in Jersey.

Both issues are best addressed through market analysis. With regard to the first area, work undertaken would seek to identify which of GPL's products has pricing power and so may be considered to require some degree of regulatory control of prices. The issue of whether one or more baskets is considered appropriate would also normally be expected to rest on analysis of markets and the possibility of substitution between products in response to price changes. This would be picked up in the programme of work referred to in 4.2.

4.4 As discussed above, there are a number of potential impacts on the financial position of Guernsey Post which can be considered to be outside that company's full control. These include:

- general consumer price inflation;
- volume growth or decline outside of a pre-determined range;
- changes to the size of pension deficits;
- certain types of input costs which are a significant part of overall costs.

In both the UK and Jersey, as well as in other jurisdictions, automatic mechanisms have been developed that seek to manage risks of this type. Automatic adjustments have a number of advantages, including that their responses and therefore impacts are more timely and immediate; they are likely to be less costly in terms of regulatory intervention; and they are transparent to stakeholders.

In terms of the development of the price control structure for Guernsey Post, the following would seem appropriate:

- to assess whether these risks and indeed others that may be more specific to the circumstances of Guernsey Post might best be managed through the development of automatic mechanisms within the structure of the price control;
- where this appears to be the case, to develop and test out the likely effectiveness of such mechanisms.

4.5 To a considerable extent, the duration of a price control depends on the effectiveness of its structure and where, for example, automatic mechanisms for managing risk are considered robust it may be possible to extend the

[2], Postcomm has recently decided to propose a number of changes, including those to the headroom control, with a move to a basket approach to control the average level of headroom, and an explicit basket for access products

period of the control. While it seems unlikely that an improvement to the structure of the control and its management of risks would shorten the preferred duration of the control to less than three years, it may well lengthen it. Duration would appear to be an area that is best addressed after consideration of the areas above.

4.6 The OUR has stated that it is not accepting concerns expressed by Guernsey Post in relation to the OUR's BPM. Given the central role that the BPM has played (and may continue to play) in supporting the OUR's regulatory process, it would be critical for GPL to have sufficient confidence that any model used is robust enough and in line with best regulatory practice.

However, a review of the model undertaken for Guernsey Post by Oxera indicates that the BPM is not entirely consistent with standard regulatory practice, in either the postal sector or other sectors. Indeed, there are a number of significant limitations with the BPM, which relate both to the calculation of the core regulatory building blocks and the lack of any assessment of the appropriateness of the regulatory assumptions.

In addition to undermining the validity of the BPM as a tool to support robust regulatory decisions, these issues suggest that it would not be appropriate at present to make significant changes to the regulatory parameters on the basis of the results from the BPM.

The main limitations with the model relate to:

– the inconsistency between actual revenues (based on the multiple of the hard-coded price assumptions and volume assumptions) and allowed revenues (based on the RCV approach);

– the simplistic calculations of the components of allowed revenues, particularly in relation to the RCV and depreciation;

– the lack of any financeability assessment of the appropriateness of the regulatory parameters;

– the stylised nature of the financial statements—for example, it is not clear whether exceptional costs are included within the calculation of profit before tax. If these costs are incorrectly excluded, this might mean that the profit position is overstated;

– the difficulties using the model for any scenario analysis, as a result of a number of hard-coded assumptions within the model, and the failure of the model to incorporate any price elasticities.

5. Forecasts of Customer Demand

5.1 Guernsey Post notes the intention expressed by the DG to validate Guernsey Post's volume assumptions from discussions with a number of large mailers. Our own experience suggests that, for a number of reasons, such forecasts are less reliable than we would like, usually forecasts proving to be optimistic.

5.2 Guernsey Post's assessment of non bulk mail volumes reflects the general consensus that traditional mail volumes are declining and will continue to do so in the future. This issue is recognised in the recent Hooper report *"Letter volumes have continued to decline, even as the recession is starting to lift. Postal authorities are predicting declines of between 25% and 40% in the next five years."* and " *Royal Mail predicts a further decline in…addressed letter traffic volumes of over 20% between 2010/11 and 2015/16."* Guernsey Post's delivered volumes are most significantly impacted by Royal Mail volumes.

6. Inflation and Impact on Costs

5.1 Guernsey Post's assumption as to the likely general level of inflation over the price control period was based on our best assessment at the time the tariff application was submitted. Guernsey Post agrees with the DG *that "medium and long term inflation rates are particularly difficult to forecast now".* It is in the nature of such forecasts that the only certainty is that any assumption will prove to be wrong.

5.2 The consultation paper raises the question of whether the same rate of inflation can be assumed to apply to all types of costs. Guernsey Post's view is that, in practice, this is highly improbable. However, in the absence of any robust evidence to support differential inflation rates Guernsey Post, under the present regulatory regime, by default must make a general estimate. Where there is robust evidence then Guernsey Post should apply a differential approach.

5.3 One example of where a differential rate should be applied is Royal Mail charges. These are not based solely upon RPI. At the time of submitting the tariff proposals Guernsey Post, in the absence of any evidence to the contrary, assumed that Royal Mail charges would increase in line with general inflation. This is on the basis that any increase is tied to the increase in Royal Mail Mailsort prices, price controlled in the UK by Postcomm. On 8 November Postcomm announced proposals that might allow Royal Mail to increase Mailsort prices by up to 12% and, as outlined at paragraph 2above, it is possible that the final level of charges will not be known until sometime in February 2011.

5.4 A further example of where a differential rate should be applied relates to International mail where Royal Mail charges to Guernsey Post will reflect not only RPI but also movements in the value of sterling relative to other currencies.

5.5 Guernsey Post welcomes the DG's suggestion that it is worth considering a system where prices could be adjusted on the basis of the most recently available inflation data - such a system would be more logical and fairer, ensuring that risk is shared more evenly.

6. External Costs – Royal Mail Charges and Conveyance Costs

6.1 Royal Mail charges – there are two separate sets of charges.

6.1.1 **Downstream Access (DSA) charges** (and access conditions) are fixed by Royal Mail Wholesale (RMW) and are not negotiable. This applies to Guernsey Post, other postal administrations, other operators and direct access customers alike. The DSA market is price controlled by the UK postal regulator, Postcomm. Guernsey Post is not permitted to negotiate its own access prices. In these circumstances Guernsey Post can see no argument not to treat these Royal Mail charges as 100% "pass-through".

Guernsey Post agrees that it has some commercial freedom to negotiate prices with DSA operators for that element of the work that is not RMW charges. The key point to note here is that such prices are only available for, at most, a 12 month period – it is not possible to get confirmed prices for a longer period. At the present time we do not have either RMW or operator prices beyond March 2011.It is for this reason that Guernsey Post proposes that the price controlled element of DSA prices should be restricted to those costs directly incurred by Guernsey Post plus a contribution element as set out in the tariff submission.

6.1.2 **Retail charges** to Guernsey Post are effectively set by Royal Mail on a take it or leave it basis – attempts to refuse to accept prices have in the past been met with the threat of a drastic reduction in service. Our ability to "negotiate" better rates is confined to relatively minor tinkering and trade-offs between products. It is our understanding that Royal Mail will not and can not discriminate between Guernsey Post and Jersey Post thus making it impossible to negotiate a Guernsey deal. The situation is complicated by the fact that, under the terms of the current contract, increases in charges for 2011-12 and 2012-13 are, in the absence of any agreement otherwise, constrained to the level of increase in Mailsort prices – these prices are determined by Postcomm. On 8 November Postcomm announced proposals that appear to allow Royal Mail to increase Mailsort prices by up to 12% - at the time of writing this paper it is not clear what the actual increase will be and the position may not be clear until February 2011, two months after the Final Decision is due.

In these circumstances there would appear to be three alternatives:

- to set prices based on the original assumption that charges will increase in line with general inflation
- to set prices based on an increase in charges of 12%
- to defer setting prices until the actual increase is known

Each has a set of risks attached – setting prices based on that assumption that charges will rise by 3.5% entails the risk that Guernsey Post is left with a considerable shortfall in revenue. Setting prices on the basis of a 12% increase entails the risk that Guernsey Post makes excessive profits. Neither risk is acceptable.

Although changing the current system would not by itself resolve the problem outlined above Guernsey Post supports the suggestion that Royal Mail Retail charges should also be treated as 100% "pass-through" costs on the basis that Guernsey Post cannot effectively influence them – in practice at the present time they are being determined by Postcomm.

6.2 Conveyance costs

Guernsey Post does not support the view that these should generally be regarded as "pass-through" costs. Although contract prices are effectively set by the market where Guernsey Post is one player the overall level of costs incurred is impacted by factors over which Guernsey Post can exercise some control. These include, for example, the efficient filling and despatch of containers. Possible exceptions to not treating these costs as "pass-through" would be in the event of fuel surcharges (or other airport levies) and additional security arrangements that may be imposed on Guernsey Post from time to time. Some of the precedents indicate that under some circumstances the pass-through rate could be significant (eg, 75% to 90% in the case of security costs in London airports).

7. The range of activities for which the DG needs to set price controls

In his last determination the DG removed all packets from the Reserved Area and products in this area are now fully open to competition. Competitors are active and have taken market share. Guernsey Post believes that there is no longer any reason why products in this area should be subject to price control.

8. Proposed efficiency savings

At the time of writing this response Guernsey Post has not seen the full report on possible efficiencies from the DG's advisors. As indicated in our Tariff submission Guernsey Post's price proposals are predicated upon very significant reductions in both operational and overhead expenditure. To some extent the detail of how these are to be delivered is yet to be determined. Guernsey Post reiterates its belief that the efficiency review should focus on the key issues and not minor detail.

9. Pension Costs

Although generally supportive of the high level analysis of pension issues put forward in the consultation paper Guernsey Post has a number of points it wishes to make.

9.1 Guernsey Post does not understand the issue raised by the DG as to 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*". The consultation paper states that "*the OUR expected a marked efficiency improvement in the last four years. This would have had the result that Guernsey Post '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."*

This statement is incorrect on two counts. First, Guernsey Post made more than the required efficiency savings in the operations area during the period in question and, second, we did that by reducing the number of employees in operations rather than following the OUR's suggested reduction in overtime hours.

Guernsey Post's approach of reducing heads made a real saving in the future pension liabilities of the company – of course the existing liability for past service (now in the form of active pensioner members of the scheme) remains.

A reduction in overtime, which was the OUR's suggested form of efficiency saving, would have had no effect on pension liabilities as overtime payments are not pensionable.

Additional costs were added in some of the administrative/overhead areas to bring the company into line with legislation (e.g. Health and Safety and Financial controls) and to assist with diversification to offset the decline of the mail market. Some of that additional cost has already been removed and further efficiencies are planned through the automation of processes.

Guernsey Post has no pension liabilities outside of the States Pension scheme – it is therefore incorrect to imply that there is a "general" pension liability that is something apart from the States scheme.

9.2 The DG is seeking 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.

Guernsey Post has had, and continues to have, no influence over the structure of its pension costs. At the very point of commercialisation the States decided that Guernsey Post employees would remain States employees for pension purposes.

9.3 The DG is seeking views on an appropriate period over which a state-owned operator should fill a funding gap in a States pension scheme. From a Guernsey Post perspective this comes back to the fundamental question of control of the scheme. Whilst Guernsey Post may have opinions on this, as will the DG, the fact remains that the States set the assumptions to be made by the scheme actuaries and the Admission Agreement sets a requirement that the liabilities of the Guernsey Post part of the scheme are fully funded.

9.4 The consultation paper questions whether Guernsey Post customers … and Guernsey Post itself, ….should bear the same pension costs as the States themselves, where pension costs, ultimately, fall on tax payers and not on customers.

As outlined above Guernsey Post is tied to the current scheme via the Admissions Agreement and our employment contracts. Changes that are agreed with our employees/Unions can be made trouble free. Any change which is imposed will face both legal and industrial relations challenges

10 Capital Investment

The consultation document states that the DG believes Guernsey Post should share with him the business cases it makes when assessing its capital investment so that a clearer view can be had on whether they should be allowed.

Guernsey Post recognises that capital investment is a critical element of the price control process in determining both the level of depreciation it recovers through postal prices and the return it is allowed to make on its capital. In the same way that the OUR carries out an efficiency review of Guernsey Post's revenue expenditure, it should be able to assess Guernsey Post's capital investment plans.

Guernsey Post believes that the OUR's evaluation should take place by reviewing its preliminary business cases as part of the process for determining Guernsey Post's prices over the three year price control period i.e. before the OUR's final decision. GPL believes that the OUR should not request the final business cases produced before the capital investment proceeds i.e. during the price control period, for the following reasons:

1. The OUR has already seen the preliminary business case that justifies the investment
2. Prices have already been fixed on the basis of the approved capital investment
3. The board and the executive team is responsible for approving final business cases
4. This bureaucracy would be intrusive and impractical, restricting Guernsey Post's ability to act commercially

If Guernsey Post makes material capital investments during the price control period that it had not forecast as part of its original tariff submission i.e. there was no preliminary business case reviewed by the OUR, or significantly exceeds the cost of the capital investment it had originally forecast, then the OUR should evaluate the capital investment at the start of the next price control process to determine if it should be allowed or not.

Guernsey Post believes the OUR will need to clarify the methodology it will be using to evaluate Guernsey Post's capital investment and who will be responsible at the OUR for its evaluation (including their qualifications and experience).

Guernsey Post and the OUR should also agree a minimum threshold for providing preliminary business cases as part of the price determination process.

Guernsey Post and the OUR also need to consider the implications for prices and capital expenditure of any new price control framework they agree, e.g. the impact on prices in a year of heavy capital investment under the 'pay as you go' approach.

11. What return on capital is appropriate for a States-owned entity?

The consultation document states that the DG is asking for views on whether the real rate of return for Guernsey Post should be changed from the real 7.1% that he determined in 2005/6.

Guernsey Post notes that the risk free rate and the equity market risk premium used in determining Guernsey Post's cost of equity can be obtained from publicly available data. Guernsey Post observes only that the Competition Commission adopted an equity risk premium of 4-5% in its most recent decision on Bristol Water, and a real risk free rate of 1-2%.

Guernsey Post believes that its equity beta, and indeed that of the postal industry as a whole, is significantly higher than the 0.75 that the OUR used in its last determination. Indeed the asset betas for TNT and Deutsche Post are 1.06 and 1.11 respectively as at 29 October 2010, whilst they are significantly larger and more diversified than Guernsey Post, albeit with different capital structures.

Guernsey Post argues for an equity beta significantly higher than 0.75 for the following reasons:

1. Technological change is undermining demand for postal services as new substitutes become more attractive
2. Environmental pressures are undermining demand for postal services as people seek methods of communication that are more friendly to the environment
3. Barriers to entry in the Bailiwick postal market are falling and actual and potential competition is increasing. There is significant uncertainty as to the future level of the reserved area
4. Guernsey Post is dependent on three or four key customers

5. With the strain on public finances in the UK, the threat of the removal, or changes to, LVCR is increasing
6. Guernsey Post's pension deficit is increasing as life expectancy rises
7. Guernsey Post is dependent on Royal Mail, with whom it has little buying power as a result of relative size of lack of end to end alternatives
8. Guernsey Post is small and lacks of economies of scale

12. Cost Reflectivity of Tariffs

Guernsey Post welcomes the DG's decision to recognise that a problem exists with the current definition for International Large Letters, and consequentially that Royal Mail will charge Guernsey Post the higher packet rate for items which exceed the 20mm depth and 500g weight criteria.

Guernsey Post's current tariff proposal goes some way to rectifying this, and attempts simplification of pricing with minimised customer confusion. To do this, there needs to be a differentiation between straight line pricing (SLP - used by Bulk Mailers), and Business/Public Tariff users.

For Bulk mail, Guernsey Post has introduced a new International "Flat Letter" SLP tariff, which has acceptance criteria of depth (<20mm and weight<500g) to all countries, dispensing with the higher rest of the world (RoW) zone classification This product is priced competitively, and below current International Large Letter prices. As a result, all bulk mail which conforms to the criteria will use this lower priced product. All mail which does not conform to these criteria will, by definition, be classified as packets for charging purposes. For that reason, the International Large Letter SLP tariff must reflect packet costs, and be priced accordingly as a packet tariff.

The need for this product to be properly priced was first articulated to the OUR and to customers in Guernsey Post's tariff submission in May 2009. If the changes were to be made from April 2011 that would provide a notice period of nearly two years.

The situation with Public and Business tariff is less straightforward. Firstly, the tariffs have been simplified and in some cases reduced by the removal of the higher priced Rest of World (RoW) zone. This has reduced tariff yield by about £10k for Large Letters alone.
However it is clear that items which weigh over 500g will be charged by RM as packets, and so the weight steps above level this must attract the relevant packet prices, (even though we have no indication of any volume at this weight).
Below 500g, there will be a proportion of mail falling between 20mm and 25mm which is acceptable as International Large Letter, but will attract the higher packet charge from RM. It is also anticipated that this mail will come from small business users and private mailers via post office counters. In the current price proposal, GPL has assumed that this proportion (technically

packet) will be order of 20%, and set the International Large Letter price to cover that packet cost assumption. GPL is of the view that this would be more acceptable from a customer view point than the alternative of setting up and publicising these additional acceptance criteria, purely for international public posting customers. We are content to continue for the 2011-12 year on this basis, monitoring the issue, given that the proposed pricing assumptions are adopted.

13. Conclusion

This document sets out, of necessity, a fairly high level representation of Guernsey Post's views. Guernsey Post and the DG have already commenced discussions on the issues identified and Guernsey Post looks forward to continuing these.