



PORTS OF JERSEY
YOUR ISLAND GATEWAY

**Ports of Jersey's Response to CICRA's
Consultation and Initial Notice on the
Determination of Prices for 2018**

January 2018

Ports of Jersey's Response to CICRA's Consultation and Initial Notice on the Determination of Prices for 2018

Introduction

Ports of Jersey (POJL) welcome the opportunity to respond to CICRA's Consultation and Initial Notice on the determination of prices for 2018¹.

POJL believes that CICRA have misunderstood the cost of the intended investments in their calculation of the permitted price increase from April 2018. They have therefore significantly underestimated the price rise necessary to finance the four investment projects proposed. We believe that they should correct their mistake and reissue their Initial Notice as quickly as possible.

Background to the 2018 Submission

PoJL had not been able to explain to CICRA's satisfaction the rationale for our intended 2017 price increase of 2%, and hence we had to forgo that adjustment. We took some learning points from that process and applied them to the 2018 submission in the hope that it would improve the process. Our learnings from 2017 and approach to 2018 are presented at Appendix 2.

POJL is a complex business, with various business lines. The 2018 submission sought to simplify the process by concentrating on a few identified projects, rather than the totality of our business, and present the rationale on a simple cash flow basis to avoid further complexities of explaining accounting standards.

Calculation of the allowed price increase

PoJL does appreciate that CICRA was attempting to be helpful in taking some of the aspects of our submission as given, and applying some simple logic to aid in their understanding. We believe CICRA's approach in calculating the 1.3% proposed price cap is as follows:

- Using Table 1 of our original submission, determined that £1.3m was the capital investment level in 2018.
- Depreciated the £1.3m over a 5 year period, so c. £250k per annum
- Added a 5% cost of financing, so c. £65k per annum
- This came to £0.3m, which was about 25% of PoJL's requested £1.3m
- 25% of 5.2% is approximately 1.3%, which was the basis of CICRA's initial notice.

However the cash cost of the four capital investment projects is **£13.98m** rather than the £1.3m that CICRA suggest (which is the **average annual cost**, rather than the cash cost of the additional capital expenditure). We alerted CICRA to this mistake on 9th January and met with them on 15th January to discuss this.

¹ CICRA 17/33 <https://www.cicra.gg/media/597758/poj1313j-initial-notice-ports-of-jersey-limited-2018-price-determination.pdf>

Appendices 2 and 3 of our submission set out the costs of the four projects² as:

- IT System - £8.264m
- PODB - £686k
- Finance System £1.4m (over 5 years – the full 10 year cost is £2.5m)
- Elizabeth Harbour £2.53m

We spread this cost of £13.98m over an assumed 10 year asset life (we discounted the cost of Elizabeth Harbour to reflect the longer asset life of this asset) to give the £1.3m figure in Table 1 of our submission (30% discount on £2.53m reduces the £13,980 to £13,221, which divided by 10 gives £1.32m). This was the basis of our request for a 5.2% price rise³. To be clear, £1.3m is the average annual cost over 10 years as identified in Table 1 of our original draft submission, not the total cost of our proposed investments and it is therefore wrong to depreciate this figure as CICRA have done. Were CICRA to continue with this approach it would be a strong disincentive to POJL against carrying out any discretionary investment.

Using the CICRA approach (as set out above) of depreciating the £13.98m capital cost of the investments over a 5 year asset life would give an annual cost of £2.796m. The cost of financing at 5% would add another £699k, giving an overall revenue requirement of £3.495m. This would be equivalent to a **14% price increase under the approach set out by CICRA.**

CICRA's consideration of POJL's request

We welcome CICRA's preference for a move to a longer term price control to provide a greater degree of certainty for the business and shareholders going forward. We agree that this is not something that could be put in place in time for the 2018 price increase, but it is something that could be developed during 2018 and put in place for the 2019 price increase. We believe that CICRA should ensure that they devote sufficient resources to this workstream to ensure that this is the case.

Our submission was based on the focussed question of funding the additional cost of four key investments that POJL is undertaking, rather than the financial situation of the business as a whole. CICRA's comments relating to the financial position of POJL are therefore misplaced, as well as being based on an incorrect understanding of our finances.

CICRA stated that the 2016 profits of £10.9m was "*substantially better than had been previously indicated in POJL's own December 2016 Strategic Business Plan which had indicated the likelihood of post-tax losses being accrued by the business in 2016 and 2017*". This fails to recognise that the £10.9m profit relates to a 15 month, rather than 12 month period and is based upon FRS102, whereas the December 2016 Strategic Business Plan was prepared on a different accounting basis (Jersey Financial Reporting Manual – JFReM)⁴. The difference between the forecast and the reported numbers was due to the different approaches to asset valuation and depreciation in the different accounting methodologies, rather than better than expected commercial performance. A more sensible 'like for like' comparison is based on EBITDA.

² Appendix 1 summarises the annual costs of the four capital projects and provides a split between Opex and Capex until 2022

³ Following our submission and prior to CICRA's publication of the Initial Notice we offered to explain our submission, costs and calculations to CICRA in more detail, but they cancelled the two meetings that we set up to do so

⁴ POJL historically used JFReM as the accounting standard for the States of Jersey, however following Incorporation we have changed to FRS102.

2016 EBITDA - £10,785 – POJ Annual Report
2016 Forecast – £11,253 - December 2016 Strategic Business Plan
2017 Forecast – £11,919 - December 2016 Strategic Business Plan

As can be seen, the 2016 performance was worse (not better) than indicated in the December 2016 Strategic Business Plan. The lack of a reasonable price increase was a material contributing factor in this result.

CICRA also comment on POJL's cash reserves of £28m and conclude that *"it would not be necessary to finance the additional capital expenditure on a cash basis in order for POJL to carry out the work indicated"*. This seems to assume that the projects included in the Price Submission form the entirety of the POJL Capital Programme - which is not the case. The December 2016 Strategic Business Plan contains details of the additional infrastructure capital requirements (Forecast 2017 spend of £31.3m) as have the recent presentations regarding the Airport Masterplan (which was attended by CICRA) and forthcoming Harbour Masterplan. It is therefore incorrect and misleading to suggest that POJL have £28m sitting in the bank that could be used to pay for the four capital projects.

It is incorrect to judge a focussed request for funding for one set of projects by reference to wider aspects of the business without a proper appreciation of those wider considerations. The ring fenced approach for specific projects was specifically discussed with CICRA prior to our 2018 submission, and it appeared to be a structure that would work. If CICRA wish to expand the parameters of their review of the submission then this should not be done on a 'cherry picking' basis, i.e. the full context of POJL's business needs to be considered - which we understood CICRA were content to avoid for the purposes of the 2018 price submission.

CICRA have also not considered the appropriate size of financial reserve required by a company such as POJL, in particular the need to have sufficient cash reserves to meet unexpected liabilities without facing cash-flow constraints.

Therefore the comments about the financial strength of the business (and therefore CICRA's conclusions about the appropriate balance between the request for a price increase and the interests of customers and port users) are based on an incorrect interpretation of the evidence – both measures that CICRA have identified, when properly considered would point to greater support for granting POJL's request than CICRA suggests.

CICRA bases their assessment of POJL's submission on three assumptions:

- A cost of capital of 5%
- A short (5 year assets life) for all assets involved
- Commencement of depreciation in 2018

For the purposes of this response, it is not necessary to decide on a cost of capital (since we did not include the cost of financing in our submission), however we have previously provided CICRA with a reasonable assessment of POJL's cost of capital⁵ which CICRA do not appear to have considered. Given that some of the capital expenditure has already been incurred, we think that commencing a depreciation schedule in 2018 is fair, rather than generous. However, even with a zero cost of financing and a 10 year rather than 5 year asset life, the depreciation cost alone justifies our price request, adding a cost of financing as CICRA suggest would increase the justifiable size of price increase even more. Using the CICRA methodology would lead to a 14% price increase. Therefore

⁵ This was included in our 2017 price submission

we believe that we have been extremely conservative in only asking for a 5.2% price rise and we would urge CICRA to reissue the Initial Notice agreeing to our request.

CICRA suggests that if in future it is in a position to make better assumptions, it can in determining future prices take account of any substantial changes to the assumptions in its Initial Notice to mitigate the effect of previous assumptions. We believe that it would be entirely inappropriate for CICRA to seek to correct their mistake in the Initial Notice through future price increases. This is for three reasons:

- Given the size of the difference, it would lead to the need for very significant price rises in the future, which customers are unlikely to be in favour of and could put at risk some more marginal routes that are valued by passengers;
- POJL (unlike other regulated businesses) do not have in place a regulatory framework that can be transparently adjusted to increase or decrease the revenue requirement of the business. It is therefore impossible to demonstrate what the allowed future revenue would have been without underfunding in 2018 and what the appropriate level of funding should consequently be to adjust for the mistake; and
- It would add significant extra complexity to any future pricing framework.

Consultation with customers

POJL has considered CICRA's comments regarding the need for consultation. In terms of customer consultation on this year's price increase, as CICRA says, it is difficult to consult meaningfully with customers on IT projects which are not discretionary and we therefore welcome CICRA's decision to waive the requirement to first consult with our customers.

To be clear, POJL did not say that *"it does not consider it appropriate to consult customers before it has certainty over the level of price increases which should be permitted"* as CICRA suggests, instead we said *"it is difficult to effectively discuss pricing propositions with customers when POJL is not in a position to introduce any changes agreed with customers without regulatory approval"*. To put this into context, we consulted very extensively with a wide range of our customers over our 2017 price submission⁶. Our customers almost unanimously agreed that our proposal of a 2% price rise (which was similar to the rate of inflation at the time) was an appropriate and acceptable increase. However CICRA ignored the outcome from that consultation and did not move forward with the price increase process. During this process CICRA did not keep us informed of their intentions in relation to our price request and we were unable to keep customers properly updated on the plans for potential price increases, having to give them multiple conflicting and confusing messages about the level and timing of the increase – in the end we withdrew our request in July 2017 and had to inform customers of this outcome. We therefore believe that our statement was justified.

We are not seeking a *"bilateral discussion between CICRA as economic regulator and POJL as Jersey's licenced port operator"* – indeed it would be impossible for the regulatory price setting process to be a bilateral discussion, since it is based on a public consultation which allows all interested stakeholders to comment and respond. However, we still do not see how it is possible to effectively discuss the balance between service improvements and investments with customers and to help determine the priorities between parts of the business competing for limited resources, when the outcome of a potential investment project could be: the 5.2% price increase that we have asked for, the 1.3% price increase that CICRA have calculated based on a misunderstanding of the cost of the

⁶ Details of our discussions with a wide range of users and customers were set out in our 2017 price submission

investment, or a 14% price increase which is the result of applying the CICRA methodology to the actual cost of the investment. The reason that customer consultation works in other regulatory regimes, is that they have in place a well understood regulatory framework that specifies how the costs of investments are added to the Regulatory Asset Base and remunerated through prices based on an understood cost of capital. Such a regulatory framework allows a sensible conversation between the regulated company and its customers over investment plans and whether they are appropriate and offer value for money, when it is understood how the costs of investments are likely to be recovered through charges – this is not the case for Ports of Jersey.

We hope that in advance of the 2019 price submission, CICRA will have made sufficient progress in developing a long term pricing framework for POJL, that we will have a clearer framework within which to effectively undertake customer consultation on that and future submissions.

Benchmark Comparisons

When evaluating the reasonableness of a 5.2% price increase over two years, it is important to consider what other businesses in comparison sectors have done.

The increase that POJL is proposing is consistent with other business operating in similar sectors and/or economic conditions. Further, the proposed increase is less than Jersey RPI for the period. Meanwhile, the increase determined in CICRA's Initial Notice falls well short of what the basket of comparators (as provided in Appendix 3) has identified.

Determination of Price Increase

CICRA has set out a 5 year schedule of permitted price increases for port operation services in the Initial Notice – 1.3% in 2018 and 0 for 2019 to 2022. Our submission was for a one-off increase in prices in 2018, we did not provide (nor were we asked for) any information relating to the costs or financial situation of our business for subsequent years or the need for price increases after 2018. CICRA therefore have no basis on which to make a determination of the maximum price increase for 2019 to 2022 or to satisfy themselves that they have made this determination in line with their duties under Article 26 of the Air and Sea Ports (Incorporation) (Jersey) Law 2015. They cannot have satisfied themselves that they have best ensured that POJL *"has sufficient financial resources to discharge its liabilities under securities issued by the company to the States"* since they have not requested or received appropriate information on which to make such a judgement. We therefore believe that the CICRA decision should be restricted to only cover the requested price rise in 2018 and that it is wrong for CICRA to make a decision for subsequent years until they have proper information on which to do so.

Publication of consultation responses

We note that CICRA have changed their stated approach to publication of consultation responses from their previous approach of *"In line with its consultation policy, CICRA intends to make responses to the consultation available on its website"*⁷ to *"CICRA intends to make responses to the Initial Notice available for inspection"*. We are disappointed that despite their stated intension and our formal request⁸, they have not published previous consultation responses on their website and we are concerned at the increased lack of transparency that is signalled by this new approach.

⁷ See for example CICRA 17/11 and previous CICRA consultations

⁸ Email from Andrew Boustouler to Jonathan Tooley dated 14th December 2017

Transparency is important because it allows stakeholders (including POJL) to make informed responses to policy proposals such as are contained in the Initial Notice. CICRA's approach does not reflect regulatory best practice and is at odds with the Principles of Good Regulation⁹.

Conclusion

As discussed above, CICRA's draft determination is based on a misunderstanding of the cost of the required investment projects that we discussed in our submission. As a result their proposed price increase in 2018 will not provide the funds necessary for us to carry out those investments. For subsequent years CICRA do not have sufficient information to set a price cap. We therefore ask CICRA to correct their mistake and reissue their Initial Notice with our request for a 5.2% price increase in 2018.

**Ports of Jersey
January 2018**

⁹ Better Regulation Task Force, December 1997 (revised October 2000), Principles of Good Regulation

Appendix 1: Annual cost of the four capital projects in POJL's submission and split by Opex and Capex

TOTAL CASH COST

| (£000s) | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | TOTAL |
|----------------|--------------|--------------|--------------|------------|------------|--------------|------------|------------|------------|------------|---------------|
| IT System | 1,423 | 743 | 745 | 750 | 750 | 1,377 | 619 | 619 | 619 | 619 | 8,264 |
| PODB | 100 | 586 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 686 |
| Finance System | 150 | 710 | 180 | 180 | 180 | 180 | 380 | 180 | 180 | 180 | 2,500 |
| Eliz. Terminal | 0 | 500 | 2,030 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 2,530 |
| TOTAL | 1,673 | 2,539 | 2,955 | 930 | 930 | 1,557 | 999 | 799 | 799 | 799 | 13,980 |

OPEX

| (£000s) | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|----------------|------------|------------|------------|------------|------------|------------|
| IT System | 249 | 493 | 545 | 550 | 550 | 519 |
| PODB | 0 | 0 | 0 | 0 | 0 | 0 |
| Finance System | 0 | 0 | 180 | 180 | 180 | 180 |
| Eliz. Terminal | 0 | 0 | 0 | 0 | 0 | 0 |
| TOTAL | 249 | 493 | 725 | 730 | 730 | 699 |

CAPEX

| (£000s) | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|----------------|--------------|--------------|--------------|------------|------------|------------|
| IT System | 1,174 | 250 | 200 | 200 | 200 | 858 |
| PODB | 100 | 586 | 0 | 0 | 0 | 0 |
| Finance System | 150 | 710 | 0 | 0 | 0 | 0 |
| Eliz. Terminal | 0 | 500 | 2,030 | 0 | 0 | 0 |
| TOTAL | 1,424 | 2,046 | 2,230 | 200 | 200 | 858 |

Appendix 2: Learnings from the 2017 Process for the 2018 Process

| Learning point from 2017 process | Approach to 2018 Process |
|---|--|
| PoJL is a complicated business, and it can be difficult to understand the depth and breadth. | Produce a 'theme' based position, where we identify some discrete investment projects to base an increase. This should be simpler to follow, and would not require a review of the entirety of the business. |
| PoJL had communicated the intended price increase with our customers in advance of our 2017 submission, where it was noted by CICRA that this was prior to seeking CICRA approval for any price rise. | Prepare a document in principle to gauge CICRA's view of the rationale prior to engaging with customers. Whilst we are pleased that CICRA acted swiftly with the paper, it did not provide time to fully consult with customers ahead of publishing the Initial Notice, although we were able to alert them. |
| Given the complexity of PoJL's business, the presentation of our numbers meant several iterations had to occur in an attempt to present something CICRA could understand. | Keep the justification and explanation to some independent projects, and reflect the numbers for those projects only, in an attempt to make it simpler to follow. Further, rather than complicating accounting treatments of OPEX and CAPEX, we provided a 'cash flow' view. |
| The 2017 proposal was for a modest 2% increase, which was necessary to ensure PoJL could invest over the capital programme period (25 years) without requiring large one-off increases in the future. | It was acknowledged by CICRA that we should consider the forgone 2017 price increases in future submissions. We therefore identified 5.2% for 2018 (which 2.6% per annum), which is consistent with PoJL's aim of avoiding large one-off increases in the future. |
| It was not clear in the 2017 price submission where the risk was if it was not delivered, nor which investments might have to be foregone without the price increase. | By isolating the 2018 price increase submission to four identified projects (the themes), the hope was that this connection could be better understood. It is important to understand that it was not for the totality of our Capital Programme. |