Jersey Competition Regulatory Authority

Explanatory notes regarding Consultation Document 2007-1 Price Control for Jersey Post

16 January 2007

Explanatory note on issue 1

Potentially regulated services

The JCRA has reviewed the Postal Services (Jersey) Law 2004 (the 'Postal Law') and Jersey Post's Class II licence to clarify the legal definition of the products that it can potentially regulate.

- Condition 20.3 of Jersey Post's Licence allows the JCRA to "determine the maximum level of charges the Licensee may apply for Licensed Services or Postal Services provided to fulfil the Universal Services Obligation ('USO'). The JCRA interprets this to mean that it can regulate products or services within the licensed area, and products or services outside the licensed area that are provided to fulfil the USO.
- Part 2, Condition 7 of the Postal Law defines the Licensed Area[1] to exclude the delivery of letters involving a payment of more than £1.30 or weighing more than 500 grams. That is, an operator does not require a licence to provide products or services with these characteristics.
- Condition 12.3 of the Licence defines the USO. The definition includes a requirement on Jersey Post 'To procure, to the extent within the Licensee's control, the delivery of Mail[2] to destinations outside the Island of Jersey at least at the same frequency as at the Licence Commencement Date[3], or at such other frequency as may be agreed by the JCRA' and 'To provide services for registered and insured Mail'. For the purpose of setting this price control, the service requirements of the USO (e.g. number of daily collections and deliveries) are assumed to be as per Jersey Post's existing operations.

Based on these legal requirements, the JCRA concludes that it has the legal right to regulate products and services that are within the licensable area (i.e. up to £1.30 and 500g) and those products and services that form part of the USO, regardless of whether these exceed £1.30 or 500g.

The JCRA is of the view that this means that all of the products and services listed in Table 1 could potentially be regulated. For example, products delivered outside of Jersey that lie outside the licensable area are provided as part of the USO (licence condition 12.3 (c)). Similarly, heavy 'signed for' mail items up to 20 kg may be outside the licensable area but are required under the USO. The JCRA also considers the delivery of all mail within Jersey to be part of the USO obligation and, therefore, considers it appropriate to include

1 The term 'licensed area' is synonymous with the term 'reserved area' in other jurisdictions. The terminology used in the law is retained here however.

2 'Mail' is defined in the Postal Law as 'postal packets'. Postal packets are defined as 'anything that weighs no more than 20 kilograms, and is for the transmission by post or is transmitted by post'.

3 1 July 2006.

products and services of all weight steps and prices, relating to local mail deliveries, to be included within the set of potentially regulated products. All items that weigh more than 20kg are outside the definition of 'postal packets' and are therefore not part of either the licensed area or the USO obligation.

The JCRA reserves the right to reconsider, at a later date, the list of products that are considered to be provided as part of the USO obligation.

Licensed products and services	Additional products and services provided as part of USO obligation
Letter postal services	**Letter postal services**
Local letter service(≤ 500g and/or ≤ £1.30)	Local letter service (>500g and/or >£1.30)
Domestic (UK and other CI's letters) (≤ 500g and/or ≤ £1.30)	Domestic (UK and other CI's letters) (>500g and/or >£1.30)
European airmail letters(≤ 500g and/or ≤ £1.30)	European airmail letters (>500g and/or >£1.30)
International airmail letters (Zone 1) (≤ 500g and/or ≤ £1.30)	International airmail letters (Zone 1) (>500g and/or >£1.30)
International airmail letters (Zone 2) (≤ 500g and/or ≤ £1.30)	International airmail letters (Zone 2) (>500g and/or >£1.30)
Airmail postcards	
International airmail postcards	
International air letter	
International pre-paid aerogramme	
Bulk & fulfilment services	**Bulk & fulfilment services**
Local letter bulk mail(≤ 500g and/or ≤ £1.30)	*Local letter bulk mail (>500g and/or >£1.30)*
Bulk Letter priority to UK (Sea) (J+3)	*Bulk Letter priority to UK (Sea) (J+3)*
Letter (≤ 100g and/or ≤ £1.30)	Letter (>£1.30)
Large letter priority (≤ 500g and/or ≤ £1.30)	Large letter priority (>500g and/or >£1.30)
Small packet priority (≤ 300g and/or ≤ £1.30)	Small packet priority (>£1.30)
Packet priority (≤ 500g and/or ≤ £1.30)	Packet priority (>500g and/or >£1.30)

Large packet priority(≤ 500g and/or ≤£ 1.30)	Large packet priority(>500g and/or >£1.30)
Extra large packet priority(≤ 500g and/or ≤ £1.30)	Extra large packet priority(>500g and/or >£1.30)
Bulk Letter Economy to UK (Sea) (J+5)	*Bulk Letter Economy to UK (Sea) (J+5)*
Letter (≤ 100g and/or ≤ £1.30)	Letter (>£1.30)
Large letter priority (≤ 500g and/or ≤ £1.30)	Large letter priority (>500g and/or >£1.30)
Small packet priority (≤ 300g and/or ≤ £1.30)	Small packet priority (>£1.30)
Packet priority (≤ 500g and/or ≤ £1.30)	Packet priority (>500g and/or >£1.30)
Large packet priority(≤ 500g and/or ≤ £1.30)	Large packet priority(>500g and/or >£1.30)
Extra large packet priority(≤ 500g and/or ≤ £1.30)	Extra large packet priority(>500g and/or >£1.30)
Bulk posting (Residue) to UK (Sea) (J+5)	*Bulk posting (Residue) to UK (Sea) (J+5)*
Letter (≤ 100g and/or ≤ £1.30)	Letter (>£1.30)
Large letter priority (≤ 500g and/or ≤ £1.30)	Large letter priority (>500g and/or >£1.30)
Small packet priority (≤ 300g and/or ≤ £1.30)	Small packet priority (>£1.30)
Packet priority (≤ 500g and/or ≤ £1.30)	Packet priority (>500g and/or >£1.30)
Large packet priority(≤ 500g and/or ≤ £1.30)	Large packet priority(>500g and/or >£1.30)
Extra large packet priority(≤ 500g and/or ≤ £1.30)	Extra large packet priority(>500g and/or >£1.30)
Palletised packets	*Palletised packets*
< 3 litre (≤ 500g and/or ≤ £1.30)	< 3 litre (>500g and/or >£1.30)
< 6.5 litre(≤ 500g and/or ≤ £1.30)	< 6.5 litre (>500g and/or >£1.30)
< 8 litre (≤ 500g and/or ≤ £1.30)	< 8 litre (>500g and/or >£1.30)
< 15.5 litre (≤ 500g and/or ≤ £1.30)	< 15.5 litre (>500g and/or >£1.30)
< 24 litre (≤ 500g and/or ≤ £1.30)	< 24 litre (>500g and/or >£1.30)
International letters, flats and packets	*International letters, flats and packets*
Letter priority (≤ 100g and/or ≤ £1.30)	Letter priority (>£1.30)

Large letter priority (≤ 250g and/or ≤ £1.30)	Large letter priority (>£1.30)
Packet priority (≤ 500g and/or ≤ £1.30)	Packet priority (>£1.30)
Large packet priority (≤ 500g and/or ≤ £1.30)	Large packet priority (>500g and/or >£1.30)
	Parcel services
	Local parcel services (≤20kg)
	Domestic parcel services (≤20kg)
	International standard parcel service (≤20kg)
	International economy parcel service (≤20kg)
	Other services
	Direct Mail
	Signed for (Recorded delivery) (≤20kg)
	International signed for (Recorded) £30 max comp (≤20kg)
	International signed for (Recorded) £100 max comp (≤20kg)
	Special delivery
	Business Reply (Local)
	Business Reply (UK, IOM and CIs)
	Redirection – Residential Customers
	Redirection – Business Customers
	Standard PO Box Facility
	Parcel Service PO Box Facility
	Retention of mail
	Poste Restante
	Articles for the Blind

	Mail to addresses within the British Forces Post Office
	FreePost Local
	FreePost UK

Table 1: Potentially regulated products and services

Competitive assessment

It is not necessarily the case that all potentially regulated products should be price regulated. The decision about whether or not to include one of these products in the control depends on whether market forces are expected to constrain Jersey Post's behaviour in determining the price and quality of service for that product. It is therefore appropriate to assess the extent to which competitive forces impact on the provision of each of the products.

To undertake this assessment we consider the following factors.

- *Barriers to entry*: this factor relates to the ease with which another undertaking could legally provide postal services within Jersey (i.e. barriers to entry to becoming a Jersey based postal operator). The extent to which barriers to entry may be lessened over the price control period is also considered.
- *Scale of competition*: this factor relates to an evaluation of the extent to which Jersey Post is currently constrained by other postal service providers. These constraints can relate to other companies offering postal services on the island or, given the large volume of mailings that leave the island, to other postal operators offering services in other jurisdictions. A consideration of the extent to which competition from other operators is expected to develop during the price control period is also considered.
- *Customer awareness and behaviour:* this factor relates to the extent to which customers are expected to have an ability and willingness to switch their mailings away from Jersey Post to an alternative service provider (either within Jersey or in another jurisdiction). The evaluation depends on the extent to which customers are considered to be aware of alternative options and the existence of barriers to switching. Again, the criterion is reviewed in the context of current customer behaviour and potential changes in that behaviour during the price control period.
- *The effectiveness of competition*: the final factor is only considered when existing competition in the market has been identified, either from another Jersey based operator or from another jurisdiction. In this situation it is important that the JCRA reviews whether the scale and nature of the competition provides a sufficient constraint on Jersey Post to warrant the removal of a product from the scope of the control.

These factors are consistent with the assessment criteria used by Postcomm when determining the scope of Royal Mail's price control. The use of a competitive test is also consistent with methodologies used by Ofgem and Ofcom when determining whether to remove price controls from particular products (e.g. retail energy services).

Each of the competition factors are considered in turn. First, the impact of the factor is reviewed at sectoral level. Second, the impact for specific products – or group of products – is considered given the sectoral review. Finally, for each product the analysis is used to indicate whether each factor is seen as positive or negative in terms of its impact on the extent to which a product faces competitive constraints.

The analysis is undertaken based on current information. The extent to which changes may arise over the three year price control period is also considered.

Barriers to entry

Barriers to entry can be grouped into two categories – legal barriers and economic barriers. Each is considered here.

Legal barriers

A number of legal barriers may affect the costs that a potential entrant could face when trying to provide postal services in Jersey. These relate both to the Postal Law and to other general laws in Jersey.

- Under the Postal Law, any operator can provide mailing services for items that weigh more than 500g and/or are priced above £1.30. Below this threshold, operators need to apply to the JCRA for a licence to provide postal services. In addition, courier services lie outside the licensed area because we understand that the minimum charge for these services is approximately £5 regardless of whether the item weighs less than 500 grams. While this suggests that the licensed area is 'open to competition', the JCRA needs to consider the impact of any licence application on Jersey Post's financial resources (Article 8 (1) (b))[4]. It is expected that this may constrain the number of potential entrants in the market, and/or the scale of individual entrants. At the very least, it means that it may take some time before an entrant can go from deciding to enter the market to actually entering the market as a licensed operator.
- The Regulation & Undertakings Law requires new businesses to apply for a licence that specifies the right to trade in Jersey and set limits on the number of staff that can be recruited. For a company that does not currently operate in Jersey, this could at least delay the time it would take a

4 Under Article 8(1)(b) of the Postal Law, the JCRA has a primary duty to ensure that Jersey Post Ltd has sufficient financial resources to discharge its pensions liabilities to the States.

potential entrant to become operational in Jersey. The constraint is less of an issue for companies already operating in Jersey (e.g. a current fulfilment customer who obtains a postal licence to self-supply postal services), particularly as the additional activities undertaken may be reasonably minor relative to the overall business of the customer (e.g. a bulk fulfilment customer that exports primarily to the UK already sorts the mail and takes it to St Helier Harbour for transfer to Jersey Post). For a very large customer, a change in the roles of existing staff may be all that is required. In addition, the customer would need to arrange conveyance to the destination country and obtain access to the delivery network of a postal operator in that country.

- Planning restrictions may limit the extent to which a company that does not currently operate in Jersey could establish a sufficiently large base to enable it to carry out its activities. However, an existing fulfilment customer may not need any additional space if it were to provide postal services itself.
- A postal operator providing mail export services would ideally need to have access to facilities at the Harbour that allows them to consolidate mailings into large trailers for despatch overseas. It could be difficult for any company to build new facilities as planning regulations in Jersey are potentially restrictive. However, a new operator would not necessarily need to own or build premises at the docks. Existing shipping companies at the docks (e.g. Condor Logistics and Ferryspeed) could potentially provide services to a new operator to undertake the consolidation for them. The scale of services that could be offered by these companies may be limited, however, and would have to be paid for by the operator. The extent to which this could be a barrier therefore, ultimately, depends on the prices that would be offered by these shipping companies. It is assumed that large operators would be able to negotiate a reasonable price, but that the cost would be higher for smaller operators.

A company attempting to establish itself in Jersey may have to meet certain regulatory requirements before it could begin operations. In contrast, the legal barriers facing an existing fulfilment customer that decided to apply for a postal licence are likely to be significantly lower, although the constraint on the JCRA's issuing of licenses remains.

Economic barriers

Two principal sources of economic barriers to entry can exist in the postal market.

- *Economies of Scale:* the existence of (large) economies of scale may limit the number of operators who can profitably compete in the market.
- *Incumbent advantage:* an incumbent postal operator, with a universal service obligation, may have a brand advantage over potential entrants and may have exclusive access to customer information. The importance of these advantages may vary, for example, by customer-type.

Both these factors are considered here in the context of the Jersey postal sector.

Economies of scale

The volume of mail handled by Jersey Post is small when compared to other postal operators (e.g. Royal Mail). There is therefore a question as to whether Jersey Post itself is able to exploit the full benefits of economies of scale in its operations. Given this, the probability of a new entrant obtaining sufficiently large volumes to allow it to take advantage of economies of scale in the delivery of local mail is considered to be reasonably low.

However, a large proportion of Jersey Post's mail is exported. An operator that chooses to serve customers with non-local mailings may not require the same level of scale to operate at a profit, since the upstream activities can be more easily scaled to the volume actually handled. Even if the economies of scale are significant, postal operators in other jurisdictions may be able to combine outbound mail from Jersey with their existing mail streams to achieve higher volumes.

Similarly, a customer that chooses to provide its own postal services may not require the same scale of operation. In this context it is important to consider the additional activities that the customer would have to undertake and to identify the importance of scale in determining the cost of these activities.

- First, the customer would have to consolidate the mailings onto large trailers at St Helier Harbour. As discussed above, the price offered by shipping companies for this service is expected to be volume dependent.
- Second, the customer must arrange for the mail to be transported from Jersey to the country of origin. Again, it is expected that the volume and frequency of mailings may affect the customer's ability to obtain discounted prices from the shipping companies. This requires sufficient volumes going to a single destination.
- Finally, the customer must negotiate a contract with a postal provider for delivery of mail in the destination country. Most postal operators will offer discounted prices for mail that has been pre-sorted and that meets minimum mailing standards (including minimum volume limitations).

Taken together, the analysis of the additional activities of an exporting postal customer that becomes a licensed postal operator suggests that the mailings involved would need to be sufficiently large to enable it to obtain sufficiently low costs to bypass Jersey Post. This would only apply to a small number of companies, although these are the companies that represent a large proportion of Jersey Post's overall mailings.

Incumbent advantage

Jersey Post has been providing postal services to mailers for a long time and has developed its own reputation and brand. As the only current universal service provider, Jersey Post can provide guarantees on the delivery of domestic and international mail (as required by the USO) that other operators may not be able to match.

Customers that primarily send mail within Jersey are expected to place a value on the recognised service associated with the Jersey Post brand. A new licensed operator offering Jersey-based delivery services may find it difficult to demonstrate that it could provide the same level and scope of service.

The service provided to customers with export mailings is dependent both on the reputation of Jersey Post and on the reputation of the postal operator providing delivery services in the destination country (e.g. Royal Mail). In this context, customers are expected to place a value on existing relationships with Jersey Post for activities undertaken in Jersey, and to place a value on Jersey Post's ability to negotiate quality of service standards and reasonable prices from the operator in another country.

The importance of these reputation effects may vary depending on the identity of the alternative postal operator.

- A new postal operator based in Jersey may be unlikely to convince customers that it could provide the same level of service, both in terms of conveyance of mail, negotiations with other postal operators for delivery and the ability to manage the customs-side of the fulfilment operation.
- An existing postal operator from another jurisdiction would be in a better position to demonstrate a reputation for high service standards in delivery in their own country, and may be well placed to negotiate contracts with operators in other countries. The prices obtained from Royal Mail are expected to be higher than those currently paid by Jersey Post (up to 2009). In addition, if the operator is from a jurisdiction that also benefits from a fulfilment industry, that operator may be able to match Jersey Post's expertise in the management of the customs-side of this business. There are a limited number of such operators however.
- A postal customer that self-supplies its postal services is only concerned about the price and quality of service offered by postal operators in other jurisdictions for delivery of their mail. The customers would, presumably, be able to avail of existing listed tariffs (for bulk mail products, or potentially access products), but would need to meet all the physical requirements of existing products. It is unlikely that the customer would be able to negotiate a contract that would result in prices as low as those that Jersey Post currently pays to Royal Mail. The pre-existing relationship between Jersey Post and Royal Mail may therefore limit the potential for an existing customer to reduce its costs by providing its own postal

services. This could also be true of the relationship that Jersey Post has already established with operators in other countries (e.g. TPG). This is particularly important given the high proportion of costs that relate to these Royal Mail contract costs. Furthermore, a customer would have to invest time and cost to develop an expertise in managing the customs clearance model. This is something that Jersey Post has already developed an expertise in.

The above discussion suggests that brand may be less of an issue for export mailings than for local mailings. However, other operators (including customers that obtain a postal service licence) may find it difficult, at least in the first two years of the price control period, to compete with Jersey Post's pre-existing relationship with Royal Mail and/or to match Jersey Post's expertise in the provision of customs-related services as part of the fulfilment products.

Product assessment

Based on this sectoral analysis, legal barriers to entry are expected to be significant, at least for the short-term, for companies that wish to set themselves up in Jersey for the first time. The legal barriers are less significant for companies already operating in Jersey that choose to apply for a postal service licence (e.g. a large fulfilment customer). Here the key barrier is the need to obtain a licence from the JCRA. The conclusion, therefore, is that legal barriers are significant for the majority of non-priority products except for fulfilment products.

In addition, legal barriers are expected to be low for services which are currently provided by courier companies – with the existence of these competitors indicating that barriers are not insurmountable. This relates to special delivery and signed-for services, to parcel deliveries (the majority of which are expected to be deliveries between businesses), and to international priority mailings.

The importance of economic barriers also varies by type of mailing. Economies of scale may not be as important for operators (including self-supply by a customer) providing postal services for export mailings as they are for operators providing delivery services in Jersey. However, sufficient volumes would be required to reduce the costs associated with conveyance and delivery by another postal operator in the destination country. Furthermore, another operator (including a current postal customer) is unlikely to be able to match Jersey Post's expertise in managing the customs-side of the fulfilment business or to match the prices currently paid to Royal Mail for delivery services.

Therefore, for the period of the price control, it is concluded that economic barriers – particularly Jersey Post's own reputation and pre-existing

relationships with Royal Mail and HM Customs & Revenue - are sufficiently high to limit the ease with which another operator can provide similar services for export mailings.

Based on this analysis, Table 2 provides a list of the services that are expected to have high barriers to entry today and those that are expected to have low barriers to entry today, and/or potentially in the future.

High barriers to entry today	Low barriers to entry today	Low barriers to entry in future
Letter postal services Local letter service Domestic (UK and other CI's letters) European airmail letters International airmail letters (Zone 1) International airmail letters (Zone 2) Airmail postcards International airmail postcards International air letter International pre-paid aerogramme		
Bulk & fulfilment services Local letter bulk mail Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets		**Bulk & fulfilment services** Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets
	Parcel services Local parcel service Domestic parcel service International standard parcel service International economy parcel service	**Parcel services** Local parcel service Domestic parcel service International standard parcel service International economy parcel service
Other services Direct Mail Business reply (UK, IOM and other CI's) Redirection (Residential and business) Standard PO Box Facility Parcel Service PO Box Facility Retention of mail Poste Restante Articles for the Blind Mail to addresses within the British Forces Post Office FreePost (Local and UK)	**Priority services** Signed for (recorded delivery) International signed for (recorded) letter Special delivery	**Priority services** Signed for (recorded delivery) International signed for (recorded) letter Special delivery

Table 2: Barriers to entry by product

Scale of competition

In this section we consider the extent to which Jersey Post faces competition from:

- other postal companies operating within Jersey;
- postal operators in other jurisdictions; and
- other communication media.

Postal companies in Jersey

At present Jersey Post faces limited competition from other postal companies operating in Jersey. UK based catalogue companies have employed island-based agents to deliver catalogue orders on the island, thereby by-passing Jersey Post's delivery network. The scale of this activity is unlikely to be significant relative to all inbound mailings.

The main competitive constraint on the Island comes from courier companies. At present there are over 20 independent courier companies operating on the Island, including DHL, UPS, TNT, Regency, Lynx, Hi-Speed Freight and InterLink Express. These companies offer services similar to Jersey Post's special delivery and 'signed-for' services. Jersey Post has indicated that its Special Delivery Product has a high share of the Jersey to UK market but that it has very little of the Jersey to European/Rest of the World market. However, a number of international companies based in Jersey are participants in global contracts with the international courier companies that provide them with preferential rates for deliveries to the UK and elsewhere.

Courier companies are also expected to act as a constraint on the pricing of parcel services offered to customers, although the impact of that constraint will depend on the differential between Jersey Post's price and the courier's price, and the price sensitivity of the customer base (in particular whether it is mainly residential or business mailers).

Postal companies in other jurisdictions

As noted earlier, a large portion of Jersey Post's mail items are delivered outside of Jersey. It is therefore important to also consider the extent to which Jersey Post currently faces competition from postal operators in other jurisdictions. These operators will compete with Jersey Post if postal customers:

- remain based in Jersey but choose to send their mailings from another country (e.g. a banking customer could get an office in the UK to print off and mail letters to its customers); or

- choose to relocate to another jurisdiction *because* of the potential for lower postal prices[5].

We consider, in the context of the 'customer behaviour' criteria, the extent to which customers are willing and able to switch postal providers. We focus here on evidence provided by Jersey Post on the extent to which operators in other countries have already placed a constraint on their behaviour.

- The JCRA has been advised that two pick and pack customers[6] have migrated to Guernsey and at least two others have opened operations in Guernsey alongside those in Jersey, with the plan to migrate volume out of Jersey. While the 'value added services' provided by OSL business is not part of the price review (and whilst recognising that OSL is due to close at the end of March 2007)[7], the loss of these customers affects volumes handled by the postal services business unit. Furthermore, the JCRA understands that the change in location by these two customers provides an indication that customers could choose to move to Guernsey and continue to benefit from the more lenient LVCR rules there. This would be driven by changes in the treatment of the fulfilment industry in Jersey relative to Guernsey, rather than differences in postal prices or service. It is therefore not evidence of competition in the postal sector itself.
- A number of Jersey mailers have sent mail, which was previously handled by Jersey Post, to the UK for delivery. This, in itself, indicates that the competitive threat has affected Jersey Post's behaviour for bulk mailing products within Jersey and to the UK.

Other media

Jersey Post also faces potential competition from other communication sources. For example, the financial institutions in Jersey are expected to move over time to undertaking an increased proportion of transactions with customers online rather than by post. The impact of these changes is expected

5 It is recognised that a number of fulfilment customers have been requested to leave the island by the States of Jersey (as part of the EDD February 2006 fulfilment policy). This affects Jersey Post's volumes and revenue but is not a consequence of competitive pressure in the postal market. As such, these customer movements do not affect the competitive assessment for the decision on the scope of the price control.

6 There are two categories of fulfilment companies; one is a 'Third-Party Service Provider' ('3PS'), which is provided by Offshore Solutions Limited ('OSL'), although Jersey Post is in the process of closing down this operation. The other is Jersey Post Logistics, which provides the transport logistics on behalf of all fulfilment companies based on the Island. OSL allows fulfilment companies access to 'pick and pack' services and is designed to encourage fulfilment business to operate from the Island. Jersey Post provides the warehousing and logistics functions on behalf of these companies.

7 Announced by Jersey Post on 5 January 2007.

to take some time to emerge, however, and is not likely to be significant during this price control period.

Product assessment

The evidence provided by Jersey Post suggests that fulfilment products, and other bulk mailings, may be somewhat constrained by competition from postal operators in other jurisdictions. However, no evidence has been provided to suggest that Jersey Post's share of the fulfilment business from Jersey has been significantly eroded. It is therefore concluded that, to date, the scale of competition for fulfilment products is low. This may change over the course of the price control however, with an increase in the scale of competition.

Jersey Post's special delivery, signed for, international priority services and parcel services face competition from courier companies operating on the Island. The extent of competition faced by other products is limited however. These conclusions are summarised in Table 3.

Scale of competition low today	Scale of competition high today	Scale of competition high in future
Letter postal services Local letter service Domestic (UK and other CI's letters) European airmail letters International airmail letters (Zone 1) International airmail letters (Zone 2) Airmail postcards International airmail postcards International air letter International pre-paid aerogramme		
Bulk & fulfilment services Local letter bulk mail Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets		**Bulk & fulfilment services** Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets
	Parcel services Local parcel service Domestic parcel service International standard parcel service International economy parcel service	**Parcel services** Local parcel service Domestic parcel service International standard parcel service International economy parcel service
Other services Direct Mail Business reply (UK, IOM and other CI's) Redirection (Residential and business) Standard PO Box Facility Parcel Service PO Box Facility Retention of mail Poste Restante Articles for the Blind Mail to addresses within the British Forces Post Office FreePost (Local and UK)	**Priority services** Signed for (recorded delivery) International signed for (recorded) letter Special delivery	**Priority services** Signed for (recorded delivery) International signed for (recorded) letter Special delivery

Table 3: Scale of competition by product

Customer awareness and behaviour

The extent to which a customer may consider using an alternative to Jersey Post for the delivery of mail items will depend on the price sensitivity of the customer. In general:

- residential customers would not be expected to consider switching given the low proportion of total expenditure that is related to postage stamps;
- small and medium-sized businesses are relatively unlikely to switch, particularly as they may not be able to avail themselves of any volume-related discounts offered by other operators; and
- large businesses are more likely to consider a range of options for delivering postal items to other businesses and to their customers.

Given this, we focus here on the switching behaviour of Jersey Post's large bulk mailers – both fulfilment customers and other customers (e.g. large financial institutions).

As noted above, a number of Jersey-based customers have already switched from Jersey Post to Royal Mail for the delivery of items to Jersey and the UK (without moving location themselves). In addition, other customers have indicated that this is an option that they may consider in the future. This suggests that large mailers are willing, and able, to switch from Jersey Post for items that can be easily printed and mailed from another location. It is unlikely that this option is readily available for many items. For example, we understand that some Jersey-based financial institutions consider it important that overseas clients with Jersey off-shore tax status received mail with a Jersey post mark.

The option of switching postal supplier by moving location appears to be less prevalent. In particular, customers are not expected to change their location *because of* the price of postage. Other factors may affect this decision. For example, one large fulfilment customer emphasised that it had historical links with Jersey that would constrain any decision to move. Indeed, the costs of relocation would have to be balanced against any savings in postage costs. Furthermore, fulfilment customers could be restricted in the locations that they could move to if they wish to avail themselves of fulfilment benefits.

In principle, a large customer could switch away from Jersey Post and provide its own postal services (having obtained a licence to do so). It is expected that large fulfilment customers would be in a position to do this. However, as noted above, they may not be able to compete on price at present given the prices currently paid by Jersey Post to Royal Mail. Furthermore, as the liberalised market is in its infancy it may take some time for customers to understand the extent to which this option is available to them.

As with the other criteria, the existence of courier services suggests that there is customer switching across service providers for special delivery, signed for, parcel services and international priority mailings. Based on this analysis, Table 4 summarises the conclusions on customer awareness and behaviour by product.

Low customer ability and/or willingness to switch today	High customer ability and willingness to switch today	High customer ability and willingness to switch in future
Letter postal services Local letter service Domestic (UK and other CI's letters) European airmail letters International airmail letters (Zone 1) International airmail letters (Zone 2) Airmail postcards International airmail postcards International air letter International pre-paid aerogramme		
	Bulk & fulfilment services Local letter bulk mail Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets	**Bulk & fulfilment services** Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets
	Parcel services Local parcel service Domestic parcel service International standard parcel service International economy parcel service	**Parcel services** Local parcel service Domestic parcel service International standard parcel service International economy parcel service

Other services	Priority services	Priority services
Direct Mail Business reply (UK, IOM and other CI's) Redirection (Residential and business) Standard PO Box Facility Parcel Service PO Box Facility Retention of mail Poste Restante Articles for the Blind Mail to addresses within the British Forces Post Office FreePost (Local and UK)	Signed for (recorded delivery) International signed for (recorded) letter Special delivery	Signed for (recorded delivery) International signed for (recorded) letter Special delivery

Table 4: Customer switching by product

Effectiveness of competition

An assessment of the effectiveness of competition is only relevant for those services that are constrained by existing competition or potential entry (i.e. with low barriers to entry and customer willingness and ability to switch).

The analysis suggests that special delivery, signed for, parcel services and international priority mail services face competition from courier services. There are over 20 courier companies in Jersey, and particularly given the size of the island, it is expected that these operators place a constraint on Jersey Post's pricing behaviour for these products. Competition is therefore expected to be effective for these products.

In addition, bulk and fulfilment products (to the UK and the rest of the world) face some competition from postal operators in other jurisdictions and there is evidence that customers are willing to switch away from Jersey Post. However, the scale of competition is not considered significant at this stage and the economic barriers to entry are considered to be high for the current price control period:

- Jersey Post retains a large share of the fulfilment traffic from Jersey;
- it is unclear the extent to which competition in the postal market itself is affecting customer decisions; and
- other operators (including postal customers themselves) could find it difficult to obtain prices from Royal Mail that are similar to those offered to Jersey Post for the period up to 2009.

Therefore, whilst competition is emerging, it is not expected to be effective in constraining Jersey Post during the price control period. This is an area that may require reassessment during the next price control review.

For all other products, competition has not yet emerged and is not expected to develop significantly over the price control period. Effective competition is therefore not expected to arise. This suggests, in itself, that regulation may be required for these products, at least for the current price control period.

Summary of product-by-product assessment

This (necessarily) high level of review suggests that it is reasonable to categorise Jersey Post's potentially regulated services into three categories:

1. *Non-competitive:* Services that are not subject to competition and are unlikely to become subject to competition during the price control period. This is because they face high barriers to entry, there is no entry or competition from other jurisdictions and customer ability and willingness to switch is limited.
2. *Borderline:* Services that are subject to some competition but the effectiveness of that competition is expected to be limited over the course of the price control period. Over the course of the price control, it is expected that barriers to entry will be surmountable by potential entrants and customers will be willing to consider switching to alternative mailing services.
3. *Competitive:* Services that are currently subject to effective competition, with low barriers to entry, an existing competitive base at present, and customer ability to switch.

The products that fall into each category, based on the analysis described above, are shown in Table 5 below.

Non-competitive	Borderline	Competitive
Letter postal services Local letter service Domestic (UK and other CI's letters) European airmail letters International airmail letters (Zone 1) International airmail letters (Zone 2) Airmail postcards International airmail postcards International air letter International pre-paid aerogramme	**Bulk & fulfilment services** Local letter bulk mail Bulk Letter priority to UK (Sea) (J+3) Bulk Letter Economy to UK (Sea) (J+5) Bulk posting (Residue) to UK (Sea) (J+5) Palletised packets International letters, flats and packets	**Parcel services** Local parcel service Domestic parcel service International standard parcel service International economy parcel service
Other services Direct Mail Business reply (UK, IOM and other CI's) Redirection (Residential and business) Standard PO Box Facility Parcel Service PO Box Facility Retention of mail Poste Restante Articles for the Blind Mail to addresses within the British Forces Post Office FreePost (Local and UK)		**Priority services** Signed for (recorded delivery) International signed for (recorded) letter Special delivery

Table 5: Product-by-product competition assessment

Explanatory note on issue 2

Comparison of revenue and tariff controls

There are two basic forms of control: the formulae can either set limits for revenue (usually by means of a control on average revenue) or for tariffs (through a tariff basket control). It is important to note that neither form of control sets a limit on the prices charged for individual products, except in the extreme case where a separate control is set for each individual product. Instead the company is given the freedom to rebalance prices within the regulated control so long as overall the revenue earned is no more than the permitted allowed revenue. Consequently, further limits on tariff rebalancing may be required, and these are discussed later in this section.

We discuss revenue based and tariff based price controls in turn.

Fixed revenue control

At the simplest level, the JCRA could take the revenue that it has calculated is sufficient for the company to carry out its activities efficiently and set the control so that the company can recover this revenue. This is known as a fixed (or total) revenue control. However, this form of control is rarely used since the revenue that the company can recover is unaffected by any difference between forecast and outturn volumes. It therefore provides a strong incentive for the company to reduce output since, providing a proportion of its costs are variable, it will increase profits by reducing its volumes within any control period.

Average revenue control

Given this drawback of a fixed revenue control, it is more common for the form of the control to be based on average revenue. In such a control, total revenue divided by total output – the average revenue – of the firm is constrained to be no greater than a fixed price cap. The measure of output used as the denominator is chosen to reflect the particular cost driver of the business. In the case of Jersey Post, output would be defined as the number of mail items. An average revenue control has a number of advantages.

- It is relatively simple to administer: in its simplest form, a single value for average revenue can be set within the licence to be adjusted by the RPI-X formulae.
- It will provide an incentive to grow volumes if the allowed average revenue exceeds the marginal cost of expansion. Although this may be deemed to be a disadvantage for certain industries (such as electricity distribution where concerns about energy efficiency may be raised) it may be considered an advantage in other sectors.

- It is relatively easy to include new products into an average revenue control within a control period. In addition, because it is a control on revenue rather than price, it is also flexible enough to cope with any fundamental change to the structure of prices (such as a move from weight to size based pricing) that may occur after the control has been set.

This type of control has been used in a number of industries in the UK, for example airport charges are based on the total revenue per passenger an airport can earn each year. However, there are potential disadvantages associated with this type of control:

- When the company sets its prices at the start of a year, it must do so on the basis that those prices, together with the forecast of volumes, will result in the average revenue not exceeding the cap that has been set. Because volumes are not certain when prices are set, it may be that actual average revenue differs from the cap. A correction factor is therefore normally applied to return any over-recovery, or collect any under-recovery, in the following year of the control, together with an adjustment for interest to be paid on that money in the intervening period. In order to provide companies with an incentive to forecast correctly, a lower interest rate may be applied to under-recovered revenue than it is to over-recovered revenue[8].
- Fixing the average revenue for a group of products allows significant scope for the company to rebalance tariffs whilst still meeting the overall cap. However, as we discuss below, additional constraints can be placed within the form of control to limit the scope for such rebalancing.
- Applying a single average revenue to a set of diverse products of different value and cost may not be appropriate. In particular, it will be likely to result in an incentive for firms to reduce volumes of higher cost products and increase volumes of lower cost products, since they both attract the same allowed average revenue. Even if the company cannot influence volumes, it may still face a risk of revenue dilution through the unexpected loss of lower cost volumes or benefit from revenue enhancement if it is above average cost volumes that are being lost. This problem can be reduced by using different average revenues for groups of products of different value. This is known as a weighted average revenue control.[9] At the extreme, a separate average revenue can be set for each product[10]. This is effectively the control that Postcomm has set for Royal Mail.

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8 For example, interest is paid at base rate plus 4% for an over-recovery and at base rate for an under-recovery within Royal Mail's control.

9 This is the approach used in the UK electricity distribution price control. This form of control was put in place to protect distribution companies from the potential loss of cheaper high voltage customers.

10 In this way, the control is similar to the tariff basket control although it is based on actual volumes rather than historic volumes.

Tariff basket control

This form of control is based on restricting the average of prices for a grouping of products. In particular, prices have to be set so that the weighted average price is no more than the overall price ceiling that has been set. The weights that are applied to the products are usually historic, and are often based on the percentage of total turnover of each individual product.
The advantages of such a control are as follows:

- If the weights are based on historic data, prices can be set with certainty at the start of the period with no requirement for a correction factor.
- If the tariffs reflect the costs of the products, there is less risk that the company may have an incentive to reduce volumes for high cost products compared with a simple average revenue control.

The telecommunications sector in the UK has tended to be regulated through the application of a tariff basket control. However, there are disadvantages with this control:

- A tariff basket control can be complex given the need to include multiple products, and their base level prices, within the control formulae.
- Although the control is based on individual tariffs, it does not prevent the company rebalancing tariffs within the overall control. For example, a 5% increase in the price of an item which contributed 10% of the revenue would contribute the same to the weighted total as a 10% increase on an item that contributed only 5% of its revenue. Regulatory oversight, or further restrictions on rebalancing, may therefore still be required to prevent unacceptable changes to the structure of charges.
- One of the main disadvantages of this type of control relates to difficulties in incorporating new products within a control period. This is because there is no existing weight to apply to that product within the basket. In addition, the control will need to be changed if there is any fundamental change to the structure of charges as the base prices will need to be reset.
- The tariff basket approach may give incentives to set higher prices for those products where volumes are increasing most rapidly (assuming that the weights are based on historic values and the higher prices do not stop the increasing volumes).

Rebalancing restrictions

We have noted that the form of control will still provide a company with a certain amount of discretion to rebalance tariffs whilst still meeting the overall control. The JCRA could take the view that the price control will just be used to control the overall level of revenue that the firm is able to obtain and that it will regulate the structure of charges as a separate exercise. This is the approach that has been favoured by Ofgem. However, additional constraints

could be included within the form of control to restrict Jersey Post's freedom to rebalance prices without the JCRA's prior approval. This should reduce the amount of work that the JCRA has to undertake on assessing proposals for rebalancing tariffs within a control period and provides Jersey Post with some guidance about what changes in the structure of tariffs are deemed to be acceptable without the requirement for additional evidence.

Some rebalancing of tariffs may be appropriate to bring prices more closely into line with costs. However, there is a need to balance the freedom of Jersey Post to determine its structure of charges with a recognition that it has a dominant market position and could use such freedom to the detriment of customers and competitors. In particular, since competition will not necessarily develop at the same speed during the price control for every product within the control, there may be a concern that Jersey Post could reduce prices for products that faced competition and recover the lost revenue by raising the price of products to captive customers, even if this were not related to costs. Additional constraints on tariff rebalancing may therefore be required.

We have already discussed in Explanatory Note 1, that the JCRA proposes to have two separate controls, one for fulfilment products and one for other price regulated products. We noted that this may prevent Jersey Post from rebalancing prices between these groups of products. In addition, further restrictions could be placed on rebalancing tariffs within each separate control, given that we cannot be certain that competition will develop at the same speed for all products within each separate control.

By way of a reference case, the first control on Royal Mail allowed Royal Mail to increase any individual price within the tariff basket by up to 2.5% above the average price change each year, without Postcomm's prior approval, providing it made corresponding price reductions on other products in order to stay within the overall cap. The second control raised this threshold to 3%[11], with a supplementary restriction to prevent the universal service basic stamp price from increasing by more than 2p in any year. Similar restrictions could be placed on Jersey Post.

11 Postcomm also introduced a limit to the number of years over which rebalancing thresholds could be applied to the subsequent year only. This would prevent Royal Mail carrying over the threshold and making large one-off changes in the later years of the price control.

Explanatory note on issue 3

A forward-looking price cap should be set to allow the regulated company to earn sufficient revenue to fund the expected efficient costs of providing the services covered by the control and required by law. Allowed revenue can be calculated in two ways, with the main difference arising in the treatment of capital expenditure.

- The cash flow approach sets allowed revenue in each year equal to the sum of operating expenditure, capital expenditure and a margin on turnover for that year. Such an approach was used for the first Royal Mail price control.
- The Regulated Asset Base (RAB) approach sets allowed revenue in each year equal to the sum of operating expenditure, depreciation and a return on a regulatory asset base (RAB) for that year. This method has been commonly used in price controls for industries with long-lived assets, such as the energy network businesses.

The advantages and disadvantages of each methodology are considered here, and a conclusion reached on the appropriate option to use for the calculation of Jersey Post's price control.

Cash flow approach

Under the cash flow approach, customers fund expected operating expenditure and capital expenditure in the year that it is expected to be incurred at the time the price control is set. This has implications for investment incentives, prices, efficiency and return to shareholders. We assess each of these factors in turn. Practical considerations for calculating the price control using this approach are then discussed.

Investment incentives

Because capital expenditure is funded when it is incurred – 'pay as you go' - a regulated company has certainty that the full cost of investment will be recouped, once it has been included within the regulator's estimation of allowed revenue. Therefore, providing the investment is included in the regulator's forecast of capital spend within a price control period, there is little residual risk that the asset will subsequently be stranded. Such concerns would be most acute for investment projects that take a number of years to undertake and that relate to assets that have a long-life.

The cash flow approach finances expected efficient expenditure, rather than actual expenditure. As discussed below, this is to the company's benefit if expenditure is below expectations. However, if expenditure exceeds expectations the company bears the risk of the overspend. In particular, the cash flow approach has no clear mechanism within it for allowing the company to recover the cost of any expenditure that it may have incurred

within a control period that was not forecast when the control was set. It would be possible to introduce specific mechanisms that trigger changes in the control to allow for unexpected investments to be funded (assuming they are considered to be efficient by the JCRA) but it would add complexity to the arrangements and could result in additional work for the JCRA within the control period.

Prices

The impact of cash flow financing of capital expenditure on prices, will depend on the scale and cyclicality of the investment programmes. If capital expenditure is a significant proportion of total costs (and hence allowed revenue), and if projects are lumpy in nature, this methodology can result in price volatility within a regulatory period and/or across regulatory periods.[12] In contrast, if capital expenditure is a small proportion of allowed revenue and/or the level is similar from year-to-year, volatile prices are less likely to emerge.

Efficiency

Incentives to improve cost efficiency are strong under the cash flow approach. If the company delivers a capital expenditure project for £1m less than had been forecast, it gets to retain this benefit during the control period. This provides an incentive that is equivalent to any one-off opex efficiency saving[13].

Return to shareholders

With the cash flow approach, shareholders are provided with a margin on turnover. This is expected to provide them with a return, or ‘insurance’, to compensate for the risks that they face during the regulatory period. The risks relate to adverse shocks that the firm may experience within a control period that could lead to an increase in costs (for example through higher than expected wage demands) or reduced volumes (for example through the loss of fulfilment volumes due to changes in the tax regime). The extent to which shareholders need to be compensated for such risks will depend on the degree of exposure that the company faces. The regulatory regime can, in part, manage this exposure. For example, volume adjustment mechanisms can be included in a price control to limit exposure to volume shocks.

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12 In core network industries (e.g. energy distribution and water and sewerage services), capital expenditure is 50-60% of total costs. In contrast, Jersey Post’s annual capital expenditure is in the region of 5-10% of total cost. The impact of capital expenditure on prices will clearly be different in these sectors. Furthermore, asset lives are long in the core network industries (e.g. 50 to 60 years for pipes), implying that large levels of enhancement expenditure will be required at discreet points in time.

13 For ongoing opex or capex efficiency savings the firm would expect to retain the benefit until the next price control review when it would expect the efficiency to be reflected in lower opex or capex forecasts going forward.

An appropriate margin will therefore provide shareholders with an adequate return to compensate for the risks that they face. However, there is no requirement to provide a return to finance long-term investments given that expenditure is financed as it is incurred.

Practical implications

Calculating allowed revenue using the cash flow approach requires data on:

- annual efficient operating expenditure;
- annual efficient capital expenditure;
- annual turnover; and
- a margin on turnover.

Data on each parameter needs to be available for the set of products included in each of the proposed price controls.

Under this approach, assumptions must be made about the appropriate margin to be allowed on turnover and about the efficiency factor that will be applied to operating expenditure and capital expenditure forecasts going forward. The proposed approach for Jersey Post's price control is presented here.

- *Efficiency*– the price control model includes an efficiency assumption for operating expenditure and capital expenditure. The model allows for the implications of changing this efficiency assumption to be assessed.
- *Margin on turnover* – one could regard the margin as being analogous to a premium that an insurer would require to provide risk compensation to the shareholders of a business that faces comparable risks. An assessment of margins allowed by other regulators in similar industries is used to provide evidence about the required margin for Jersey Post. Again, the model allows for the impact of changing the margin to be assessed.

Data provided by Jersey Post on operating expenditure, capital expenditure and turnover (assuming it relates to the products in each control) can be used as the opening position in the price control model to calculate allowed revenue using the cash flow approach. The future values of each variable may differ to Jersey Post's forecast, depending on the efficiency improvement assumed and the allowed margin on turnover.

RAB approach

With the RAB approach, operating expenditure is financed on a 'pay as you go' basis (i.e. cash flow) but capital expenditure is financed over the life of the assets that the investment relates to. For example, if there is an investment in a gas pipe that has a useful economic life of 50 years, the capital expenditure will be financed over 50 years. Under this approach, shareholders can expect

to earn both a return of the investment (depreciation charge) and a return on the investment (cost of capital times the RAB) for the life of the asset.

The RAB is calculated as an opening asset value plus expected efficient new investment less depreciation of the asset base. At each price review, expected capital investment in the previous regulatory period is replaced with actual efficiently incurred investment.

The impact of this approach on investment incentives, prices, efficiency and shareholder return are discussed here.

Investment incentives

When investments are funded over the life of the asset, companies bear the risk that regulators will not provide the required funding in later years. For example, the allowed cost of capital could be reduced below the actual borrowing rate at a future price review. This risk may dissuade companies from undertaking an investment in the first place, particularly where the asset has a life significantly in excess of the length of the price control. However, since the regulator may be more likely to remunerate investment that has been incurred, but was not forecast, in a future control period (through the adjustment to the RAB described above), it may mean that a company is more likely to make such investments under this methodology.

Prices

As noted above, prices under the cash flow approach will be volatile if capital investments are large and lumpy. The RAB approach reduces this volatility by providing companies with a smoothed depreciation profile over the life of the asset. This is particularly important when the investment costs are large and lumpy.

Efficiency

The incentives to reduce operating costs are similar under the cash flow and RAB approach. However, the incentives to reduce capital expenditure are likely to be lower with the RAB approach. This is because the company retains only the depreciation and return on the saving, rather than the entire value of the saving, up to the next price review. Furthermore, because operating costs and capital investment are treated in different ways, input choices may be distorted by the use of the RAB methodology, unless it is properly applied.

Return to shareholders

In principle, the company should recoup the full cost of the investment under the cash flow and RAB approaches (in net present value terms). However, with the RAB approach shareholders face cash flow costs during the investment programme. In particular, expenditure will exceed revenue in the early years, but will be lower towards the end of the asset's life. This means that in any given year, the company's accounts may show a loss (i.e. the depreciation charge will be less than actual capex spend). Shareholders will therefore have to meet the costs of financing this profile of cash flow, and the risks associated with it.

The allowed cost of capital determined by the regulator therefore has to reflect the risks of both equity and debt providers, and is expected to compensate shareholders for the non-diversifiable risks faced by the business. Again, the risks can be managed, to some extent, by the precise nature of the regulatory regime. The cost of capital may be different to the allowed margin on turnover, as a return is provided for upfront financing of investment as well as for compensation for the risks that are faced. Furthermore, the risks under the RAB and cash flow approaches may be different, requiring different levels of compensation.

Practical considerations

Calculating allowed revenue using the RAB approach requires data on:

- annual efficient operating expenditure;
- the RAB value at the start of the price control period (opening value) and the average economic life of assets;
- annual efficient capital expenditure; and
- the cost of capital.

Data on each parameter (apart from the cost of capital) needs to be available for the set of products included in each of the proposed price controls.

The three key challenges here are the determination of the opening value of the RAB, the calculation of the appropriate cost of capital and the determination of efficient operating and capital expenditure.

- *Opening asset value* – when a price control is first introduced, a decision must be made on the appropriate opening value of the asset base. A number of options have been used by regulators including the market value of assets (for listed companies), the book value of assets and the modern equivalent asset value. In addition, regulators must determine whether the asset lives used in a company's accounts are appropriate. If it is found that they are not, adjustments to the accounting value will be required to reflect alternative asset life assumptions.

- *Cost of capital* – regulators generally calculate the required cost of capital using the Capital Asset Pricing Model (CAPM). In many sectors, and jurisdictions, the value used is based on a review of regulatory precedent, particularly where stock market data is not available for the company concerned. The downside of such an approach is that comparisons will need to be made with companies that do not face identical risks.
- *Efficiency* – the efficiency improvement assumption can be calculated in the same way for the RAB approach as was suggested for the cash flow approach, although it could be argued that expected capex efficiencies will be greater under the cash flow approach given the stronger incentives the methodology provides to reduce capital spend.

Proposals

Based on the above analysis, it is proposed that the cash flow approach is used to calculate allowed revenue for Jersey Post.

- Relative to total expenditure, capital investments are small and asset lives are, in general, short. For Jersey Post, capital expenditure typically represents in the region of 5-10% of total expenditure in a year. This compares with a figure of approximately 55% for a water and sewerage company. In addition, capital investment in the water and sewerage industry is in the pipeline network or in long-lived assets such as treatment works or reservoirs. These are assets with assumed economic lives of 50 to 60 years. In contrast, many of the assets in the postal sector (e.g. IT, vans, etc) have much shorter asset lives – in general around 5-7 years. Therefore, there is less reason to be concerned that a cash flow approach will result in volatile prices in this sector[14].
- Shareholders are provided with investment certainty and strong efficiency incentives.
- The data required to determine allowed revenue should be easier to source than it would be if a RAB approach was adopted.

The investment plans that have been identified by Jersey Post for the three year control period do not contain any investments that we consider cannot be financed within the proposed price control period. We therefore consider that it may be appropriate to apply the cash flow approach for this control period. If in a future control period an investment was required that would be expected to have a material impact on price trends if treated under the cash flow approach, then the JCRA may want to consider applying a hybrid approach. This could incorporate all other investments on a 'pay as you go'

14 Property owned by Jersey Post is an asset category that could be considered to have a long asset life. However, the market rental price of the property can be included in the operating expenditure category. This is a simpler approach to use for property, as it ensures that the property in a RAB does not need to be revalued at each price review (to take account of market changes and property disposals and acquisitions).

basis but funding of the identified large capital programme through a depreciation charge and a return on the asset value (investment cost) for the duration of the asset life.

Explanatory note on issue 4

The JCRA has to determine the period over which the price control will apply before it needs to be re-set. The decision on the appropriate length of the control period requires a balance to be reached between a number of conflicting objectives. These include:

- the provision of efficiency incentives;
- the need to share efficiency savings with customers (and realign prices with costs); and
- the management of uncertainties and risks faced by shareholders.

As a practical matter, there should also be some recognition of the limitations of current information availability. Further, the JCRA needs to determine when the control will commence and whether an adjustment should be made for the first year so that the control year will in future start on 1st January. These issues are discussed in turn and we present our proposals at the end of this explanatory note.

Efficiency incentives

Efficiency incentives will be stronger the longer the duration of the price control. This is because the regulated company will be expecting to retain the benefit of any cost savings that it achieves for longer, resulting in a higher expected net present value of these savings.

In practice, it is not possible for the JCRA to know how the savings made by a company might be expected to differ as the retention period changes. However, while savings are comparatively easy to find, for example in the period immediately following the introduction of an incentive control, a relatively short retention period is likely to be enough to stimulate efficiency savings. However, a control period of two years or less is unlikely to provide much incentive for a company to reduce its costs, particularly given that the JCRA would need to start the process of reviewing the control almost immediately after the original control was set.

Sharing efficiency savings with customers

Regulators generally pass the benefits of achieved efficiency savings onto customers at the time of the next review, both for equity reasons and to ensure that prices are realigned with actual costs. The negative consequence of lengthening the control period to provide a regulated company with the incentive to make efficiency savings is therefore that customers will be paying prices that reflect costs higher than actual costs for longer.

If the sharing of efficiency savings takes place at the time of the price review, then a shorter control period is preferable if the realignment of prices to costs is a priority. However, it should be noted that customers may be better off with a longer control if this means that over time prices are lower because of the stronger efficiency incentives. Unfortunately, in practice, it is not possible for the regulator to know what this optimal retention period might be. It should also be noted that mechanisms could be designed that share efficiency savings automatically with customers during a regulatory period, or that allow the retention of cost savings for periods that may exceed the end of the control period.[15]

Management of risks and uncertainties

Price controls are forward-looking in nature and are therefore based on assumptions about future costs and volumes. There will, inevitably, be some uncertainty in the determination of these forecasts, resulting in differences between actual and expected values during the regulatory period. This may result in prices and costs falling out of line during the regulatory control period for reasons other than because unforeseen efficiency savings have been achieved.

There are a number of ways that a regulator can deal with exogenous shocks and uncertainties in the regulatory regime.

- Mechanisms could be put in place that allow for a price control to be reopened if the company suffers a significant shock that jeopardises its finances. The provision in Jersey Post's licence that allows them to request a review of prices if it is found that they cannot fund the USO is an example of such a mechanism.
- Automatic adjustments can be included in the price control formula, to enable allowed revenue to change in response to the movement of selected parameters. For example, the control could be designed to permit an automatic adjustment to be made to allowed revenue if actual volumes differ from forecast volumes by a specified percentage.
- The shareholder (i.e. the States) can be provided with an insurance 'buffer' to cover them for the risk of unexpected exogenous shocks. The margin on turnover in the cash flow methodology provides this insurance.
- A short regulatory period can be used, so that volume and cost allowances can be adjusted to reflect actuals within a short space of time.

A longer control may therefore need to be balanced with the introduction of additional regulatory mechanisms to balance the sharing of risks between shareholders and customers.

15 For example, the mechanisms introduced by Ofwat and Ofgem to allow the rolling-retention of efficiency savings for a 5-year period, regardless of the year of the control in which the saving was actually made.

Information availability

Jersey Post has indicated that it cannot provide forecast data beyond 2009 and even considers that the data provided for 2009 highly uncertain. There are also concerns about whether the quality of current data provided by Jersey Post is sufficient to allow cost allocations to be made to individual products given that the ABC model is in its infancy and has not yet produced costs for a full year. Furthermore, Jersey Post has indicated that it may wish to introduce further fundamental changes to its structure of charges within the next few years.

These issues mean that there may be a case for having a relatively short initial control, to allow time for the quality of information on which to base the control to be improved and to enable any fundamental change to the structure of charges to be developed.

Volume uncertainty

Jersey Post's costs and revenue both vary with the volume of mail being handled, and unexpected changes in the volumes of mail handled by Jersey Post within the price control period could result in windfall gains or losses to the business.

By their very nature, volume forecasts are unlikely to equal actual out-turn volume and this can be the benefit or detriment of the company. For example, Royal Mail benefited from significant increases in volumes relative to forecast during their first price control period.

Under the weighted average revenue control, average revenue will adjust in line with the change in volume. At the same time, costs will vary with volume variation. The extent of the cost difference will depend on the proportion of costs that are considered fixed. The price control model assumes a volume to cost ratio of 0.5 for controllable costs (assuming 50% of costs are fixed and 50% are variable). The ratio of volume to Royal Mail charges is 1 (i.e. a 10% increase in volume leads to a 10% increase in Royal Mail charges). At the end of any year of the price control period there may be a difference between the allowed revenue determined by the weighted average revenue control and the revenue required to recover actual efficient costs. This is the risk that arises from variation between actual and forecast volumes.

It is appropriate for the benefits and risks of variation between actual and forecast volumes to be shared between customers and the company. This provides regulatory certainty and can be designed to ensure that the party best able to manage the risk bears the risk. The mechanisms that could be introduced to manage the sharing of this volume risk and this risk is expected to manifest itself in two ways.

- General trends in postal sector growth, competition developments, and minor changes in the LVCR rules will result in differences between actual and forecast volumes.
- Policy decisions – within Jersey or by the UK Treasury – will remove or significantly alter the LVCR rules, ultimately resulting in the demise of the fulfilment industry.

The JCRA proposes that different mechanisms are used to manage these two situations.

- An automatic volume adjustment should be included in the control formula to allow for manageable variation between actual and volume forecasts to be taken into account at the end of each year. It is appropriate to set a minimum threshold on the size of the variation that would trigger the adjustment. We discuss below how this threshold could be determined.
- A licence condition could be introduced, alongside the control, which specified that the control would be reopened during the regulatory period if the extreme situation of the LVCR being removed, or significantly altered, arose. We discuss below how this reopening could work.

Together these two mechanisms could reasonably be expected to be sufficient to manage any volume risks that Jersey Post faces, and to enable customers to benefit from any up-turn in volume relative to the forecasts used in the price control determination.

Automatic volume adjustment

A volume adjustment mechanism can be included in the price control formula, to automatically change the allowed revenue in any year to reflect variation in volume growth. The adjustment would be triggered if actual volumes were higher or lower than the forecast volumes plus a specified margin. The margin is introduced to reflect the amount of risk that the company could be expected to manage itself. A separate adjustment factor could apply to each of the controls for postal services and fulfilment services.

Postcomm uses a threshold of 2% above or below assumed volumes for the volume adjustment mechanism in Royal Mail's licence. This reflects an assumption that Royal Mail is able to manage volume variation inside this threshold. It is proposed that a similar threshold is used by the JCRA for Jersey Post. Our review of the sensitivity of Jersey Post's financial position to changes in volumes suggests that variation within this threshold would not have a significant adverse affect on the company.

For the postal services control, if volumes are 2% higher or lower than forecast, the control could be adjusted to allow Jersey Post to keep 50% of the revenue difference arising from the volume variation. This reflects the assumption that on average 50% of costs are fixed and 50% are variable, resulting in a 10% increase in volume leading to a 5% increase in costs.

Similarly, Jersey Post would be compensated for 50% of the loss in revenue arising from volumes being lower than forecast.

For the fulfilment control, if volumes are more than 2% higher or lower than forecast, the control could be adjusted to allow Jersey Post to keep 75% of the revenue difference arising from the volume variation. This reflects the assumption that 75% of the costs of the fulfilment business are variable, reflecting the significant proportion of costs that relate to Royal Mail charges for this business. Similarly, Jersey Post would be compensated for 75% of the loss in revenue arising from fulfilment volumes being lower than forecast.

The adjustment could be applied in arrears at the end of each year of the price control period. The JCRA may need to introduce a specific element in the price control formula to explain how the adjustment would arise. Once the control had been designed, however, the adjustment would be automatic, requiring no intervention from the regulator other than the cross-check each year that the control had not been breached.

Re-opening the control

The JCRA believes that Jersey Post's viability may be jeopardised if the fulfilment industry was removed – as a result of the Jersey Government or the UK Treasury removing or significantly changing the LVCR rule – and the proposed price control was retained. This event would be outside of the company's control and it seems appropriate to introduce a specific mechanism to manage the risk of this extreme event arising.

As the fulfilment and postal services businesses are included in separate price controls there is no scope for rebalancing across the businesses under the current proposals. In general this is appropriate, given the need to limit the risk of rebalancing endangering the development of competition in the fulfilment sector. However, if the fulfilment business is significantly reduced, it is expected that Jersey Post's ability to finance the provision of existing services could be in danger.

The JCRA therefore proposes introducing a condition in the licence that specifies that the price control would be re-opened in the event that the LVCR rule was to be removed or changed significantly. The condition would be carefully worded to ensure that it only applies for extreme policy driven changes. Ongoing changes in the market would be addressed through the automatic volume adjustment factor in the price control. Furthermore, Jersey Post is also protected by the licence condition that requires a review if it is unable to finance its USO.

The re-opening condition would trigger a new price review at the time that the JCRA was certain the event was going to occur. For example, the review could be triggered when an announcement had been made with a specified

timetable for any changes. The review would be expected to cover all aspects of a price review, including the re-evaluation of the scope of the control, volume forecasts, required expenditure and the allowed margin. The JCRA could also need to consider at the time the appropriate length of the revised control, particularly if there is uncertainty about the exact impact of the change in the LVCR rules.

Explanatory note on issue 5

The price control is set to ensure that Jersey Post earns sufficient revenue to finance the efficient provision of the following:

- products and services provided by Jersey Post's postal services business unit;
- products and services provided by Jersey Post's fulfilment business unit; and
- the net loss associated with the retail services business unit.

Margin on turnover

Under the cash flow methodology, a regulated company is allowed to earn a margin on turnover, in addition to operating and capital expenditure being financed on a 'pay as you go' basis. The margin is provided to compensate the shareholders for managing any remaining risks that the company faces.

Jersey Post's required margin

The JCRA has obtained information on the margin on turnover (or 'mark-up' on costs) allowed by regulators in other sectors. The focus is on other regulated industries with low levels of capital expenditure. Specifically, we review cases in the postal, energy supply, broadcasting and telecommunications sectors. It is recognised that the specific risks faced by these businesses may vary from those faced by Jersey Post. However, the review of other regulatory decisions provides an indication of the range of margins that is considered appropriate.

For example, the Office of Utility Regulation in Guernsey ('OUR') is a useful comparator. In its decision to cap postal price for Guernsey Post until 2010, the OUR has determined that proposed margins for the company's price controlled business for the period 2006/07 – 2009/10, should be the following:

	06/07	07/08	08/09	09/10
Margin	2%	2%	5%	6%

Source: www.regutil.gg/utility/post

Similarly, comparing the margins earned by other small island postal operators such as Malta Post and Isle of Man Post produces the following:

Malta Post 3.7% (2003)
Isle of Man Post 2.3% (2004)
Source: www.maltapost.com/www.iompost.com

By way of further comparison, Table 12 below provides a summary of the allowed margin decisions made by regulators across a range of sectors.

The margin varies from 1.5% to 5%, depending on the case being considered. In all cases, the margin is expressed on the basis of profit before interest and tax. Where a regulator has allowed a margin above 3%, in the case of the South Australia Electricity Supply sector, specific company risks (relating to volume uncertainty) were cited as the reason for introducing variation relative to similar sectors in other states. In most cases, the margin was determined by reviewing evidence on regulatory decisions in other sectors and by cross-checking that the profitability of the business was sufficient given the proposed margin.

Company (Regulator)	Industry / Country	Margin (allowed)	Revenue (actual)	Notes
Royal Mail (Postcomm)[16]	Post / UK	1.5% Or 2.8%	£5,608 (03/04)	Operating profit margin (including pension deficit / surplus) for 2003/04, in 2000/01 prices Operating profit margin (excluding pension deficit / surplus) for 2003/04, in 2000/01 prices
BSKyB (OFT)[17]	Wholesale provision of premium pay TV sports & film channels / UK	1.5%	n.a.	The minimum required "return on revenue" (operating profit / revenue) considered appropriate by the DGFT in 2002.
BT (MMC)[18]	Calls-to-mobile service provision / UK	1.5%	£657m (97/98)	The minimum required "return on revenue" (operating profit / revenue) for BT's calls-to-mobile activity.
Scottish-Hydro Electric plc (MMC)[19]	Electricity supply / UK	0.5%	£460.8m (93/94)	The minimum required "return on revenue" (operating profit / revenue).
BGES (CER)[20]	Gas supply / Ireland	1.3%	€739m (y/e Dec 05)	Mark-up on gas procurement, transport and distribution costs.
BGT (Ofgem)[21]	Gas supply / UK	1.5%	n.a.	Profit margin on turnover.
(Ofgem)[22]	Electricity supply / UK	1.5%	n.a.	Mark-up on all costs.
(IPART)[23]	Gas supply / NSW, Australia	2%	n.a.	June 04 – June 07
(ESC)	Gas supply / Victoria, Australia	2 – 3%	n.a.	2002
(ICRC)	Gas supply / ACT, Australia	3%	n.a.	2001

16 2006 Royal Mail price and service quality review – Consultation on principles, September 2004, Chapter 2, Table 2.2

17 BSkyB investigation: alleged infringement of the Chapter II prohibition, OFT, 17 December 2002, Chapter 11, para 413.

18 BSkyB investigation: alleged infringement of the Chapter II prohibition, OFT, 17 December 2002, Chapter 11, para 401. British Telecommunications plc: A report on a reference under section 13 of the Telecommunications Act 1984 on the charges made by BT plc for calls from it's subscribers to phones connected to the networks Cellnet & Vodaphone, MMC, 21 Jan '99 (see appendix 5.5)

19 Scottish-Hydro Electric plc, A Report on a reference under section 12 of the Electricity Act 1989, MMC, June '95 (appendix 4.18)

20 Proposed Decision on Bord Gáis Energy Supply Revenue For Domestic and small Commercial and Industrial Customers (Non-Daily Metered Market),CER, 21 July 2006, Chapter 2

21 Review of British Gas Trading's Price Regulation; Final Proposals, OFGEM, February 2000, Chapter 7

22 Reviews of Public Electricity Suppliers 1998 to 2000; Supply Price Control Review, Final Proposals, OFGEM, December 1999, Para 7.3

23 Review of Gas and Electricity Regulated Retail Tariffs: Issues Paper, IPART, October 2003

(IPART)[24]	Electricity supply / NSW, Australia	2%	n.a.	
(SAIIR)[25]	Electricity supply / South Australia, Australia	5%	n.a.	
(OTTER)[26]	Electricity supply / Tasmania, Australia	1.5%	n.a.	Net profit after tax/ total revenue. Not including an 0.85% allowance for working capital, bringing the total margin up to 2.35%.
(ICRC)[27]	Electricity supply / ACT, Australia	3%	n.a.	Retail margin on sales.

Table 6: Examples of profit margins set by regulators

Source: As cited

Ideally, we would wish to draw on wider evidence from the postal sector beyond the UK. However, unlike in the traditional utility businesses of electricity, gas, telecoms and water networks, the regulation of postal operators in Europe is still in its infancy. As a consequence the margins may vary not only because of the underlying risk of the business, but also because of differences in the degree of constraint applied to postal operators by government departments and agencies. For this reason we consider that the UK experience remains the most relevant for the JCRA to draw upon.

Therefore, based on the evidence from other regulated industries described above, particularly Postcomm's most recent decision with respect to Royal Mail, a margin on turnover of about 3% is proposed for Jersey Post. This margin is applied to the costs of the price controlled activities (controllable and non-controllable operating costs plus capital costs) plus Jersey Post's forecast of expected losses on retail operations.

The price control model has been used to confirm that, with a price control based on a margin of 3%, the company can finance the provision of current postal, fulfilment and retail services and also finance the repayments of the loan to the States of Jersey. The JCRA does not consider that any additional premium is required to reflect the fact that Jersey Post is materially smaller than Royal Mail. In this respect the JCRA note that although Ofwat set a higher weighted average cost of capital for the smaller water only companies, this was to reflect the higher costs associated with equity trading and with raising debt and equity capital rather than because it felt that the companies faced greater risk.

It is recognised that the proposed margin is significantly lower than the margin currently earned by Jersey Post (when OSL and ProMail are excluded from the financial analysis). However, this reduction in margin is considered

24 NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07: Final Report and Determination, IPART, June 2004, Appendix 3.4

25 Electricity Retail Price Justification: Final Report, ECSOSA, September 2002, Chapter 6

26 Investigation of Prices for Electricity Distribution Services and Retail Tariffs, Draft Report (Consolidated Report), OTTER, June 2003, Para 7.3

27 Investigation into Retail Prices for Non-Contestable Electricity Customers in the ACT: Final Determination, ICRC, May 2003, pg. 23

appropriate given the low level of risk that the company has to manage in the proposed price control regime, and the regulatory precedent on required margins. It should be remembered that a company can earn more than the allowed margin set by the regulator if it makes efficiency savings, or benefits from volume increases, beyond those assumed when the control was set (subject to any limits determined by an automatic volume adjustment mechanism). For example, Royal Mail earned a margin of 5.6% on its price controlled activities in 2003/04, relative to its allowed margin of 2.8%.

The JCRA therefore proposes a margin of about 3% in the price control period.