



Office of Utility Regulation

Impact of Royal Mail Charges on Guernsey Post Tariffs

Consultation Document

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Office of Utility Regulation

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1. Introduction

In January 2011, the Director General of Utility Regulation (“DG”) determined the maximum income that Guernsey Post (GPL) could obtain from its customers over the three-year period beginning on 1 April 2011. He also determined the maximum tariffs that GPL could charge its customers in the year 2011-12.

This three-year price control would normally have started in April 2010 but was delayed by one year by agreement between GPL and the OUR. The main reason was uncertainties concerning the charges that Royal Mail would make to GPL to handle all the traffic that it sends to the UK. These charges account for about half of GPL’s costs. By January 2011, this uncertainty, if anything, had been increased by a consultation on a significant increase in Royal Mail prices which its regulator (Postcomm) announced in November 2010.

In order to reduce uncertainty as much as it was in his power to do, the DG made a three-year price decision in January 2011 – on which GPL was able to act to fix its tariffs for April 2011 – but made it subject to revisions as uncertainty progressively lifted in a number of areas, one of which was Royal Mail charges. Now that Royal Mail and GPL have negotiated charges for the current year, GPL’s full-year costs for 2011-12 can be assessed more reliably. As a consequence of the importance of RM charges for GPL overall costs, the DG considers it necessary to review GPL’s tariffs and is consulting on GPL’s proposed tariff increase.

The context for this consultation is that GPL engaged in a significant change programme for its operations in October 2010 and is continuing with structural changes during the current year. In view of the demanding efficiency targets reflected in the tariffs allowed by his January 2011 decision, the DG considers that the 2011 increase in RM charges are costs which GPL may need to pass to its customers in the form of increased prices for some postal services in Guernsey. He has therefore considered GPL’s application and commenced the process of consulting on it.

As explained below, the timing of the date of GPL’s tariff increase is relevant. GPL’s proposal is that they should go up on 1 August 2011. The DG is therefore also consulting on this date and on the principle of using a fast track process whereby his decision would follow this consultation without the intermediate step of a draft decision consultation.

In deciding to re-assess the prices that GPL charges its customers in 2011-12, the DG is aware of the impact tariff changes have on all users of the postal service in Guernsey. When he made his decision in January 2011, the DG had assessed the

efficiency of GPL's business carefully and ensured that the maximum revenue he allowed GPL to recover from its customers reflected significant efficiency improvements in its operations. The DG's aim continues to be that of ensuring that postal customers are only asked to pay for efficiently incurred costs.

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

2. Purpose and Structure of the Consultation

This consultation applies to the tariffs that GPL will charge its customers for the rest of its financial year to 31 March 2012. The OUR is inviting comments from all interested parties on the following points:

- GPL's proposed price changes;
- the implementation date of these changes;
- the timetable and process proposed for determining new tariffs.

The consultation 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 changes in Royal Mail charges that caused GPL to ask for a re-assessment of its 2011-12 tariffs;
- Section 5: Explains the changes in tariffs (detailed in Annex A) on which the DG is consulting as well as the proposal to allow new tariffs to come in force as soon as 1 August 2011;
- Annex A: Contains a short report and explanation by GPL of its proposals and shows the proposed individual GPL tariffs for the period 1 August 2011 to 31 March 2012

Interested parties are invited to submit comments in writing or by email on the matters set out in this paper to the following address:

Office of Utility Regulation,
Suites B1 & B2, Hirzel Court
St Peter Port
Guernsey
GY1 2NH
Email: info@regutil.gg

All comments should be clearly marked “Impact of Royal Mail Charges on Guernsey Post Tariffs” and should arrive before 10am on Monday 4 July 2011.

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

3. Legislative and Licensing Background

Legislation and States Directions

The main legislative provisions of relevance to this Consultation 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 DG¹ in relation to:

- the identity of the first licensee in a utility sector; the DG issued the first postal sector licence to Guernsey Post Limited;
- 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, 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."

The States of Guernsey department Commerce and Employment consulted in January 2011 on its 'Review of the Universal Postal Service & Obligation', with the intention of establishing whether the USO definition above still met the needs of Guernsey and provided a good balance between the services supplied under the Obligation and its costs.

A decision on the postal USO is for the States to make in due course. The DG is conducting this consultation within the framework of the current definition of the USO.

States' Direction: The Reserved Area

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".

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 does not require licensing, such as personal delivery by a sender, or the delivery of court documents and banking instruments. In addition, any postal services which are provided outside the reserved area can be provided without the need for a licence. However, the DG has consulted on the possibility of licensing all operators active in the postal market, so as to protect the USO and ensure that competition takes place to the benefit of all customers. Eventually, the States will decide whether legislation is amended to introduce a wider licensing requirement.

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 2010² 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.

4. Changes in Royal Mail Charges

GPL pays Royal Mail for the mail that GPL sends to Royal Mail ('northbound traffic') for distribution in the UK and for onward transmission to other countries. Similarly, Royal Mail pays GPL for the cost of delivering mail originating outside Guernsey ('southbound traffic') which GPL delivers in the Bailiwick.

² *The Post Office (Reserved Postal Services) Order, 2010 - S.I. 84*

GPL has a contract with Royal Mail that provides for an annual negotiation of charges in advance of a financial year. Royal Mail charges to GPL are linked to the price that Postcomm, Royal Mail's regulator, allows it to charge its business customers in the UK as, in some respects, GPL is similar to one of Royal Mail's large customers. As Royal Mail had made an emergency request to Postcomm in November 2010 for a significant increase in its business tariffs, which Postcomm granted in February 2011, negotiations could not begin in earnest before then.

The Postcomm decision in February 2011 allowed Royal Mail to increase the price of retail business mail products by 12% and access products (also used by business customers) by 15% on average over the year. GPL negotiated with Royal Mail that its charges would, on average, increase by less than that for most mail sent by GPL to the UK. Royal Mail payments to GPL have also increased. However, as the volume of 'northbound' traffic is much higher than 'southbound' traffic, the payments received by GPL are much smaller in absolute terms than those GPL has to make to Royal Mail. They are however important because they contribute to supporting the cost of the USO in Guernsey.

Royal Mail wanted these charges implemented as early as possible and, essentially, would not agree to a date later than 1 July.

GPL believes that Royal Mail was prevented from increasing its charges to GPL as much as the maximum it is allowed to charge its UK customers by the fact that some alternatives to Royal Mail now exist for most of the mail journey to its destination. The exception usually is the last leg of the service, namely the delivery of mail to recipients' UK addresses, which remains Royal Mail's natural monopoly. Competition now exists for mail traffic between the Channel Islands and the UK in at least two ways:

- GPL business customers could use other mailers than GPL; such mailer might be reliant on Royal Mail for a small part only – as little as the final delivery - of its postal services;
- GPL itself is exploring arrangements with UK postal organisations other than Royal Mail which would enable it to by-pass most of Royal Mail network and its associated costs; as noted in Annex A, it will offer a renewed Downstream Access (DSA) service from 1st August, which could yield significant savings for many customers.

5. Impact of Royal Mail Charges on GPL's Tariffs

When the DG determined the maximum tariffs that GPL could charge its customers in 2011-12, he agreed with GPL that Royal Mail charges should be forecast – for the sake of determining a number - to increase by a measure of inflation. This was fixed at 3.5% annually for the next three years for both the payments made to Royal Mail and those received from it. This consultation results from the fact that Royal Mail charges have increased by nearly 10% on average instead of the forecast 3.5%.

The full-year impact of the new Royal Mail charges, had they been implemented on 1 April 2011, and taking account of the additional payments made by Royal Mail, would have been nearly £1.5 million. However, Royal Mail charges, in fact, will not apply retrospectively from the beginning of the year but will be implemented on 1 July 2011. They will cause GPL's net costs to increase by just over £1 million compared to forecast.

Timing of Guernsey Post tariff increases

GPL is proposing to increase public tariffs for the traffic affected by Royal Mail charges on 1 August.

The DG sees merit in allowing GPL to respond with tariff increases to the increase in RM charges as soon as reasonable. Whatever the amount that GPL is allowed to recover for 2011-12, an early start to recovery results in a smaller increase in its tariffs.

For GPL to increase its prices on 1 August, the DG needs to make a decision by mid-July at the latest in order to allow sufficient time for implementation of price changes by 1st August. Following this consultation, the DG therefore proposes to omit the next stage of publishing a 'Draft Decision' and consulting on it. This consultation asks respondents' views on this shortened process and on the implementation date of 1 August for GPL's tariff increase.

Extent of Guernsey Post tariff increases

The tariff changes that GPL proposes are described in Annex A, together with an explanation of the changes.

The tariff changes proposed by GPL will enable it to recover the £1m rise in its RM costs over the rest of the financial year 2011-12 and mirror the rise in Royal Mail individual charges. Public tariffs for local and international mail (outside the UK) are unchanged while tariffs for mail to the UK go up significantly.

The DG is consulting on whether to allow GPL to recover the £1m that Royal Mail charge increases add to its costs by the end of the 2011-12 financial year.

As he has completed a full price review in January 2011, six months ago, this tariff change is not a suitable opportunity for revising the balance between GPL tariffs or the extent to which GPL should improve its efficiency. The DG's preliminary view is that changes in tariffs should reflect the manner in which Royal Mail costs have changed.

The DG would welcome views on these matters.

6. Next Steps

The DG is asking for responses to this consultation by 10am on Monday 4th July 2011. He will consider these responses carefully. He may then issue a decision by Friday 15 July, particularly if he had decided to allow an implementation date for the new tariffs of 1 August 2011.

/ends

Annex A

GUERNSEY POST TARIFF INCREASE APPLICATION

JUNE 2011

Introduction

Following several months of resolute negotiation, Guernsey Post (GPL) has agreed new rates with Royal Mail (RM) for 2011/12 that are considerably better than its contract provides for and relevant benchmarks, but which are still higher than the 3.5% increase assumed in its 2011/12 price control.

From 1st August 2011, GPL is asking the OUR to recover these rates in higher postal prices for those products affected, but will not be making any more profit than forecast in the price control.

GPL is frustrated to have to seek to raise prices after freezing or reducing most prices in the current price control that began on 1st April 2011. We were able to hold or lower prices by committing to cutting our controllable expenditure (excluding RM charges) by £3m in 2011/12, which the OUR welcomed.

GPL has accepted some unfavourable changes to its terms and conditions to help secure the better rates from RM and we are relaunching an alternative to our traditional bulk mail services called DSA, which should allow our bulk mail customers to realise significant savings.

We believe that even after these increases our prices are still extremely competitive.

Background

In January 2011, the OUR approved GPL's price control for the three years ending 31 March 2014. The price control was based on the assumption, however, that RM charges would rise by only 3.5% per annum.

The OUR and GPL were aware at the time that the increase in GPL's RM charges was going to be significantly higher than 3.5% in the 2011/12 financial year, based on RM's tariff application to Postcomm (the UK postal regulator), which asked for increases in domestic bulk business rates of up to 16%. Because of the uncertainty and the need to set prices, however, both parties agreed to return to the price control when the deal with RM had been finalised.

We informed all customers in January 2011 that we might need to reset prices later in the year, following completion of the contract negotiations with RM.

In November 2010, RM asked Postcomm's permission to raise bulk business prices by £100m. The purpose was to finance RM's modernisation programme and the ongoing provision of its Universal Service Obligation (USO). GPL's contract with RM is linked to UK bulk business rates. In February 2011, Postcomm approved RM's request, which effectively meant that the average increase in bulk business prices was 15%.

In May 2011, following several months of robust negotiation, GPL agreed a favourable deal with RM that was significantly better than originally feared, but will nonetheless call for higher postal prices.

Guernsey Post's price application

Based on our belief that the deal with RM is a good outcome for both customers and GPL, GPL is seeking to recover in higher postal prices solely the cost increases that we have agreed with RM.

We have tried to keep our price application as simple and transparent as possible. GPL's revised prices will reflect RM's rate increases, which will be passed on to our customers without increasing our margins or our profits. In fact, GPL's prices will be slightly lower than the unit increases GPL has agreed with RM to reflect the fact that RM did not increase its rates to GPL on 1st April 2011 as originally forecast.

All other things being equal, with the new RM rates and GPL's proposed prices, GPL's profits in 2011/12 will be the same as the OUR and GPL expected when we agreed the price control in January 2011.

GPL is looking to change the prices only of those services that are directly affected by the increase in RM charges, which are mainly bulk and public services destined for the UK.

Bulk large letter and packet prices will increase on average by just over 1p and 8p respectively (or 2.8% and 6.5%), whilst the average public tariff for sending a letter to the UK will increase by 2p (4.4%) to 47p, a large letter by 3p (5.2%) to 61p and a packet by 9p (3.8%) to £2.49. UK business tariff rates will also rise by 2p, 3p and 9p respectively for each format. Meanwhile, GPL will hold international prices for bulk and public services and thereby absorb the cost increase that exceeded 3.5%. Local prices will also remain unchanged.

We are planning to increase prices to customers from 1st August 2011, subject to OUR approval. We believe this gives our customers sufficient notice, particularly as we advised them of the potential increase in January 2011, and it will reduce the risks GPL faces if our tariffs are not aligned with our RM rates over a long period of time.

Rationale and justification for the price increase to GPL customers

GPL has negotiated a good deal with RM, but it will still result in major cost increases that the company is unable to absorb without losing money. Our RM charges will be £1m higher in 2011/12 than we forecast, and every month GPL is unable to raise its prices after 1st August will cost it approximately £130,000. GPL is therefore in the difficult position of having to raise postal prices, a decision we have not taken without careful consideration.

GPL has negotiated hard with RM. Because our contract with RM is linked to UK bulk business rates, we were facing an increase of 15% when Postcomm announced its price control decision in February 2011, but we have managed to secure an increase that is substantially lower.

We have worked hard on behalf of customers and our company to obtain a good deal and indeed RM's final offer was materially different from its first, making some valuable concessions. Moreover, the relationship with RM is significantly better than previous years and we are seeing the benefit of this in more flexible, whilst still firm, negotiations.

GPL is able to continue to freeze local prices because we have agreed a favourable rate with RM for the delivery of mail coming southbound from the UK, which contributes to the cost of the Bailiwick USO. This should help to make the USO more sustainable and make it less dependent on the price of local and northbound mail.

GPL is sharing in the pain with our customers by accepting some adverse changes in our terms and conditions with RM. These modifications to our terms and conditions have helped GPL to achieve a lower increase, thereby benefiting customers.

We have benchmarked the rates from RM and our analysis indicates that the rates we have been offered compare favourably with the fully discounted retail rates available to large posting customers in the UK. This gives us extra confidence that we have negotiated a good deal.

We recognise that our price increases will affect all customers, particularly our bulk customers, at a time when many of them are under intense pressure from a weak UK economy, structural change in their markets and uncertainty arising from the UK government's attitude to LVCR.

This is why we are pleased to have secured a better deal than the terms outlined in our contract with Royal Mail, and why we are especially delighted to launch a reinvigorated Downstream Access (DSA) service with from 1st August, as an alternative to our traditional bulk mail offering. Our new DSA service could yield significant savings for many customers.

Depending on the average weight of their mail, some of our bulk customers could enjoy lower prices against our proposed bulk prices for both their large letters and their packets, but in particular packets. Indeed, some of the prices for our new DSA service are lower than our current bulk mail prices, and will enable customers to realise a significant reduction in their postage costs.

Furthermore, customers will not need to sort their bulk mail because we are offering an unsorted service, which could also lower their labour and/or capital costs. Conversely, customers may need to invest to comply with the access, information and presentation requirements of DSA that all operators impose.

The new DSA service will be very attractive to many customers and we would argue has helped us to achieve the deal we have agreed with RM for traditional bulk services because it could lead to a loss of volume for RM Retail. However, we should remember that there is still no nationwide end to end alternative to RM in the UK that offers the same level of service and ease of access requirements, and therefore the absence of competition restricts GPL's negotiating position.

Not only have we negotiated vigorously to minimise the RM rate increase, it is worth emphasising that we are working hard to deliver the £3m of cost savings that underpin the current price control, which is enabling us to keep prices as low as we can. Although we are proposing to increase prices now, we froze or reduced the price of many services as part of the current price control, many of which remain frozen or reduced such as local and international mail.

Our proposed bulk prices are still very competitive in relation to the rates customer could obtain in the UK and the level of service is equivalent. Furthermore, our headline public rate to the UK is lower than Jersey and is only 1p higher than the UK, in spite of having to fly it across the Channel.

Proposed price tables are available to view at Annex B to this document.