**Jersey Competition Regulatory Authority**

**Consultation Document 2007-1**

**Price Control for Jersey Post**

**16 January 2007**

## INTRODUCTION

The Postal Services (Jersey) Law 2004 (the 'Postal Law') established the Jersey Competition and Regulatory Authority (JCRA) as the authority responsible for the regulation of the postal sector in Jersey. The Postal Law came into force on 1 July 2006. Condition 20.3 of Jersey Post's licence[1] allows the JCRA to determine – within certain limits - the maximum level of charges the Licensee may apply for Licensed Services or Postal Services provided to fulfil the USO.[2]

The JCRA aims to promote the interests of postal users in terms of quality, value for money, and (where possible) choice. In order to further this aim, the JCRA needs to decide whether or not to regulate Jersey Post prices, and, if the answer is in the affirmative, what services should be included in the regulation and what form this regulation should take.

The JCRA proposes to introduce price regulation on a selected range of Jersey Post services ('regulated services'). The goal of this consultation paper is to elicit views and comments on the scope and form of the proposed regulation. These views and comments will enable the JCRA to make its final determination of the optimal form and scope of the regulation of Jersey Post prices. In order to ensure that all interests will be taken into account, the JCRA welcomes responses to this consultation paper from all interested parties, be it in their capacity of consumers, suppliers or competitors.

In section 1, the JCRA welcomes your response on the issue of whether of not there should be price regulation, and if so, with respect to what services. In sections 2 and 3, we discuss the form of the proposed control. In section 4, we discuss the proposed length of the price control period. In section 5, we discuss the proposed margin that Jersey Post will be allowed on the sale of its various regulated services. The JCRA on its website www.jcra.je/news provides an Explanatory Note on the various issues covered in this Paper if additional information is required.

The final submission date for comments is no later than **5 p.m. on 16 February 2007.**

Submissions should be clearly marked "Comments on Jersey Post Price Control" and may be supplied either in hard copy or electronically, addressed (as appropriate) to:

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[1] This can be found at www.jcra.je/postal.

[2] The Law specifies the duties and powers of the JCRA in the sector, whilst the Class II licence applied to Jersey Post sets out the specific restrictions applied to the company and provides further detail on the role of JCRA.

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The JCRA reserves the right to publish on its website any submissions to this or other consultations. Any commercially sensitive information that a stakeholder may wish to submit as part of a response should therefore be clearly marked as such.

## Issue 1: For which services does Jersey Post face competitive constraints?

A responsible regulator tries to balance the costs and benefits of regulation, taking into account existing instruments provided by, for example, the Competition (Jersey) Law 2005 (the 'Competition Law'). The question of whether or not there should be specific regulation for the postal sector depends on the relative efficiency and effectiveness comparing the situation with and the situation without regulation. International practice shows that undertakings in traditional monopoly industries like post are generally subject to sector-specific regulation. The first period of the introduction of competition in sectors that were previously characterised by legal monopolies often requires regular intervention by the Authorities, and in such a case, sector specific price regulation is preferred to reliance on general competition law.

In order to determine what services should be price-regulated, the JCRA applies a competitive assessment test. This test involves assessing the extent to which the provider has market power. Factors that need to be taken into account are barriers to entry, the scale of competition, customer awareness and behaviour and the effectiveness of competition. If there is sufficient competition from other providers or countervailing buyer power by customers to constrain JP from profitably imposing price increases, the particular services do not require regulation.

The JCRA has concluded on a preliminary basis (i.e., subject to the results of this consultation) that there are sufficient competitive pressures to constrain JP's prices with respect to Parcel Services and Priority Services (see table 1 below).

| |
|---|
| **Parcel Services**<br>Local parcel service<br>Domestic parcel service<br>International standard parcel service<br>International economy parcel service |
| **Priority Services**<br>Signed for (recorded delivery)<br>International signed for (recorded) letter<br>Special delivery |

Table 1

The JCRA has concluded on a preliminary basis that there are insufficient competitive pressures with respect to Letter Postal Services and Other Services (see table 2 below).

| |
|---|
| **Letter Postal Services**<br>Local letter service<br>Domestic (UK and other CI's letters)<br>European airmail letters<br>International airmail letters (Zone 1)<br>International airmail letters (Zone 2)<br>Airmail postcards<br>International airmail postcards<br>International air letter<br>International pre-paid aerogramme |
| **Other Services**<br><br>Direct Mail<br>Business reply (UK, IOM and other CI's)<br>Redirection (Residential and business)<br>Standard PO Box Facility<br>Parcel Service PO Box Facility<br>Retention of mail<br>Poste Restante<br>Articles for the Blind<br>Mail to addresses within the British Forces Post Office<br>FreePost (Local and UK) |

Table 2

With respect to Bulk and Fulfilment Services (see table 3 below), the JCRA has concluded on a preliminary basis that they are subject to some competition but that the effectiveness of that competition is limited over the course of the proposed price control period.

| |
|---|
| **Bulk & Fulfilment Services**<br>Local letter bulk mail<br>Bulk Letter priority to UK (Sea) (J+3)[3]<br>Bulk Letter Economy to UK (Sea) (J+5)<br>Bulk posting (Residue) to UK (Sea) (J+5)<br>Palletised packets<br>International letters, flats and packets |

Table 3

### *Question 1*

For the reasons set out above, the JCRA concludes on a preliminary basis that Letter Postal Services, Bulk Fulfilment Services and certain other services such as Redirection Services and PO Box facilities should be price controlled. Do you agree with the JCRA's approach to the competitive assessment and its recommended proposals as to which products should be price controlled and which should not? In relation to Bulk & Fulfilment Services, the JCRA specifically invites comments on whether operators in other offshore

[3] 'J' indicates the day of posting. The number appearing after J+ specifies the number of days from posting to delivery.

jurisdictions should be considered to provide a competitive constraint on Jersey Post.

## Issue 2: Form of control

For our purpose, there are two basic appropriate forms of price control:

- Revenue control sets limits on revenue, normally by means of a control on (weighted) average revenue. Under such regulation, total revenue divided by total output (i.e. the average revenue) of the undertaking is constrained (i.e. cannot be greater than a fixed price cap).
- Tariff control sets limits on the tariff for a basket of services. Prices have to be set so that the weighted average price is no more than the overall price ceiling that has been set.

Price control is commonly used by Regulatory Authorities in many jurisdictions to allow the regulator to minimise the potential for price increases for those products and services in which the operator is dominant. Price control is adopted by both the UK and Guernsey postal regulators in ensuring that postal tariffs reflect more closely the cost of the provision of the service.

The JCRA strives to adopt international 'best practice' for regulatory process, but it takes into account specific features of the Jersey market where appropriate. Average revenue control is relatively easy to administer and hence more suitable to a small market. A main (relative) disadvantage is the scope for Jersey Post to rebalance prices whilst still meeting the overall price cap. The JCRA therefore proposes to use weighted average revenue control with average revenues calculated for (a) postal services and (b) fulfilment products (see Annex 2). This type of control is similar to a tariff basket control, however, it is based on outturn volumes rather than on historic weights. In addition, the JCRA proposes that further limitations should also be placed on Jersey Post's ability to rebalance tariffs within a product category.

**Question 2**
Do you agree with the proposed weighted average revenue yield control with individual average revenues for each product? Do you agree with the level of aggregation i.e. (a) postal services and (b) fulfilment products?

## Issue 3: Allowed Revenue

The form of regulation proposed in the previous section should be set to allow Jersey Post to earn sufficient revenue to fund the expected efficient costs of providing the services covered by the control and required by the conditions of its licence to fulfil the universal service obligations. Allowed revenue can be calculated in two ways, either by the cash flow approach or the regulated asset base approach:

- The cash flow approach[4] sets allowed revenue in each year equal to the sum of operating expenditure, capital expenditure and a margin on turnover for that year. Under this approach, customers would 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. A potential disadvantage is huge year-to-year changes in the allowed revenue if the undertaking makes very large investments in only some years. 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 the RAB for that year. A potential disadvantage is uncertainty for the undertaking since recouping the full costs of investment depends on future behaviour by the regulator. This method has been commonly used in price controls for industries with long-lived assets, such as the energy network businesses.

Based on the relative merits of these methodologies and the appropriateness to the postal sector, specifically the fact that this is not a very capital intensive industry, the JCRA proposes to use the cash flow approach.[5]

**Question 3**
Do you agree that the cash flow approach be used to calculate allowed revenue for Jersey Post?

## Issue 4: Length of the control period

The JCRA has to determine the period over which the first price control will apply. The decision on the appropriate length of the control period requires a balance to be reached between basically two conflicting objectives:

- In order to provide efficiency incentives, the control period should be reasonably long. The regulated undertaking may expect to retain the

[4] This is also known as the 'pay as you go' approach

[5] For Jersey Post, annual capital expenditure typically only represents in the region of 5-10% of total expenditure in the year and hence there are no strong disadvantages offsetting the advantages of simplicity and the certainty of inclusion of the full costs of the investment.

efficiency savings it achieves during the control period, hence a longer control period implies a higher net expected present values of savings.

- There will inevitably be some uncertainty about the future, resulting in differences between expected values and the actual values. For example, Jersey Post's costs and revenue vary both 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. In general, the longer the control period, the greater the uncertainties.

The form of the regulation can to some extent address the inherent uncertainty if it allows for resetting of the values during the control period when certain trigger values are exceeded. Again, determination of the optimal trigger value depends on a balance between two conflicting goals:

- There would be least uncertainty for the regulated undertaking if the trigger would be set at a low value.
- The potential costs for (at least) the regulator would be higher if the trigger were set at a low value.

The JCRA proposes a first price control period of about 3 years as the optimal balance between these two objectives and a reassessment of the control within that period if Jersey Post is faced with actual volumes that are 2% of the forecasted volumes.[6]

**Question 4**
Do you agree that a control period of about three years strikes the right balance? Do you agree with the 2% trigger for resetting the price control?

## Issue 5: Allowed margin

Under the proposed cash flow regulation (see 3. Allowed Revenue above), a regulated undertaking is allowed a margin on turnover in addition to the operating and capital expenditure being financed on a cash flow basis.

The margin that Jersey Post is allowed to earn will reflect the risks that the undertaking faces in management of the efficient provision of current postal, fulfilment and retail services. The margin can be compared to both regulated and unregulated undertakings when allowing for the differences in risks.

[6] The trigger of 2% is benchmarked bearing in mind that Postcomm uses a threshold of 2% above or below assumed volumes for the volume adjustment mechanism in Royal mail's licence (see Explanatory note on issue 4).

The JCRA proposes a regulation in the form of RPI-X. That is: the revenue for the services (see 2 Form of Control above) can only increase compared to the level in the previous period by RPI inflation minus an X-factor. This implies that the there is only a small risk from changes in RPI. As was stated above, the JCRA also proposes a trigger of 2% differences between actual volumes and forecasted volumes in order to trigger resetting control values.

The JCRA concludes that as Jersey Post faces few risks during the proposed control period, the margin should be set at about 3% over the control period. This is in line with international comparison of regulated industries.

**Question 5**
Do you agree that Jersey Post's profit margin for the control period should be set at about 3% over the control period?