PoJ1395J

Ports of Jersey Long-term Pricing Framework

Assumptions

Draft Decision

Jersey Competition Regulatory Authority

Document No: CICRA 18/46 **14 December 2018**

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Contents

1. Overview

1.1 Ports of Jersey Limited (**PoJL**) is the company that owns and operates the airport, harbours and marinas in Jersey. It is the only licensed port operator for Jersey.

1.2 The Channel Islands Competition and Regulatory Authorities (**CICRA**) is the economic regulator with specific responsibilities in respect of the oversight of PoJL. As part of its oversight role CICRA is developing a pricing framework for PoJL.

1.3 CICRA is introducing a pricing framework to incentivise PoJL to act in a manner that protects and furthers the interests of ports users in the short and long term. The process of introducing a pricing framework is an interactive one. CICRA provides regular updates of its work, releases information and issues consultation documents for comment. Interested parties have the opportunity to respond and their views are taken into account by CICRA in arriving at its decisions.

1.4 In September 2018, CICRA began the public start of the process to introduce a pricing framework by issuing a Call for Information, seeking the views of interested parties about the assumptions proposed by PoJL to underpin a pricing framework. The consultation closed on 2 November 2018. Seven responses were received from the States of Jersey, Condor, Manches-Iles, Blue Islands, Mr Finch, St Helier Boat Owners' Association and one confidential response.

1.5 This Draft Decision sets out the conclusions which CICRA has reached on key assumptions to underpin a pricing framework, having taken full account of responses to the Call for Information, and having carried out further research to ensure it has fully addressed respondents' points and to develop its own assessment. It provides interested parties with a further opportunity to comment, prior to CICRA issuing its Decision. CICRA reserves the right to revisit its Decision at a later stage in the process to introduce a pricing framework, on the basis that further and more detailed information may be provided.

2. Summary of Draft Decision

2.1 This section of the Draft Decision provides a summary of the conclusions which CICRA has reached, having taken full account of responses to the Call for Information, and having carried out further research, to ensure it has fully addressed respondents' points and to develop its own assessment.

Assumption	Draft Decision
Starting Point	• The Air and Sea Ports (Incorporation) (Jersey) Law 2015; • The Air and Sea Ports Incorporation (Transfer) (Jersey) Regulations 2015; • The report and proposition 'Incorporation of Ports of Jersey' (P.70/2012); and for the reasons set out above, to a lesser extent, • Evidence and assurances provided to Scrutiny Committees • CICRA's Proposed Regulatory Framework • The Case for Incorporation
General Inflation	3.0% per annum for modelling purposes, with the exception of existing property leases which should reflect the terms of the agreements in place.
Business Volumes	• 2.7% for air passengers; • 1.25% for sea passengers; and • 0.53% for freight & fuel.
Master Plans contained within the Long Term Capital Plan	Airport - £34.05m (based on a total investment of £40m), Harbour – decision deferred PoJL will be required to demonstrate delivery of the project at, or below, the cost allowed. In the event of a cost overrun, PoJL will be required to demonstrate how it intends to 'make good' the overrun.
Long term capital plan	£73.562m over the period of the pricing framework with the requirement that PoJL • demonstrates that it has engaged fully and meaningfully with stakeholders, reflecting the views expressed by stakeholders during that engagement process, or state why particular feedback has not been reflected;

	• demonstrates how its capital expenditure has / will meet the current and future needs of its customers; and • demonstrates that it has delivered those projects at a cost of no more than the minimum amount of money needed. In the event of a cost overrun, PoJL will be required to demonstrate how it intends to 'make good' the overrun.
Commercial Projects	£17.998m over the period of the price control framework. PoJL must separate commercial from non-commercial projects. Commercial projects should be included on the basis of an appropriate contribution, and non-commercial projects should distinguish between revenues, costs and capital required.
Net Debt on Core Activities	No limit set.
Net Debt on Commercial Projects	Debt on specific projects should be assessed on a project by project basis.
Cost of Debt	3% pre-tax nominal cost in the medium term 5% pre-tax nominal cost in the long term
Operating Cost Efficiency	1.0% in real terms per annum
Depreciation of Fixed Assets	PSO assets - the expected cost of purchasing PSO assets should be allowed in the calculation of revenue, if necessary, but depreciation should not be taken into account. For all Business Assets (those which generate revenue directly or indirectly, including substantial infrastructure such as runways and harbour ramps) depreciation should be allowed over the full anticipated useful life of the asset, based on its actual cost or FRS102 value.
Public Service Obligations	The cost of the PSOs should be assumed at the current (2018) level in real terms less the efficiency assumption set elsewhere in this decision.

Community Support	The cost of community support should be assumed to continue at the current (2018) level in real terms less the efficiency assumption set elsewhere in this decision.
Dividend to Shareholder	Nil
Funding Philosophy	Funding for investments will be from a combination of retained capital and debt raised without SoJ guarantees and from retained capital. CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that PoJL should assume the use of a single till based on CICRA's definition that 'all activities (both regulated and non-regulated 'commercial' activities) are taken into consideration when determining the level of charges'. PoJL should not explicitly separate harbour operations from airport operations or make any other possible divisions such as separating public service obligations for the purposes of determining this pricing framework. In the longer term PoJL should generate revenues from investments and operations which cover the actual cost of those investments and those revenues should be linked closely to costs.
Period of Pricing Mechanism	5 years
Other matters	In its next submission, PoJL will be expected to explain how it proposes to utilise its existing cash reserves.

3. Introduction

3.0 Ports of Jersey Limited (**PoJL**) is the company which owns and operates the airport, harbours and marinas in Jersey. PoJL is the only licensed[1] port operator for Jersey, providing commercial port operations and services to a diverse range of customers.

3.1 The Channel Islands Competition and Regulatory Authorities (**CICRA**) is the economic regulator with specific responsibility for the oversight of PoJL. The duties of CICRA are stated in the Air and Sea Ports (Incorporation) (Jersey) Law 2015 (the Law) and are set out in full in Appendix 1.

3.2 In summary, in addition to licensing port operators, CICRA is responsible for regulating so as best to:

a) protect and further the interests of ports users in the short and long term;
b) ensure that all reasonable demands for port operations can be satisfied;
c) ensure that port operations are provided efficiently and effectively; and
d) ensure that PoJL (as a licensed port operator) has sufficient financial resources.

3.3 In discharging its duties as economic regulator, CICRA places particular emphasis on the oversight of those services provided by PoJL of which PoJL is the dominant supplier[2].

3.4 A CICRA priority is to develop and implement a pricing framework which ensures that charges levied by PoJL, for services where it has been found to be dominant, are reasonable, reflect a fair sharing of risk and incentives between PoJL and ports users, and provide sufficient financial resources to allow for the provision of port operations in both the short and long term.

3.5 CICRA is adopting a proportionate and pragmatic approach to the development and implementation of a pricing framework, by relying whenever possible on the information already used by PoJL, subject to an ongoing assessment of the effectiveness of this approach. This is appropriate because, relative to many other economies in which economic regulation occurs, Jersey's is small. The complications and therefore costs inherent in adopting a more intrusive regulatory approach, for example requiring the development of specific regulatory models, need to be proportionate to the benefits likely to be achieved.

3.6 In September 2018, CICRA began the public start of the process to introduce a pricing framework by issuing a Call for Information[3] (the **Call for Information**) seeking the views of interested parties about the assumptions proposed by PoJL that underlie its business plan, which were presented by PoJL in their document 'Ports of Jersey – Long Term Capital and Funding Assumptions and Regulatory Principles arising from Incorporation – Submission to the JCRA'[4] (the **Submission**). The consultation closed on 2 November 2018. Seven responses were received from the States of Jersey (**SoJ**), Condor, Manches-Iles, Blue Islands, Mr Finch, St Helier

[1] *https://www.cicra.gg/media/2989/ports-of-jersey-limited-licence.pdf*
[2] *CICRA 16/41: Ports of Jersey – Assessment of Market Power. See also Appendix 1.*
[3] *CICRA 18/40: PoJ1395J - Ports of Jersey Long-term Pricing Framework - Assumptions - Call for Information*
[4] *See Annex A of CICRA 18/40*

Boat Owners Association and one confidential response (the **Confidential Response**). The non-confidential responses are published on CICRA's website www.cicra.je.

3.7 This Draft Decision sets out the conclusions which CICRA has reached, having taken full account of responses to the Call for Information, and having carried out further research to ensure it has fully addressed respondents' points and to develop its own assessment.

3.8 It also provides interested parties with a further opportunity to comment. CICRA will use the responses to this Draft Decision, to further inform its thinking and support the development and implementation of an appropriate pricing framework which balances the needs of all stakeholders. CICRA will issue its Decision in due course.

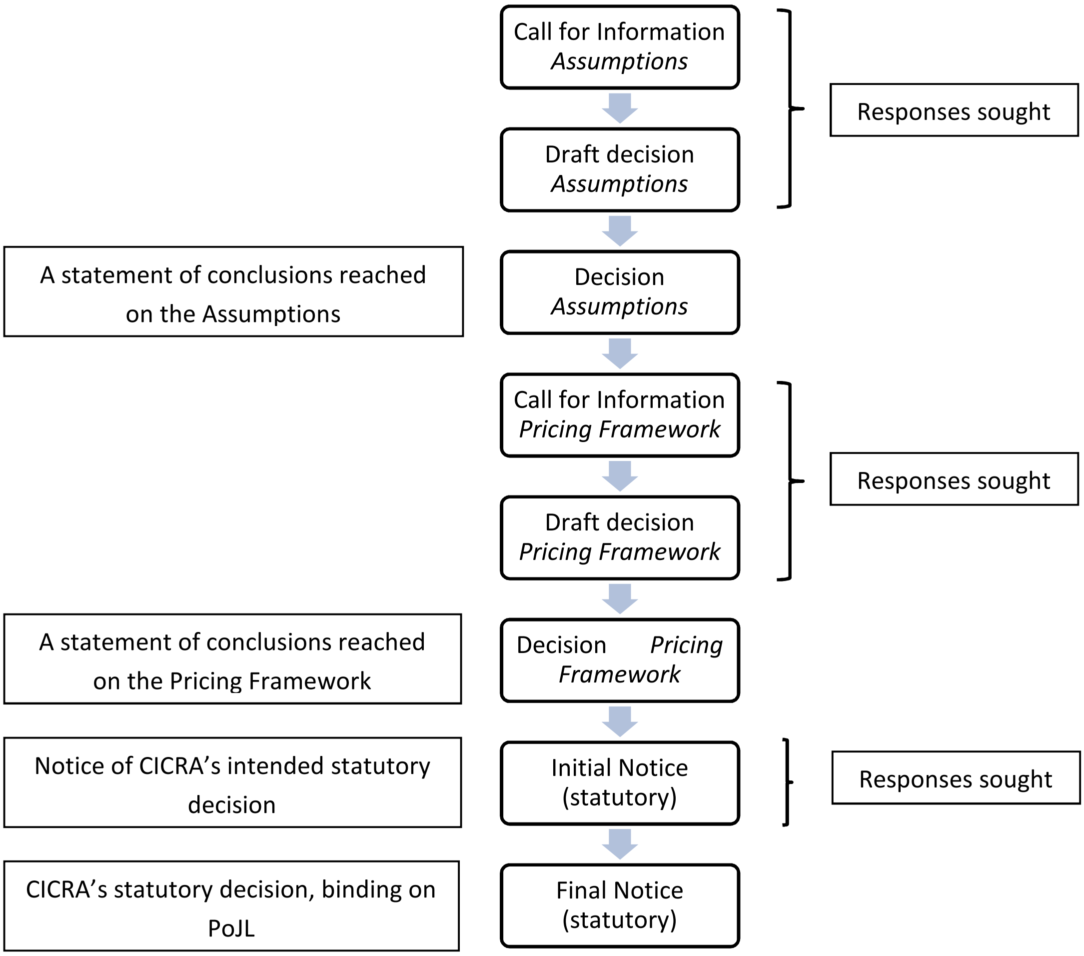
4. Process for setting a long-term pricing framework

4.1 This process for setting a long-term pricing framework has three primary stages:

a) Pre-statutory assumptions stage
b) Pre-statutory price framework stage
c) Statutory stage

4.2 The intention behind the three stages is to ensure that interested parties have an opportunity to comment separately on PoJL's assumptions (the Assumptions stage) and the actual requirements derived from the assumptions (the Pricing Framework stage) before the final Statutory stage that will bring the framework into effect.

4.3 CICRA will follow the process set out below, which is based on its standard Regulatory Consultation Process[5].



[5] *CICRA 18/29*

5. Structure of this Draft Decision

5.1 This Draft Decision is the second part of the process outlined in Section 3 above. It sets out the conclusions that CICRA has reached, having taken full account of responses to the consultation and having carried our further research to ensure it has fully addressed respondents' points. The document contains summaries of particular points raised to illustrate CICRA's reasoning.

5.2 When any further responses have been received and considered, CICRA will issue its Decision. In the event that no responses are received the Draft Decision will be confirmed as CICRA's Decision.

5.3 This document is organised around the questions asked in the Call for Information.

5.4 Details on how to respond to this Draft Decision can be found in Section 6, and a summary of next steps is in Section 7.

5.5 The legal framework, on which CICRA's determination of a pricing framework is based, is in Appendix 1.

6. Consideration of Assumptions contained in Ports of Jersey Limited's Submission

CICRA is adopting a proportionate[6] and pragmatic approach to the development and implementation of the pricing framework for PoJL, by relying, whenever possible, on the information already used by PoJL, subject to an ongoing assessment of the effectiveness of this approach.

PoJL made its submission to CICRA detailing the assumptions proposed by PoJL that underlie its business plan, on which it suggested that the pricing framework should be based. CICRA presented these assumptions in its Call for Information, seeking the views of interested parties on those assumptions.

This section presents each of the assumptions proposed by PoJL, repeats the question that was posed in the Call for information, summarises respondents' comments and provides CICRA's analysis and conclusion.

6.1 *Starting Point*

Category	*Assumption*	*Justification*
Starting Point	*Long term foundation and business philosophy are established with the Case for Incorporation documentation and the Air & Sea Ports Incorporation (Jersey)*	*Our base assumptions are borne from the Case for Incorporation and the Air and Sea Ports Incorporation (Jersey) Law. The information contained in these documents formed the basis upon which States of Jersey voted in favour of incorporating PoJL. The long term assumptions established for the modelling of the business remain true, and are reviewed annually through our Strategic Business Plan process.*

Question 1: Do you agree with PoJL's proposal that the Case for Incorporation and the Air & Sea Ports Incorporation (Jersey) Law[7] provide an appropriate starting point for the assumptions to be used for a long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.2 *Summary of responses*

Of the seven consultation responses received, five (from Blue Islands, SoJ, Condor and Manche-Iles and the Confidential Response) responded directly to this question.

6 The UK's better regulation framework suggests that 'You should ensure that the resource you invest in understanding an impact assessment is proportionate. Some of the factors that should be considered when deciding what level of analysis would be appropriate include: the scale of the expected impact, and the cost of doing further analysis relative to the benefits this analysis may yield. http://regulatoryreform.com/wp-content/uploads/2015/02/UK-better-regulation-framework-manual-guidance-for-officials-July-2013.pdf

7 https://www.jerseylaw.je/laws/revised/Pages/03.050.aspx

Three respondents (Blue Islands, Condor and Manche-Iles) agreed with PoJL's proposal that the Case for Incorporation and the Air and Sea Ports Incorporation (Jersey) Law 2015 provide an appropriate starting point for the assumptions to be used for a long-term pricing framework.

SoJ suggested that, in addition to the Air and Sea Ports incorporation (Jersey) Law 2015, the Air and Sea Ports Incorporation (Transfer) (Jersey) Regulations 2015[8] (**the 2015 Law**) and the proposition debated by SoJ (P.70/2012)[9] should be considered to provide an appropriate starting point for the assumptions to be used for a long-term pricing framework. SoJ also commented that it would expect PoJL to have taken account of changes in external factors in the three years since the legislation was passed.

The Confidential Response suggested that PoJL's business is, 'inextricably linked to SoJ itself' and that there are 'potentially some elements that PoJL is required to continue to maintain which potentially fall out of a 'traditional ports operation' commercial view'.

6.3 *CICRA analysis*

In its submission, PoJL proposed that the 2015 Law and the Case for Incorporation[10] should be considered to be the starting point for the assumptions to be used for a long-term pricing framework.

CICRA agrees that the starting point for any long-term pricing framework should be relevant legislation and government policy. In the context of the ports sector in Jersey, legislation establishes the framework within which PoJL operates, and there is currently no government policy in place.

Requirements set out in law must take precedence together with other requirements that have been considered and approved by the States Assembly over other documentation, including the Case for Incorporation. The Case for Incorporation also relied on evidence and assurances provided to the Economic Affairs Scrutiny Panel[11] and CICRA Proposed Regulatory Framework for PoJL[12]. CICRA acknowledges that other documentation provides useful context but considers it is appropriate to accord it less weight.

CICRA concurs with the comment in SoJ's response that it would expect PoJL to have taken account of changes in external factors in the three years since the legislation was passed and the other documentation referenced above was prepared. It is also relevant to note that the purpose for which the Case for Incorporation was prepared was not to support the development of a long-term pricing framework, which was an input and not an outcome on which SoJ approved incorporation.

[8] https://www.jerseylaw.je/laws/enacted/PDFs/RO-106-2015.pdf

[9] https://statesassembly.gov.je/assemblypropositions/2012/p.070-2012.pdf

[10] https://www.gov.je/SiteCollectionDocuments/Government%20and%20administration/ID%20A%20Ports%20of%20Jersey%20incorporation%20case%20document%2020140528%20CS.pdf *(per PoJL this document was only ever produced in draft form)*

[11] https://statesassembly.gov.je/scrutinyreviewtranscripts/2015/transcript%20-%20ports%20of%20jersey%20incorporation%20-%20cicra%20-%2022%20april%202015.pdf

[12] https://www.gov.je/SiteCollectionDocuments/Government%20and%20administration/ID%2013%20CICRA%20principles%20of%20regulation%20for%20Port%20of%20Jersey%20incorporation%2020140528%20CS.pdf

6.4 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL in its submission and the consultation responses received and has concluded that appropriate starting points for the assumptions to be used for a long-term pricing framework are

- The Air and Sea Ports (Incorporation) (Jersey) Law 2015;
- The Air and Sea Ports Incorporation (Transfer) (Jersey) Regulations 2015;
- The report and proposition 'Incorporation of Ports of Jersey' (P.70/2012);
  and for the reasons set out above, to a lesser extent,
- Evidence and assurances provided to Scrutiny Committees
- CICRA principles for regulation of PoJL
- The Case for Incorporation

'Business Planning and Forecasting Assumptions'

6.5 *General Inflation*

Category	Assumption	Justification
General Inflation	*Modelled at 3% per annum*	*3.3% per annum is the very latest view from SoJ Fiscal Policy Panel on long term inflation.*

Question 2: Do you agree with PoJL's proposal that 3% general inflation should be used as an assumption for a long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.6 *Summary of responses*

Of the seven consultation responses received, five (from Blue Islands, SoJ, Condor, Manche-Iles and the Confidential Response) responded directly to this question.

- Four responses (from Blue Islands, SoJ, Condor and Manche-Iles) agreed with PoJL's proposal that 3% should be used as an assumption for a long-term pricing framework.
- The Confidential Response also agreed with PoJL's proposal, but suggested that property leases should be considered separately given that 'they are placed out to tender and thus enjoy market rate'. It also suggested that port facility charges (harbour dues) are affected by outside influences and that the need to increase port facility charges could be reduced or negated by increasing volumes.

6.7 *CICRA analysis*

In its submission, PoJL proposed an assumed level of inflation of 3%, consistent with Jersey's Fiscal Policy Panel's (**FPP**) assumption for RPIY (all items excluding mortgage interest payments and indirect taxes) but below the FPP's assumption for RPI of 3.3%.

In determining what an appropriate level of general inflation should be, CICRA considered

a) the level of inflation proposed by PoJL in its submission of 3%;
b) the FPP's assumptions for RPI of 3.3% and RPIY of 3.0%; and

c) the level of inflation assumed in the financial modelling considered in P.70/2012 of 2.5%.

CICRA agrees that an appropriate level of general inflation should be assumed within a long-term pricing framework.

Both PoJL's proposal and the FPP's assumptions are above the 2.5% level assumed by P.70/2012. CICRA considers that it is appropriate to use the most up to date forecast information.

RPI is increasingly considered as flawed and outdated as a measure of inflation. RPIY (which excludes housing costs) as a measure is closer to the internationally comparable measure of inflation, the Consumer Price Index[13] (**CPI**) which Jersey does not currently calculate, but which is generally considered to be more accurate. In January 2015, the UK Statistics Authority published an independent review[14] of consumer price statistics which concluded that regulators should refrain from using RPI in pricing frameworks and instead use CPI (or CPIH).

Given the FPP's information is recognised by PoJL and CICRA to be the latest available and the use of RPIY is more closely aligned to CPI, CICRA concludes that a figure for general inflation of 3.0% per annum is an appropriate assumption for modelling purposes.

CICRA has also considered the suggestions made in the Confidential Response and agrees that for existing property leases it is appropriate to use the agreed terms.

In relation to the comment made in the Confidential Response suggesting that increasing volumes could (partially) negate the need for tariff increases, CICRA notes that the impact of any differences between actual and forecast volumes is dealt with elsewhere.

6.8 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL in its submission and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that a figure for general inflation of 3.0% per annum is appropriate for modelling purposes, with the exception of existing property leases which should reflect the terms of the agreements in place.

[13] *https://www.statslife.org.uk/economics-and-business/33-rpi-versus-cpi-what-s-the-difference-why-does-it-matter-will-it-make-you-poorer-or-richer*

[14] *https://www.statisticsauthority.gov.uk/reports-and-correspondence/reviews/uk-consumer-price-statistics-a-review/*

6.9 *Business Volumes*

Category	*Assumption*	*Justification*
Business Volumes	*Long Term business volume growth:* • *Air Passengers: 0.8% per annum long run* • *Sea Passengers: 0.0% per annum long run* • *Freight & Fuel: 0.53% per annum long run*	*Baseline (Case for Incorporation)* *Air passengers this was RDC Aviation and for Marine business this was Fishers Associates, validated through Scrutiny review independently using York Aviation and MDS Transmodal.* *Most recently, Mott MacDonald updated forecasts with the work performed on the Master Plan.*

Question 3: Do you agree with PoJL's proposal that long-term growth rates of 0.8% for air passengers, 0.0% for sea passengers and 0.53% for freight and fuel should be used as assumptions for a long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.10 *Summary of responses*

Of the seven consultation responses received, five (from Blue Islands, SoJ, Condor, Manche-Iles and the Confidential Response) responded directly to this question.

In respect of the airport

- Blue Islands and Condor agreed with PoJL's proposals in respect of volume growth at the airport of 0.8% per annum
- SoJ suggested that passenger demand at UK airports under the 'capacity constrained' scenario will grow at an annual rate of between 1.2% and 1.5% between 2016 and 2050 further commenting that 'a central forecast of 1.35% is actually significantly higher than the 0.8% projection by PoJL and [its] facilities are not currently capacity constrained'.

In respect of the harbour

- Manches-Iles, Condor and Blue Islands agreed with PoJL's proposals in respect of volume growth in sea passengers at 0% per annum and freight and fuel at 0.53% per annum, although Condor states it is unsure if the Visit Jersey arrivals growth strategy for 2019/30 had been included.
- SoJ considered that, 'given the recent declines in sea passenger volumes (14.6% between 2015 and 2017) a flat growth rate appears to be (overly) optimistic'.
- The Confidential Response suggested that, in general, construction work is cyclical and that current growth is simply 'correcting' the lower volumes seen in the recent past. The Confidential Response also suggested that, in certain areas, exceptional growth will be seen because of increases in population and 'new' products being shipped in increasing quantities including imported waste from Alderney, and exporting various waste products from the island.

6.11 *CICRA analysis*

CICRA notes that business volumes are a central element in calculating the price cap. They affect various components of the regulatory 'building blocks' simultaneously.

- Airport

In its submission, PoJL proposed long term business volume growth of 0.8% per annum for air passengers.

PoJL's projected growth in volumes in P.70/2012 anticipate a 1% per annum increase in passenger volumes at Jersey airport. These projections were subject to verification by RDC Aviation and were also validated through Jersey's governmental scrutiny process using York Aviation.

In its submission, PoJL noted that air passenger volumes have grown by 5.4% between 2015 and 2017, which is significantly above the growth volumes projected, albeit over a shorter period.

CICRA acknowledges the suggestion made by SoJ that the increase in passenger volumes should be higher than proposed by PoJL. SoJ has based its suggestion on the latest Civil Aviation Authority (**CAA**) forecast for aviation demand at UK airports, published at the end of 2017. The CAA forecast suggests an annual growth rate of between 1.2% and 1.5% in a capacity constrained scenario which could imply a higher growth rate without the capacity constraint.

CICRA has considered the UK aviation forecasts 2017[15] prepared by the Department of Transport (**DoT**), which are consistent with those suggested by SoJ as follows:

Unconstrained capacity[16]	Low	Central	High
2016 – 2020	1.5%	2.8%	4.3%
2020 -2030	1.6%	1.8%	1.8%

Constrained capacity[17]	Low	High
2016 – 2050	1.2%	1.5%

Unconstrained forecasts give a picture of underlying demand but are hypothetical as they do not take into account capacity constraints. Capacity constrained forecasts, based on available terminal and runway capacity, form the primary basis for the DoT's appraisal and decision making processes.

CICRA does not consider PoJL's growth rate to be constrained by capacity in the medium term, a view which is shared by SoJ.

[15] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/674749/uk-aviation-forecasts-2017.pdf

[16] *Unconstrained demand is premised on the absence of airport capacity constraints. These forecasts are therefore a hypothetical case independent of any airport development options and are therefore the less conservative forecast.*

[17] *Constrained capacity is premised on there being constraints to available terminal and runway capacity and is therefore the more conservative forecast.*

CICRA also considers that recent information is likely to provide a more accurate forecast of future volumes than older information.

PoJL has, over recent years, increased its volumes by more than 2.5% per annum. Jersey's population is estimated to have grown by 0.6% per annum over the past five years, the trend rate in GVA is currently estimated at 0%[18] and Visit Jersey's ambition is to reach one million visitors by 2030 which suggests a 2.5% compound annual growth rate from the 2017 base.

As such CICRA's draft decision is that the proposal of a 0.8% growth in volumes by PoJL is overly-cautious and that a growth rate of 2.7% should be incorporated as an assumption by PoJL.

- Harbour

In its submission, PoJL proposes long term business volume growth of 0.0% per annum for sea passengers and 0.53% per annum for freight and fuel.

PoJL's projected growth in volumes in P.70/2012 anticipated no increases in passenger volumes in respect of the harbour and a 5% increase in freight volumes. These projections were subject to verification by Fishers Associates and validated through Jersey's governmental scrutiny process using MDS Transmodal.

PoJL has seen a sharp decline in sea passengers since 2015 but expects to see a recovery in this market. Its submission suggested a flat growth in sea passengers over the long term until it has confidence that growth will return.

Visit Jersey's ambition is to reach one million visitors by 2030 which suggests a 2.5% compound annual growth rate from the 2017 base.

Given that PoJL expects to see a recovery in the market of sea passengers and Visit Jersey is projecting a 2.5% compound growth rate in visitor numbers PoJL's proposal of 0% seems overly cautious. As such CICRA's draft decision is that a growth rate of 1.25% should be incorporated as an assumption by PoJL.

CICRA acknowledges the suggestion, in the Confidential Response, that there is potential for new growth from increases to the island's population and 'new products'. PoJL's submission takes into account some potential new growth, making particular reference to 'two game changers, which are the likely long term decline in petroleum products and the potential significant uplift in aggregate imports'.

For freight at the harbour, Mott MacDonald has prepared updated forecasts for PoJL in conjunction with the work undertaken by PoJL on its harbour Master Plan.

CICRA considers that more recent information is likely to provide a more accurate forecast of future volumes than older information. Given that the forecast volumes have been the subject of recent independent validation (by Mott MacDonald) and include potential new growth as suggested by one respondent, there is no reason to suggest that the assumptions proposed by PoJL are not appropriate.

[18] *https://www.gov.je/Government/JerseyInFigures/BusinessEconomy/pages/nationalaccounts.aspx#anchor-1*

6.12 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that long term business volume growths of

- 2.7% for air passengers,
- 1.25% for sea passengers; and
- 0.53% for freight & fuel

are appropriate.

‘Investment Assumptions’

6.13 *Master Plans contained within the LTCP*

Category	*Assumption*	*Justification*
Master Plans Contained within the LTCP	*Airport: £42m for Integrated Terminal and associated regulatory investments* *Harbour: Phase 1 only @ £27m (Please note that further phases are being developed)*	*Airport Master Plan as per Stage 3 design estimates, validated by Corgan* *Harbour Master Plan as per Mott MacDonald plan*

Question 4: Do you agree with PoJL’s proposal that the amounts assumed by PoJL for the airport and phase 1 of the harbour ‘Master Plans’ should be used for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.14 *Summary of responses*

Of the seven responses received 6 (from Blue Islands, SoJ, Condor, Manche-Iles, Mr Finch and the Confidential Response) responded to this question.

In respect of the airport

- Manche-Iles agreed with PoJL’s proposal for the amount to include for phase 1 of the harbour Master Plan but stated that this ‘must include a real improvement of the Albert Terminal where the passengers are not treated as well as they should be’.
- Blue Islands stated that ‘it was not qualified to provide an informed opinion’ but ‘recognised the need for investment’.
- SoJ responded that ‘in the most recent update to the Strategic Business Plan 2018-2022 the total sums allocated for infrastructure investment was £40million, with £24.5million as part of the airport Master Plan with completion in 2022’.
- Mr Finch responded acknowledging that some regulatory issues have arisen due to changes over the years but that ‘the proposed expense of £42million seems completely disproportional to the advantages the passenger will experience in the proposed new building’. Mr Finch considers that the airport currently serves its purpose ‘particularly well’ and in his opinion investment should be targeted at working out how the airport can operate during bad weather.

In respect of the harbour

- Blue Islands stated that 'it was not qualified to provide an informed opinion' but 'recognised the need for investment'.
- Condor stated that 'We have insufficient information nor detailed clarity of the harbour Master Plan to make an informed comment'.
- The Confidential Response stated that 'we do not believe we understand the infrastructure and [PoJL's] responsibilities well enough to comment on this and perhaps it should be left to the professional bodies who have been consulted'.
- SoJ responded that 'As at the time of writing, the harbour Master Plan along with the anticipated level of capital investment has not been formally presented to the shareholder.

In more general comments at the start of its response, Condor expressed concern that significant development of the airport infrastructure at higher cost and in advance of harbour airport infrastructure could encourage a movement from sea travel to air travel, thereby resulting in a more difficult funding situation for the work to be done at the harbour and higher costs for passengers.

6.15 *CICRA analysis*

PoJL prepares Master Plans for the airport and harbour, grouping together aspects of the larger long term capital programme.

Delivering these Master Plans adds to PoJL's asset base, increases POJL's cost base and it is therefore more likely that PoJL will need to increase prices charged to port users.

In a competitive environment, a business such as PoJL would be incentivised to deliver Master Plans in a timely manner and at efficient cost, as not doing so would result in a competitive disadvantage. CICRA's goal when allowing PoJL to spend money delivering its Master Plans is to replicate these incentives as much as possible. CICRA does this by

- allowing expenditure only for projects which meet the needs of current and future users; and
- allowing no more than the minimum amount of money required to deliver a project.

CICRA expects PoJL to

- demonstrate that it has engaged fully and meaningfully with stakeholders, reflecting the views expressed by stakeholders during that engagement process, or state why particular feedback has not been reflected;
- demonstrate how its Master Plans will meet the current and future needs of customers; and
- deliver those Master Plans at a cost of no more than the minimum amount of money needed to deliver the project.

- Airport

In respect of the airport, PoJL's submission stated that the project 'is necessary for Jersey airport to remain compliant as airfield obstacles need to be removed and the alpha taxiway needs to be re-aligned. To accomplish this a new arrivals facility needs to be provided. In addition, there are a number of assets (such as the departures building and the passenger pier) which need investment'.

PoJL's submission also stated that 'we have engaged widely across the spectrum of customers and users of our facilities'. Its submission provided more detail around the groups engaged, the feedback sessions held and the changes to the design that were incorporated as a result of the engagement sessions. CICRA considers that PoJL has demonstrated that there has been engagement with stakeholders.

CICRA's role is to allow PoJL the minimum amount of money required to deliver a project and as such it must determine what the minimum amount of money required is. CICRA could commission its own review of the cost of delivering a project but this has cost and resource implications. Instead, consistent with its pragmatic approach to regulation, where appropriate, CICRA places reliance on the work of others, independent of PoJL, to support its considerations.

As government shareholder, SoJ considers and approves PoJL's strategic business plan. CICRA considers that it can place reliance on the fact that in order to approve PoJL's strategic business SoJ would have assured itself that the plan was appropriate, both in terms of the activities contemplated and the costs associated with those activities. SoJ's response states that the latest figure that PoJL has submitted in relation to the airport Master Plan is £40million (compared to £42m proposed by PoJL in its submission). It is not clear why the cost of the project should have risen by 5% since SoJ considered PoJL's strategic business plan in December 2017. On the basis that SoJ has scrutinised PoJL's plans CICRA considers £40m to be the most appropriate figure for the airport Master Plan, noting that only £34.05m is due to be incurred within the pricing framework period.

- Harbour

In respect of the harbour, PoJL's submission acknowledged that its 'harbour Master Plan work is not at as an advanced design stage as the Airport'. PoJL's submission provided more detail around the engagement to date which also demonstrates that the project is at an earlier stage of conception than the airport Master Plan. The consultation responses received, in particular from Condor and SoJ, suggested that significant further work is required before this Master Plan is fully developed.

The harbour Master Plan is not due to start until 2023 which, given the time horizon proposed for this price control, allows PoJL time to engage with stakeholders and fully develop its harbour Master Plans in advance of any future price control period. On that basis, CICRA does not need to make a decision at present on the appropriateness of PoJL's assumption in respect of the harbour Master Plan.

6.16 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that the amount included as the assumption for the airport Master Plan during the proposed five year price control period should be £34.05m (based on a total investment of £40m), and that the decision on the amount to be included as the assumption for the harbour Master Plan should be deferred until the next pricing framework period to allow more time for plans to be developed.

CICRA reminds PoJL that, in demonstrating compliance with the price control it will be required to demonstrate delivery of the project at, or below, the cost allowed to CICRA. In the event of a cost overrun, PoJL will be required to demonstrate how it intends to 'make good' the overrun.

6.17 *Long Term Capital Programme (LTCP)*

Category	*Assumption*	*Justification*
Long Term Capital Programme (LTCP)	*£286m (uninflated) over 25 years of investments just to keep facilities open to current standards, last reviewed June 2018. It is the LTCP that is required from core business revenues.*	*Originally built from Case for Incorporation, validated by Capita Symonds and York Aviation, updated for current position and forecast.*

Question 5: The amounts noted in paragraph 5.7 above are included in the £286m for the LTCP. In addition to specific comments in relation to the 'Master Plans', do you agree with PoJL's proposal that £286m (uninflated) of investment in the next 25 years across the facilities operated by PoJL should be used as an assumption for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.18 *Summary of responses*

Of the seven responses received, three responses (from Blue Islands, Condor and SoJ) directly answered this question.

- Blue Islands commented that, 'in the absence of more granularity on the projects included here it is difficult to comment meaningfully',
- Condor commented that it does not believe that the current plan includes what could be described as all of the important items / projects.
- SoJ commented that it was reasonable to conclude that £276 million is the most appropriate figure on the basis of the report commissioned by Capita Symonds which validated the Jersey airport and harbour proposed capital investment plan for the period from 2014-38. SoJ goes on to note that only £124m of the capital investment takes place during the proposed 10 year period of the price control and suggests that is may be more useful to ensure that all assumptions that are presented cover the same period.

6.19 *CICRA analysis*

PoJL has prepared a Long Term Capital Programme (**LTCP**) of investment over 25 years. Delivering this programme adds to PoJL's asset base, increases costs and therefore prices to port users. The LTCP was developed during the incorporation process. PoJL attempted to identify all capital investment needs for, as far as is practical, full asset lifecycle investment. The Master Plans form part of the LTCP and CICRA has taken the same approach to its considerations of the LTCP as it has to those Master Plans.

In a competitive environment, a business such as PoJL would be incentivised to deliver the programme that delivers improved outcomes for consumers, in a timely manner and at efficient cost, as not doing so would result in a competitive disadvantage.

CICRA's goal when allowing PoJL to spend money delivering the LTCP is to replicate these incentives as much as possible. CICRA does this by

a) Allowing expenditure only for projects which meet the needs of current and future users; and

b) Allowing no more than the minimum amount of money required to deliver a project.

CICRA expects PoJL to

- demonstrate that it has engaged fully and meaningfully with stakeholders, reflecting the views expressed by stakeholders during that engagement process, or state why particular feedback has not been reflected;
- demonstrate how the project will meet the current and future needs of customers; and
- deliver those projects at a cost of no more than the minimum amount of money needed.

CICRA has emphasised the importance of stakeholder engagement to PoJL on a number of occasions. On the basis of the responses received and the information provided by PoJL in its submission, with the exception of engagement with SoJ, CICRA notes that the submission does not provide evidence of stakeholder engagement, other than in respect of the airport and harbour Master Plans. On that basis CICRA could take the view that, until such time as that engagement occurs the amount to be included as an assumption in the long-term pricing framework should be zero, except in the case of the airport Master Plan as explained above.

CICRA acknowledges that PoJL engaged with its shareholder in respect of its LTCP prior to incorporation. PoJL validated its LTCP through Capita Symonds and SoJ further validated the LTCP through the scrutiny process appointing York Aviation and MDS Transmodel to independently validate the proposal.

PoJL's submission suggested that the LTCP is reviewed periodically, most recently by internal review in June 2018. Its most up to date total cost for the LTCP (2018 – 2043) is £286.06m compared with £276m at incorporation.

CICRA acknowledges that some adjustments may have been required between 2015 and 2018; indeed some expenditure will have taken place and the plan will have been extended in order to always looks at a 25 year time horizon.

CICRA has considered and concluded that, by exception, an appropriately pragmatic approach is to allow PoJL to demonstrate stakeholder engagement retrospectively (at the compliance stage). In respect of each project outlined below, CICRA will require PoJL to

- demonstrate that it has engaged fully and meaningfully with stakeholders, reflecting the views expressed by stakeholders during that engagement process, or state why particular feedback has not been reflected;
- demonstrate how its capital expenditure has / will meet the current and future needs of its customers; and
- demonstrate that it has delivered those projects at a cost of no more than the minimum amount of money needed.

PoJL has provided CICRA with a detailed breakdown of its LTCP. Expenditure over the period 2018 – 2022 can be summarised as follows

	£
Air Traffic & Navigation	4,600,000
Airfield, Aircraft and Security	9,325,000
Corporate	2,850,000
Fire Service	1,300,000
Harbour Equipment	950,000
Marine Leisure	4,140,000
Marine Services	1,450,000
Airport Masterplan	34,050,000
Navigation Aids	340,000
Passenger Handling	1,685,400
Piers, Quays and Commercial Ops	5,392,000
Property	5,150,000
Runway, Taxiways and Apron	2,330,000
£	73,562,400

Which, on an annual basis, can be broken down as

Year	£
2018	8,232,000
2019	18,265,000
2020	16,140,000
2021	15,775,000
2022	15,150,000
Total £	**73,562,400**

PoJL has also provided to CICRA a detailed project-by-project breakdown.

On the basis that PoJL's LTCP has been validated by SoJ through the scrutiny process, by independent assessors, that stakeholder engagement will be required, in advance, for each project, and that PoJL will be required to demonstrate delivery of the individual projects, CICRA considers that a reasonable assumption for the LTCP over the proposed five year price control period is £73.562m.

6.20 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that the amount included as the assumption for the LTCP over the proposed five year price control period should be £73.562m.

CICRA reminds PoJL that in demonstrating compliance with the price control it will be required to

- demonstrate that it has engaged fully and meaningfully with stakeholders, reflecting the views expressed by stakeholders during that engagement process, or state why particular feedback has not been reflected;
- demonstrate how its capital expenditure has / will meet the current and future needs of its customers; and

- demonstrate that it has delivered those projects at a cost of no more than the minimum amount of money needed.

In the event of a cost overrun, PoJL will be required to demonstrate how it intends to 'make good' the overrun.

6.21 *Commercial projects*

Category	*Assumption*	*Justification*
Commercial Projects	*A portfolio of future investments designed to provide a commercial return.*	*As per 2018 Strategic Business Plan (SBP), last reviewed Sep 2018. Updated for live and forecasted commercial projects.*

PoJL proposes that commercial projects will generate 'net revenue'[19] of £17.998m between 2018 and 2022 comprising, £11.3m from projects already completed, £5.13m from projects in progress and £1.537m from pipeline projects.

Question 6: Do you agree with PoJL's proposal that the 'commercial projects' and associated forecasted cash flows should be used as assumptions for the long-term pricing framework development? If not, what alternative(s) should be considered, and why?

6.22 *Summary of responses*

Of the seven responses received, five (from Condor, Blue Islands, SoJ, Manche-Iles and the Confidential Response) responded directly to this question.

- Condor, in principle, agreed with PoJL's proposal but noted that 'we are unable to determine if all the doable prospective commercial opportunities have been included in the modelling, if they have then fine, if they have not then the modelling is light in terms of additional revenue and profit deriving from those initiatives omitted which could mean that a higher requirement for user charges and prices has been set unnecessarily.'
- Blue Islands agreed with PoJL's proposal
- SoJ commented that the strategic business plan update presented in 2018 indicated annual revenues of £2.6m on completed commercial projects and a further £12.8m for projects which are being developed or are 'live'. However SoJ's response stated that it is unclear over what timeframe these revenues applied.
- Manche-Iles commented that it could agree with PoJL's proposal 'if Albert Quay is in the scope of this proposal' but notes that new commercial activities at the Albert Terminal are not shown in PoJL's submission.
- The Confidential Response commented that this should be left to the professional bodies who had been consulted.

[19] *PoJL has confirmed that it defines net revenue as revenue less direct operating costs.*

6.23 *CICRA analysis*

CICRA considers that commercial projects are those which fall outside of the areas in which PoJL has been found to be dominant. Those areas are set out in a previous CICRA decision[20].

In its submission, PoJL provided an overview of what it considers to be its new commercial activities, live projects and projects currently in the pipeline. Separately, PoJL has provided CICRA with more detail of these commercial projects.

PoJL proposed that £17.998m of 'net revenue' from commercial projects should be assumed over the period of the price control.

CICRA considers that a pragmatic and proportionate approach to consideration of commercial projects is to consider the business planning forecasts prepared by PoJL. These must be subject to analysis to ensure that the level of forecast contribution[21] assumed over the price control period is appropriate. If the assumed level is too low, higher charges than are necessary will be allowed for regulated services. If the assumed level is too high, lower regulated charges than are necessary will be allowed and PoJL may not have the funds required to undertake necessary investment.

In price controls, future revenues are usually forecast based on historic revenues. PoJL's proposed commercial projects comprise, 'a portfolio of future investments designed to provide a commercial return'. As such, there is no history on which to base future performance.

Benchmarking has been considered. However commercial revenues considered by, for example, the CAA in respect of Gatwick and Heathrow are focussed on revenues derived per passenger. The projects contemplated by PoJL are not generally focussed on generating additional revenues from passengers using the harbour and airport. In addition, while it may be possible to identify comparator airports, the same cannot be said for comparator sea ports given that there are few instances of sea ports being subject to regulation.

Through P.70/2012, SoJ established an agreed rate of return for commercial projects of a minimum of 8%. SoJ's response to the consultation confirmed that it has considered commercial projects as part of its overall consideration of PoJL's strategic business plan to 2022.

Consistent with the pragmatic approach being taken by CICRA, on the basis that there is nothing within PoJL's submission or in the responses received to suggest that the assumption is not appropriate, CICRA is content to for PoJL to assume a contribution of £17.998m over the period of a five year price control.

However, this contribution needs to be appropriately classified.

From the detailed information provided by PoJL it would appear that the commercial projects are a mixture of new opportunities in areas where PoJL has previously been found to be dominant, *e.g.* new hangers, and new commercial activities in markets where PoJL has not been found to be dominant *e.g.* shops and retail businesses. CICRA expects PoJL, when it makes its submission to the 'price control

[20] https://www.cicra.gg/media/3792/poj1204j-final-notice-ports-of-jersey-assessment-of-market-power.pdf
[21] Contribution (also known as 'contribution to fixed costs') is defined as revenues less variable expenses.

proper' phase of the process, to clearly distinguish between the two types of projects. Projects that fall within areas where PoJL has previously been found to be dominant fall within the price control. Projects that fall outside areas where PoJL has previously been found to be dominant fall outside the price control, although a contribution from those projects will be assumed within the pricing framework.

6.24 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that the contribution to be included as the assumption for commercial projects should be £17.998m.

In its submission for the price control proper phase, PoJL must separate commercial from non-commercial projects, as outlined above. Commercial projects should be included on the basis of an appropriate contribution, and non-commercial projects should distinguish between revenues, costs and capital required.

'Debt Assumptions'

6.25 *Net Debt on Core Activities*

Category	*Assumption*	*Justification*
Net Debt on Core Activities	*Limit set to 2.5-3.0x EBITDA, or currently £40m, until a regulatory long term price mechanism is established and proven.*	*We judge that 2.5-3.0x EBITDA is prudent for an early stage infrastructure business such as PoJL. Credit rating agencies would see this at the lower end of the Investment Grade spectrum for all companies.*

Question 7: Do you agree with PoJL's proposal that it should use a limit of 2.5-3.0x EBITDA[22] for net debt on its core activities as an assumption for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.26 *Summary of responses*

Of the seven responses received, two (from Condor and Blue Islands) responded directly to this question.

- Condor considered the limit for net debt on its core activities to be a matter for PoJL
- Blue Islands considered the assumption to be reasonable based on the comparators provided.

[22] Earnings before Interest, Tax, Depreciation and Amortisation. EBITDA is a way of quantifying the profitability of a business excluding financing activities.

6.27 *CICRA analysis*

CICRA acknowledges PoJL's view that it cannot fund the investment it considers is necessary from retained earnings and reserves. CICRA considers debt to be an important source of funding for PoJL, as it is in most commercial businesses.

PoJL's submission proposed assuming a limit to its use of debt funding. It is not clear why PoJL considered it appropriate to suggest imposing such a constraint on itself.

CICRA acknowledges that part of the rationale for the incorporation of PoJL was financial sustainability, which includes the requirement for 'considering carefully the appropriate sources of funding for major projects'.[23] One of the benefits to PoJL of incorporation was the ability to 'raise external funding in order to invest in improved technology and high quality services, and improvements to facilities for customers'.[24] CICRA therefore anticipates that PoJL will fund its investments using a mixture of debt funding and retained income.

If debt is used excessively as a source of funding, the cost to the entity using it tends to rise. However PoJL is an infrastructure-heavy business with predictable revenue streams. As stated in P.70/2012, 'both the port and the airport are, and will remain, natural monopolies in Jersey', and CICRA has found that PoJL has dominant positions in the markets for provision of a number of services. PoJL can reasonably be considered to carry lower levels of risk to its future revenue streams than the average corporate entity.

PoJL is an entity transitioning from an essentially cash-based accounting framework to a more flexible corporate structure. Debt funding for infrastructure projects can be used as a tool to secure capital in a way which ensures that assets are paid for by revenues of the users of those assets rather than revenues derived from users of pre-existing assets. Determination of the actual efficient level is therefore difficult to achieve in the absence of historical information. However, if ensuring that capital is available for investments without disproportionate charges on customers in the short term is made impossible because a limit has been set, the aims of this pricing framework would not be achieved.

CICRA does not therefore consider the imposition of a limitation on borrowing by PoJL to be in the best interests of maximising efficiency of operations by PoJL. The possible availability of cost-effective funding based on the low-risk nature of PoJL's revenues should not be foregone.

Notwithstanding the above, CICRA would not seek to force PoJL to use debt funding above the level which it can negotiate to achieve an efficient use of resources.

6.28 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that it is not appropriate to set a limit for net debt on core activities as part of this pricing framework.

[23] *P.70/2012 3.2*
[24] *P.70/2012 4.4*

6.29 *Net debt on Commercial Projects*

Category	*Assumption*	*Justification*
Net debt on Commercial Projects	*As available from institutions and partners on a project specific basis.*	*Debt may be raised solely against project assets but is usually more costly than Company debt and needs to be of a size to warrant the arrangement costs and issues.*

Question 8: Do you agree with PoJL's proposal that it should use a net cost of debt on commercial projects based on the terms that may be available from institutions and partners on a project-specific basis as an assumption for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.30 *Summary of responses*

Of the seven responses received, two (from Condor and Blue Islands) responded directly to this question.

- Condor responded that it 'probably' agreed with PoJL's proposal that it should use a net cost of debt on commercial projects based on the terms that may be available on a project-specific basis.
- Blue Islands agreed with PoJL's proposal.

6.31 *CICRA analysis*

PoJL's return from its commercial projects is relevant to the pricing framework insofar as the contribution made by such projects increases the resources available to fund its activities in markets in which PoJL is dominant.

As explained above, CICRA does not consider it to be cost-effective or appropriate to make a detailed assessment of PoJL's commercial projects as part of the determination of this long-term pricing framework. CICRA has placed reliance on the oversight of SoJ in its role as shareholder and expects that oversight to encompass consideration of PoJL's proposed commercial projects, the target return and the associated funding. The debt levels appropriate to specific projects are likely to vary depending on the detail of the project.

CICRA therefore agrees with PoJL that levels of debt for commercial projects should be on a project-by-project basis.

CICRA suggests that PoJL should be cognisant of the argument that, as a monopoly business, it would be considered 'low risk' in terms of the rates it may be able to access for debt financing. This has the potential to represent an unfair and unintended competitive advantage over other businesses.

6.32 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that debt on specific projects should be assessed on a project by project basis.

6.33 *Cost of Debt*

Category	Assumption	Justification
Cost of Debt	*5% Long Term, 3% Medium Term*	*Historic interest returns to investors has been 3%, combined with the Bank of England's target inflation rate of 2.5%, it would equate to a long run interest rate expectation of 5.5%.*

Question 9: Do you agree with PoJL's proposal to use a cost of debt of 3% in the medium term and 5% in the long term as an assumption for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.34 *Summary of responses*

Of the seven responses received, three (from Condor, Blue Islands and Manche-Iles) responded directly to this question.

- Condor responded that it 'probably' agreed with PoJL's proposal to use a cost of debt of 3% in the medium term and 5% in the long term.
- Blue Islands and Manche-Iles agreed with PoJL's proposal.

6.35 *CICRA analysis*

CICRA considers it reasonable to assume that 'medium term' constitutes up to ten years, and 'long term' includes the remainder of PoJL's planning over a 25 year period, which is consistent with information separately provided by PoJL. CICRA reads the above assumptions as indicating a pre-tax cost of debt, as PoJL has not discussed the effect of tax on the cost of debt in its submission. In the following, PoJL's submission has been taken to present a nominal cost of debt figure.

Without a developed history of borrowing to give an understanding of the market's appreciation of risk-based returns required for lending to PoJL, determination of the appropriate cost of debt relies on external indicators.

Considering long-term rates, given that the 25-year average for the Bank of England base rate is 3.5%,[25] and accepting a 1.5% increment for specific risk (as suggested by PoJL in its submission is available for a revolving credit facility) a nominal rate of 5% for long-term debt would be suggested. It is noted that a 3% average real return for investors from interest rates is cited by PoJL in it submission, notwithstanding PoJL's later statement that it expected a revolving credit facility to attract a margin of 1.5% on the basis of initial negotiations. Such a facility can reasonably be expected to attract a higher margin than more stable borrowing, and this figure can therefore be seen as an upper guide for floating rate credit margins for PoJL, and suitable for use in the absence of historical information and clear comparator companies' experience.

[25] *CICRA Analysis based on https://www.bankofengland.co.uk/monetary-policy/the-interest-rate-bank-rate using Bank Rate, Minimum Lending Rate, Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate as appropriate.*

The medium-term cost of debt suggested by PoJL appears to be appropriate, based on the ten-year average of the Bank of England base rate, rounded up to 1% in recognition of the change of the Official Bank Rate to 0.75% on 2 August 2018, and applying the same specific risk increment of 1.5% as above. This would give a total of 2.5%. In the context that PoJL considers it possible to achieve a margin in the region of 1.5% over benchmark rate (which would not necessarily be the Official Bank Rate), by adding the rounded 10-year average for the Official Bank Rate of 1% to this margin of 1.5%, a rate of 2.5% is found. 10-year UK Gilts are currently yielding in the region of 1.5%, with 30-year Gilts at c.2.0%[26], and when the same margin is added for risk a range of 3.0% to 3.5% is found. This suggests that 3.0% is a reasonable nominal assumption for the medium term in the absence of historical borrowing information for PoJL.

The use of 3% is therefore considered appropriate by CICRA. However, the inflation assumption submitted by PoJL and their medium term nominal cost of debt are the same figure. This puts PoJL's assumed real cost of debt at 0% for the purposes of its planning, which CICRA notes and accepts given the current low interest rate environment.

6.36 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that a cost of debt of 3% pre-tax nominal cost in the medium term and 5% pre-tax nominal cost in the long term are appropriate.

'Cost and Cost Pressures Assumptions'

6.37 *Operating Cost Efficiency*

Category	***Assumption***	***Justification***
Operating Cost Efficiency	*A target to reduce the cost base by 0.2% per annum in real terms against Jersey's general and activity specific inflation levels.*	*PoJL is a highly regulated business, whereby many areas of fixed costs (i.e. volume independent) are determined by international compliance standards. Detailed analysis shows the extent to which the remainder is variable. We have high influence over 10% of total opex and moderate influence over 17%, leading to a target to reduce these costs by 1% pa and 0.5% pa respectively in real terms.*

Question 10: Do you agree with PoJL's proposal that it should use an efficiency target of 0.2% (in real terms)[27] operating cost reduction for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

[26] *(Data from https://tradingeconomics.com/united-kingdom/government-bond-yield as at 14 Nov 2018)*
[27] *The concept of 'real terms' is in contrast to a value which includes inflation.*

6.38 *Summary of responses*

Of the seven responses received, four (from Condor, Blue Islands, SoJ and Manche-Iles) responded directly to this question.

- Condor responded that 'in general it could be viewed that this may not be a sufficiently stretching objective for the organisation bearing in mind PofJ is relatively recently created incorporated entity so private sector disciplines should lead to enhanced productivity and cost-effective efficiency, but clearly this is an assessment for the PofJ Board and Executive to determine'.
- Blue Islands and Manche-Iles agreed with the proposed efficiency target. Blue Islands noted that 'it was unable to scrutinise whether the reported segmentation of cost by level of control is accurate'.
- SoJ responded that it 'would be useful if the OPEX efficiency target of 0.2% was compared with best practice in other jurisdictions to demonstrate if it is an appropriate figure.

6.39 *CICRA analysis*

PoJL's submission suggested that a target to reduce the cost base by 0.2% per annum in real terms against Jersey's general and activity specific inflation levels is an appropriate assumption to inform the pricing framework. PoJL based this figure on being able to continue to make efficiencies across the business but suggested that much of its cost base is determined by international requirements, operational regulatory controls and maintaining service standards and therefore its ability to influence its cost base over the medium term is limited.

In relation to efficiencies, there are two broad approaches that CICRA could take

- Conduct its own efficiency review
- Benchmarking efficiencies targets against other harbours and airports

CICRA has considered conducting its own efficiency review and concluded that this would be contrary to the pragmatic approach it is taking, given the resources that would be required and the delay to the process that would result. CICRA takes some comfort in the fact that no consultation responses were received that suggested that PoJL's proposal is inappropriate, although Condor suggests that the target 'may not be a sufficiently challenging objective'. PoJL has proposed ongoing real-terms efficiencies.

Benchmarking efficiency targets is also problematic given the need to identify suitable comparators where efficiency data is available. Information has been found for Heathrow, Gatwick and Dublin airports. It is acknowledged that these airports differ from PoJL, including that they are at a later stage in their regulatory cycles, when regulatory pressure could be expected to have already resulted in efficiency savings, but the core activities and the broader regulatory environment (outside economic regulation) within which they operate will be broadly similar.

The CAA's current licence for Heathrow Airport[28] provides for a 1% frontier shift target (ongoing efficiency) and its licence for Gatwick Airport[29] provided for a frontier shift target of 0.9% and 1% per

[28] *CAA Economic regulation at Heathrow from April 2014: Notice granting the licence* *http://publicapps.caa.co.uk/docs/33/CAP1151.pdf p 253*
[29] *CAA Economic regulation at Gatwick from April 2014: Notice granting the licence* *http://publicapps.caa.co.uk/docs/33/CAP1152LGW.pdf p 169*

annum. The Commission for Aviation Regulation commissioned a report on Dublin Airport[30], published in 2014, which on identified efficiency savings of between 2.8% and 7.1% over 5 years.

PoJL's suggested target appears conservative in this context. On that basis, CICRA's draft decision is that an appropriate efficiency target for PoJL is 1.0% per annum in real terms for the airport.

No easily available information has been found for a comparator harbours. However, the arguments which PoJL presents for the difficulty of achieving efficiency savings in the context of a highly regulated environment are no more applicable to the harbour than the airport and therefore the harbour can reasonably be seen to have at least the same efficiency possibilities.

6.40 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that a target of 1.0% in real terms per annum for operating cost efficiencies is appropriate.

6.41 *Depreciation of Fixed Assets*

Category	*Assumption*	*Justification*
Depreciation of Fixed Assets	*Determined by the 'Jersey Financial Reporting Manual' accounting standard as in the SoJ published accounts.*	*Upon Incorporation, SoJ transferred the assets to PoJL with an assumption that they would be maintained and replaced as required. JFREM uses a Depreciated Replacement Cost (DRC) methodology to ensure replacement value is maintained.*

Question 11: Do you agree with PoJL's proposal that it should use a depreciated replacement cost methodology based on the Jersey Financial Reporting Manual (JFREM) for calculating depreciation in business plans on which the long-term pricing framework will be based? If not, what alternative(s) should be considered, and why?

6.42 *Summary of responses*

Of the seven responses received, four (from Condor, Blue Islands, SoJ and Manche-Iles) responded directly to this question.

- Condor responded that PoJL's proposal to base assumptions on depreciation on JFREM accounting standards as in SoJ published accounts was 'reasonable'.
- Blue Islands and Manche-Iles agreed with the proposal.
- SoJ responded that 'asset valuation for the purposes of determining regulated prices needs to be based on a number of other factors and not just the relevant financial accounting standards. […] It would not be appropriate to make a decision based purely on the relevant accounting standards as this may affect incentives introduced by the regulatory regime'.

[30] *Steer Davies Gleave report for the Commission for Aviation Regulation - Dublin Airport Operating Expenditure Efficiency Study – Final Report – 11 September 2014*
http://www.aviationreg.ie/_fileupload/2014final/SDG%20Opex%20Report.pdf

6.43 *CICRA analysis*

In its submission, PoJL proposed that, for the purposes of regulatory reporting, PoJL should use the asset valuation as determined by applying the 'JFREM' accounting standard which is based on a depreciated replacement cost. PoJL suggests that this will allow it 'to cover the financial capital maintenance on a depreciated replacement cost basis […] to ensure the asset base of the company is maintained over the long term'.

Depreciation is a means by which the cost of buying and then using an asset to generate revenue is recognised over the life of that asset. CICRA recognises that PoJL must have sufficient resources to maintain and replace its asset base efficiently and as necessary, and in general, would expect PoJL to follow the principle of 'user pays'.

CICRA's consideration of PoJL's asset base has identified four separate categories of assets:

- Those assets, transferred to PoJL on incorporation, for the provision of public service obligations or for their historic value (heritage assets), for example, a lighthouse, or a breakwater. With the exception of those relating to the Channel Islands Control Area (**CICA**), such assets do not generate material revenue. (**Legacy PSO assets**);
- Those assets which have been or will be purchased by PoJL after incorporation for the provision of PSO obligations, for example, a new coastguard launch. As a rule, these assets do not generate material revenue (**New PSO assets**);
- Those assets, transferred to PoJL on incorporation, which provide chargeable services which directly generate revenue (for example, the runway or a harbour ramp) (**Legacy Business Assets)**; and
- Those assets which have been or will be purchased by PoJL after incorporation for the provision of chargeable services which directly generate revenue, for example, a replacement radar array (**New Business Assets**).

<u>Legacy PSO Assets</u>

Assets with heritage value need maintenance, but are not expected to be replaced. These assets were 'cash' purchases prior to incorporation. While they need maintenance, for which CICRA expects PoJL to include anticipated funding requirements in its submission for the pricing control framework, these assets have an indefinite useful life, and therefore PoJL does not require funds to recognise the consumption of the asset. Recognising depreciation on these assets would therefore be inappropriate in the pricing framework. If the asset value were impaired for any reason, this would not be a real cost to PoJL, in terms of future revenue streams, so the accounting treatment of this loss would be irrelevant to PoJL's funding requirement.

PSO assets without heritage value (for instance a coastguard launch), which will require replacement and are used for the provision of PSO obligations, were paid for under cash accounting by SoJ. Although they continue to provide benefit, the cost of that benefit has already been paid for by past consumers. Given that they were paid for from prior revenues, it would be inappropriate to allow depreciation for these assets in the determination of a revenue requirement for PoJL. Replacement of these assets will be considered under New PSO Assets below.

The exception is the CICA which is revenue-generating. Therefore for the purpose of consideration of the assumption to be included in the pricing framework, related assets should be treated as legacy business assets (see below).

New PSO Assets

The provision of assets for PSO obligations which generate no (or immaterial) revenue is a direct cost to PoJL which is not associated with a future benefit. From a normal accounting perspective, this would suggest that the asset has no 'value in use' and therefore the full cost of buying the asset is borne immediately on purchase. As such, the cost of new items should be provided for from revenues achieved before purchase, if capital attributable to the shareholder is not available, with as much smoothing of this funding flow as possible. No depreciation should be allowed.

CICRA notes that most PSO assets do not provide a return on capital, and as an obligation imposed on PoJL by SoJ via the Law, the element of PoJL's use of capital relating to PSOs constitutes a dividend in kind provided to SoJ. The full cost of provision of PSO asset purchases, (as discussed below) should therefore be considered as to be deducted from the monetary element of any return on capital for SoJ as shareholder.

Legacy Business Assets

Assets transferred to PoJL at incorporation were transferred on the same basis as Legacy PSO assets. The full cost of the use of these assets has been covered by past revenues. It could therefore be argued that depreciation should not be recognised as an allowable expense for PoJL in this pricing framework. However, to value these as nil (as is effectively the case if no depreciation is allowed as an expense) appears inappropriate given their value to PoJL as a source of revenue generation. In addition, these assets generate revenue and in general have a useful life, and PoJL must be allowed to preserve its asset base. Therefore PoJL must be allowed depreciation on these assets.

The difference in the valuation of this class of assets under JFREM and FRS102 has not been provided in detail. However, the standard FRS102 methodology is appropriate for assets which are used in revenue generation, as they have a 'value in use' and a finite asset life over which to apportion the cost.

Over time this asset class will diminish and will be replaced by new investments (see New Business Assets below).

New Business Assets

The purchase and use of assets in revenue-generating areas falls within standard accounting treatments, which are designed to ensure the matching of use with cost. Therefore CICRA considers that depreciation of newly acquired assets should be allowed against revenues for the period concerned, to the extent that the value of the assets being used is diminished. For this pricing framework, the initial valuation should be the actual cost of the asset, and in the absence of specifically justifiable different means of determining the consumption of the value of the asset, a straight-line charging of depreciation over the asset's expected useful life would be an appropriate way of recognising the revenue requirement to cover its cost.

Summary of CICRA's position on depreciation for this pricing framework

Depreciation is a measure of the cost to an entity of consuming an asset to generate revenue over time. With the exception of the CICA, PSO and heritage assets represent a cost on purchase; no material revenue is generated and there is no ongoing capital cost to PoJL.

Legacy PSO Assets have been financed from past revenues - depreciation is not a concept which should be applied to them in the context of a pricing framework (although to maintain their integrity, maintenance will be required and revenue will be needed to cover this element).

For New PSO Assets, the cost of purchasing the asset must be held as capital by PoJL at purchase, so (with as much smoothing as possible) revenues should be allowed to ensure the ability of PoJL to renew its PSO assets as required, though not through depreciation allowances.

Business Assets and assets related to the CICA require a depreciation cost for the purposes of a pricing framework. The valuation to be used for Legacy Business assets should be one which is compatible with FRS102 in that that framework is predicated on commercial value. For New Business Assets, where asset purchases are appropriate, the depreciation cost is a reasonable cost of supplying the service, and therefore should be included in the revenue allowance for this pricing framework.

6.44 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is

- PSO assets do not usually generate a material return, and constitute a cost at purchase from a regulatory perspective. Those assets already purchased were paid for from past revenues and those to be purchased need to be purchased from retained earnings. The expected cost of purchasing PSO assets should be allowed in the calculation of revenue if necessary, but depreciation should not be taken into account.
- For all Business Assets (those which generate revenue directly or indirectly, including substantial infrastructure such as runways and harbour ramps) depreciation is an expense which should be allowed over the full anticipated useful life of the asset, based on its actual cost or FRS102 value.

6.45 *Public Service Obligations (PSOs)*

Category	*Assumption*	*Justification*
Public Service Obligations (PSO)	*PoJL will provide identified obligations, such as maintenance of Historic Harbours and provision of Coast Guard Services that would not normally be the responsibility of a commercial business.*	*The PSOs are as specified in the Air and Sea Ports Incorporation Law, and the cost of provision of these is derived from the commercial operations of the business.* *PoJL are compelled in law to provide these services.*

In total, the PSOs provide a contribution to fixed costs. The PSO associated with the airport, the CICA is revenue-generating and the PSOs associated with maritime activities are not revenue-generating.

Question 12: Do you agree with PoJL's proposal that it should assume for the long-term pricing framework that its obligation to provide PSOs as currently set out in law and that the associated costs and revenues will continue? If not, what alternative(s) should be considered, and why?

6.46 *Summary of responses*

Of the seven responses received five (from Condor, Blue Islands, SoJ, Manche-Iles and the Confidential Response) responded directly to this question.

- Condor responded that PoJL's proposal to assume that its obligation to PSOs will continue was a matter for SoJ as shareholder and PoJL as operator, but that it 'appears a reasonable approach'.
- Blue Islands responded that it agreed with PoJL's proposal and that 'Any net inflows (chiefly CICA) should be used to offset levies charged to users of the ports'.
- Manche-Iles responded that it did not agree with PoJL's proposal. In its opinion 'the PSOs must be supported by SoJ and not by an incorporated company'.
- SoJ responded that as any change to the current PSOs would require a law change it is unlikely in the medium term. SoJ expects PoJL to review the cost of providing PSOs regularly in order to identify any efficiency savings, and to take reasonable measures to ensure consistency of revenue from the CICA. It also suggests that PoJ should make it clear whether the provision of PSOs is subject to the same efficiency savings targets as other areas of the business.
- The Confidential Response stated 'we do not believe we understand the infrastructure and their [PoJL's] responsibilities well enough to comment on this and perhaps it should be left to the professional bodies who have been consulted'.

6.47 CICRA analysis

The PSOs are set out in the Law and, as SoJ's response confirms, these are unlikely to change in the medium term. It is PoJL's responsibility to provide these services, which generate some revenue and incur some cost, and therefore it is appropriate that CICRA takes this into account when establishing a long-term pricing framework.

CICRA notes that the use of a single-till methodology (see below) brings all elements of the cost and benefits of PoJL's activities into consideration, and therefore it is not possible to avoid consideration of the cost of the PSOs. The PSO's make a net contribution to PoJL's fixed costs.

The provision of PSOs is one way in which PoJL generates a 'return' to its shareholder, SoJ. The return on capital achieved by PoJL is provided to SoJ in different ways, and the PSO provision by PoJL is one of these where that provision generates cost. Where provision of PSOs generates revenue, that revenue should also fall to the benefit of SoJ. In other words, the profit of PoJL should be reduced by the cost of these services to the extent that they represent a net cost to PoJL, and increased to the extent that revenues are received from PSOs.

CICRA notes the concern expressed by SoJ regarding whether PSOs will be included in PoJL's targeted efficiencies. CICRA is unable to regulate the costs and efficiencies of PSO provision because PSOs are not licensed by CICRA and are excluded from being licensed by Article 5(3) of the Law. CICRA suggests that this is something that should be established between PoJL and its shareholder at the earliest opportunity. In the absence of a specific determination by the shareholder, at this stage in the process, an assumption consistent with that for other operating expenditure would not be unreasonable, i.e. that PSO costs should be assumed at the current (2018) level in real terms less the efficiency assumption set elsewhere in the decision.

6.48 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA that the cost of the PSOs should be assumed at the current (2018) level in real terms less the efficiency assumption set elsewhere in this decision.

6.49 *Community Support*

Category	***Assumption***	***Justification***
Community Support	*PoJL will continue to support various community activities in the same manner as before Incorporation.*	*PoJL supports key island events (the Boat Show and Air Display), provides support to a variety of Clubs, Societies and Associations, and maintains heritage assets – all of which comes with a cost.*

Question 13: Do you agree with PoJL's proposal that it should assume for the long-term pricing framework that it will continue to support community activities in the same manner as before incorporation? If not, what alternative(s) should be considered, and why?

6.50 *Summary of responses*

Of the seven responses received, five (from Condor, Blue Islands, SoJ, Manche-Iles and the Confidential Response) responded directly to this question.

- Condor and Manche-Iles responded that PoJL's proposal to continue to support various community activities in the same manner as before incorporation is appropriate.
- Blue Islands' response disagreed with PoJL proposal on the basis that 'the purpose of the incorporation of PoJL […] does not extend to the types of support listed in the submission. […] Such activities should be separated from the long-term pricing framework that should focus solely on core operational activity.
- SoJ responded that 'given the public ownership model of PoJL, SoJ would expect the company to participate in activities that provide social / environmental / economic benefit to the island. SoJ notes that the specific level of support is not defined by the shareholder and it would expect this to be reflected in KPIs set for the Executive by the Board.'
- The Confidential Response responded that 'we do not believe we understand the infrastructure and their [PoJL's] responsibilities well enough to comment on this and perhaps it should be left to the professional bodies who have been consulted'.

6.51 *CICRA analysis*

The provision of services to the community by commercial business is generally considered as part of its 'Corporate Social Responsibility'. The provision is discretionary but when appropriately targeted is generally acknowledged to result in positive benefits to the business including improved employee engagement, increased customer loyalty and positive public attention. These have to be set against the financial and resource implications, with the cost implications ultimately impacting on the financial return to the shareholder.

PoJL is no different in this regard. To the extent that it provides community support, PoJL should be able to demonstrate the positive benefits that accrue. Community support should be agreed with the shareholder.

CICRA notes that the use of a single-till methodology (see below) brings all elements of the cost and benefits of PoJL's activities into consideration, and therefore it is not possible to avoid consideration of the cost of community support. However given that the cost indirectly falls to the shareholder, to the extent that SoJ wishes to determine the level of community support, it is able to do so. In the context of the current process for development of a long-term pricing framework and in the absence of a specific determination by the shareholder, CICRA does not object to PoJL's assumption that community support will continue at 2018 levels in real terms, noting the efficiency assumption set elsewhere in this decision.

6.52 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that the cost of community support should be assumed to continue at the current (2018) level in real terms less the efficiency assumption set elsewhere in this decision.

In the context within which PoJL operates CICRA considers the matter of community support to be one for PoJL to determine in discussion with its shareholder, SoJ, given it will ultimately impact on any financial return received in the future. CICRA acknowledges that other benefits beyond financial return, e.g. wider benefit to the island, will form part of SoJ's considerations.

'Dividend to Shareholder'

6.53 *Dividend to Shareholder*

Category	*Assumption*	*Justification*
Dividend to Shareholder	*No cash dividends until the company is financially self-sustainable.*	*SoJ does not budget to receive cash dividends from PoJL and similarly is not called upon to invest. We do however provide incremental cash to SoJ via the 20% corporate tax rate on utilities, as well as covering the cost of PSO obligations which in other jurisdictions are funded by the tax payer.*

Question 14: Do you agree that PoJL's proposal that no cash dividends will be paid until PoJL is financially self-sustainable is an appropriate assumption for the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.54 *Summary of responses*

Of the seven responses received four (from Condor, Blue Islands, SoJ and Manche-Iles responded directly to this question.

- Condor and Manche-Iles responded agreeing with that PoJL's proposal that no cash dividends should be paid to SoJ until the company is financially self-sustainable.
- Blue Islands also agreed and in addition suggested that 'consideration should be given to the use of any distributable profits to reduce levies on users of the ports for growth or investment in further enhancements'.
- SoJ responded noting that the financial model contained within P.70/2012 assumed a dividend of 12.5% of profit after tax, 'although a dividend policy was to be formally agreed with the shareholder in due course'. It confirmed its expectation for a dividend to be paid from a future date.

6.55 CICRA analysis

CICRA would not expect PoJL to pay a dividend to its shareholder unless in a position to do so without jeopardising its own financial viability.

In the absence of expectation of a dividend to SoJ, CICRA agrees that there should be no dividend to the shareholder in the term of this pricing framework.

CICRA notes that, in future periods, a return to PoJL's shareholder may be required.

6.56 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that PoJL should assume that it will not be required to make a financial return to the shareholder for the period of the price control.

'Funding Philosophy'

6.57 *Funding Philosophy*

Category	*Assumption*	*Justification*
Funding Philosophy	*Funding for the capital investments will come from a combination of cash generation from core operations and commercial projects, as well as debt raised without SoJ guarantee. We envisage a single till for all CICRA economic regulated activities.*	*Over time, we expect airport operations to fund the necessary airport investments, and harbour operations to fund the necessary harbour investments. However, capital projects are 'lumpy' by nature and in any given year airport or harbour investments may be weighted heavier. The Harbour also has to cross-subsidise the Coastguard and Historic Harbours.*

Question 15: Do you agree with PoJL's proposal that it should assume for the long-term pricing framework that funding for capital investments will come from a combination of cash generation from core operations and commercial projects, as well as debt raised without SoJ guarantees? If not, what alternative(s) should be considered, and why?

6.58 *Summary of responses*

Of the seven responses received, four (from Condor, Blue Islands, SoJ and Manche-Iles) responded directly to this question.

- Condor responded agreeing with PoJL's proposal that funding for the capital investments will come from a combination of cash generation from core operations and commercial projects, as well as debt raised without SoJ guarantee.
- Blue Islands responded disagreeing with PoJL's proposal. It suggested that 'any debt raised should be with a SoJ guarantee to enable PoJL to achieve the best possible rate within the marketplace'.
- Similarly to Blue Islands, Manche-Iles disagreed with PoJL's proposal and suggested that SoJ 'should guarantee (a part) of the debt.'
- SoJ responded noting that it expects 'the Board of POJL to determine the most appropriate methods of funding capital investments […] Whilst POJL infers that lenders will take some comfort from SoJ being the sole shareholder, SoJ is unlikely to want to provide a formal guarantee for any borrowing undertaken by PoJL.

6.59 *CICRA analysis*

In its submission PoJL proposed that funding for the capital investments will come from a combination of cash generation from core operations and commercial projects, as well as debt raised without SoJ guarantee.

CICRA has a duty under the Law[31] to perform its functions so as best to protect and further the interests of users of port operations in the short and long term. Implicitly therefore CICRA must ensure that PoJL has sufficient financial resources to operate.

SoJ incorporated PoJL on the basis that it would become financially self-sustainable without recourse to SoJ.

Commercial businesses routinely use debt funding as a source of financing. CICRA considers PoJL to be no different in this respect. CICRA expects PoJL to achieve an efficient balance between debt funding and funding from retained reserves.

The issue of guarantees on debt is outside of CICRA's ability to determine and any respondents with concerns on this matter should raise them directly with the shareholder. CICRA accepts the position of SoJ which is that it will not provide any formal guarantees for borrowing undertaken by PoJL.

6.60 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that PoJL should assume that funding for investments will be from a combination of retained capital and debt raised without SoJ guarantees and from retained capital.

Question 16: Do you agree with PoJL's proposal to use a single till[32]? If not, what alternative(s) should be considered and why?

6.61 *Summary of responses*

Of the seven responses received, three (from Condor, Blue Islands and Manche-Iles) responded directly to this question.

- Condor responded that it is 'not entirely sure what definition of 'single till' is being used in this context.' However that the airport has 'consistently received a disproportionately higher share of capital funding than the harbour' which Condor believes should now be redressed so a fair allocation is invested at the Harbour and with some degree of reasonable 'catch up' for the harbour assets.
- Blue Islands and Manche-Iles responded agreeing with PoJL's proposal.

[31] *Air and Sea ports law article 26(1)(a)*

[32] *Single till – all activities (both regulated and non-regulated 'commercial' activities) are taken into consideration when determining the level of charges. Dual till – charges are determined taking into account regulated activities only. An adjusted or hybrid till includes an elements of non-regulated 'commercial' activities when determining the level of charges.*

6.62 *CICRA analysis*

In its submission PoJL proposed a 'single till' for all CICRA regulated activities. This implies that non-regulated 'commercial' activities are excluded. In its 'Call for Information' CICRA defined single till, as 'all activities (both regulated and non-regulated 'commercial' activities) are taken into consideration when determining the level of charges'.

For the avoidance of doubt the words 'determining the level of charges' refer to the level of charges allowed in markets in which PoJL is dominant.

CICRA considers the use of a single till to be implicit in the reasons for the incorporation of PoJL. The premise behind the incorporation of PoJL was to remove the need for SoJ to provide ongoing financial support by allowing PoJL to engage in borrowing and the development of commercial activities which were not feasible under a pre-incorporation model. The contribution of commercial projects to PoJL's profitability is therefore relevant to PoJL's ability to provide its core services, including those in markets in which PoJL is dominant. For instance, P.70/2012 includes the statement 'By deriving incremental revenues from the assets, revenue streams will be diversified, with consequently reduced reliance on fees and tariffs from commercial customers.'[33]

CICRA notes that the question of whether distinct sectors of activity such as the commercial port operations and airport operations should be separately self-funding is distinct from the question of whether a single till should be applied. The application of a single till relates to whether profits earned through PoJL's activities in markets in which it is not dominant should be taken into consideration when determining the level of charges in markets where it is dominant. Under single till, to the extent that activities in markets where PoJL is not dominant are profitable, revenue requirements from markets in which PoJL is dominant will be reduced (and where overall losses are suffered in markets where PoJL is not dominant, these will increase the revenue requirements from activities in markets where PoJL is dominant).

The status of PoJL as a corporate entity which is owned by SoJ and which is required by law to provide certain services (including PSOs and lifeline services), means that it is inevitable that the downside risk of its engagement in diversification of activities will always be present to the customers of its core activities: overall losses in non-core activities will have to be funded from somewhere. It therefore makes sense to take full advantage of the upside risk, which should fall to the customers of core activities as well.

CICRA therefore considers that single till (as defined at footnote 29) is an appropriate basis on which to determine this pricing framework.

6.63 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is that PoJL should assume the use of a single till based on CICRA's definition that 'all activities (both regulated and non-regulated 'commercial' activities) are taken into consideration when determining the level of charges'.

[33] *P.70/2012 Incorporation of Ports of Jersey, page 7, 4.1.*

Question 17: Do you agree with PoJL's proposal that it should not explicitly separate harbour operations from airport operations or make any other possible divisions such as separating public service obligations in the context of the long-term pricing framework? If not, what alternative(s) should be considered, and why?

6.64 *Summary of responses*

Of the seven responses received, three (from Condor, Blue Islands and Manche-Iles) responded directly to this question.

- Condor and Manche-Iles responded that they agreed with PoJL's proposal that it should not explicitly separate harbour operations from airport operations or make any other possible divisions such as separating PSOs. Condor in addition suggested the airport had 'consistently received a disproportionately higher share of capital funding than the harbour' which Condor believes should now be redressed so a fair allocation is invested at the Harbour and with some degree of reasonable 'catch up' for the harbour assets.
- Blue Islands responded that while it was in agreement that PoJL should not explicitly separate harbour operations from airport operations it 'should not be expected that in the long-term investment in the Airport and Harbour should be funded by the users of each respective port and not through a cross-subsidy'.

6.65 *CICRA analysis*

CICRA considers that in general, where new investments are made, they should be able to be funded from revenues derived from them, and if this is not possible it suggests that the project is inappropriate.

CICRA acknowledges PoJL's stated intention to move to a position where, over time, projects related to each part of its activities are funded from the revenues from those activities. CICRA does not have enough information to determine whether historically any cross-subsidisation between the harbour and airport has occurred.

CICRA notes the concern expressed by Condor its submission regarding the relative timing of investments in the airport infrastructure and that of the harbour, and the possibility that this will exacerbate the move away from sea travel towards air travel, making it harder to fund harbour investment. Whilst the greater growth in air travel is not solely the responsibility of PoJL, it is possible that the earlier investment profile for the airport will disproportionately benefit that part of PoJL's activities at the expense of others. Condor also noted that there may have been a greater allocation of capital funding to airport assets in the past and that there should be a redress of this balance.

Given this possibility, and recognising the fact that PoJL management would potentially be undertaking undue risk by aiming to implement both harbour and airport Master Plans concurrently (given the management time and attention required), and that the airport Master Plan is more advanced than that for the harbour, CICRA expects PoJL to consider this risk and aim to mitigate it to whatever extent is reasonably possible.

CICRA also notes that SoJ has agreed the order of investment, and therefore takes comfort that it is consistent with SoJ's intentions with regard to policy development.

6.66 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, the decision of CICRA is that PoJL should not explicitly separate harbour operations from airport operations or make any other possible divisions such as separating public service obligations for the purposes of determining this pricing framework. CICRA agrees that in the longer term PoJL should generate revenues from investments and operations which cover the actual cost of those investments and those revenues should be linked closely to costs.

'Term of Regulatory Period'

6.67 *Period of Pricing Mechanism*

Category	*Assumption*	*Justification*
Period of Pricing Mechanism	*PoJL seeks to establish a 10 year regulatory framework, which will encompass major investment in both the Airport and Harbour.*	*Large infrastructure business such a PoJL require a long term approach both to its finances and to physically delivering the range of required investments. A 10 year period would cover significant investment for both the airport and harbour.*

Question 18: Do you agree with PoJL's proposal that a 10 year period for a pricing framework is appropriate? If not, what alternative(s) should be considered, and why?

6.68 *Summary of responses*

Of the seven responses received, four (from Condor, Blue Islands, SoJ and Manche-Iles) responded directly to this question.

- Condor, Blue Islands and Manche-Iles responded agreeing with the proposal for a 10 year pricing framework.
- SoJ responded that 'given the long-term business planning required the States accepts that a 10-year pricing mechanism is appropriate, although SoJ acknowledges that in many UK regulated sectors a 5-year price control (without reviews) is the standard term. If a 10-year price control is agreed it should include the ability to undertake regular reviews during the 10-year period'.

Blue Islands also made points in answer to Question 20 which have a bearing on this question. It sought a 'mechanism … to periodic review during the 10 year period' insofar as outcomes might differ from assumptions.

6.69 *CICRA analysis*

In its submission, PoJL suggested a 10 year pricing framework on the basis that this 'would provide the necessary foundation to enable long term financial and funding planning for the required infrastructure investments.'

PoJL's submission sought to ensure that it had a 10-year framework with the ability to review that framework during the term. Pricing frameworks can have adjustment mechanisms built in for different variables, and are always subject to the potential for re-opening in exceptional circumstances.[34] One of the reasons for putting in place a pricing framework is to provide certainty both to the regulated entity and also to customers over the period of the control. The easier a price control is to reopen the less certainty stakeholders have. CICRA considers that setting a price control framework for a period during which it is likely to continue to be fit for purpose is preferable to setting one for a period over which it is likely to become obsolete and in need of revision.

In order to consider a 10 year price control CICRA has to be confident that PoJL's business plans are developed enough for that period. Elsewhere in this decision CICRA has considered PoJL's LTCP and found that planning beyond a five year time horizon, particularly in respect of stakeholder engagement and in relation to the harbour Master Plan, does not support a price control period beyond five years.

Mindful of PoJL's proposal, CICRA has considered price control periods in place elsewhere. Of the 21 price controls listed in a recent report by the UK Regulators' Network, only one, for the Thamas Tideway Tunnel, exceeded 8 years. Gatwick Q6 was for 7 years, and Heathrow Q6 was for 4 years 9 months originally, with extensions made to that term. Gas and electricity regulation by Ofgem has involved the highest terms other than the Thames Tideway Tunnel, with 8 year periods.[35] The businesses here are similar to PoJL in that they are businesses with significant infrastructure requirements.

The period over which a pricing framework is set need not be coincident with the term of investments expected. Anticipated investment in a period beyond that of the control can be included in the calculations for a control, so the period of an investment cycle need not be a driver for the term. The term of a pricing framework can be extended (as noted above occurred in the Q6 control for Heathrow Airport).

Notwithstanding this, SoJ noted in its response to Question 4 that 'the Harbour Master Plan along with the anticipated level of capital investment has not been formally presented to the shareholder', and other respondents and PoJL itself have made clear that the details for this element of the LTCP are not yet clear. The extension of a pricing framework into a time where such a major capital investment cannot yet be properly determined would be inconsistent with the basis upon which this process is being conducted.

CICRA therefore considers it appropriate for the term of this control to be set at 5 years. This will allow PoJL (and lenders and other stakeholders) a greater level of certainty by not leaving unnecessary indeterminacy over the possible reopening of the control-setting process. The pricing framework could then be reviewed and updated in preparation for the end of the five year period, and then

[34] *What sort of mechanisms for adjustment are appropriate will be considered at the next stage of the process of setting this pricing framework.*

[35] *UK Regulators' Network: Cost of Capital – Annual Update Report, 4 June 2018*

extended, or if the situation has changed substantially for whatever reason, a new framework could be introduced. The effect of this scheme would be to provide PoJL with essentially the same benefits they appear to have sought from a 10 year framework, including allowing them the review capacity required.

CICRA notes that it would expect any regulated entity subject to a price control to provide evidence of its compliance with that control, as well as to inform CICRA of any substantial difficulties generated by the control, their causes and impacts. Compliance reporting requirements will be determined in due course.

The further development of the pricing framework will consider questions such as what adjustment mechanisms could be included and other matters relevant to ensuring that the incentives to PoJL and the benefits to its customers are balanced and appropriate.

6.70 *CICRA conclusion*

CICRA has considered the proposal put forward by PoJL and the consultation responses received. For the reasons set out above, for the purpose of determining assumptions to be used in establishing a pricing framework for PoJL, the decision of CICRA is to set a pricing framework for 5 years with the possibility of extension following a detailed review.

<u>Completeness and Further Comments</u>

6.71 Interested parties are asked to consider the assumptions provided by PoJL as a whole.

Question 19: Do you consider the range of assumptions covered by PoJL's submission to be complete in the context of setting a long-term pricing framework? If not, which further assumptions should be considered, and why?

6.72 *Summary of responses*

Of the seven responses received, two (from Blue Islands and Condor) responded directly to this question.

- Blue Islands stated that it considers the range of assumptions to be complete.
- Condor responded 'in principle yes, but please refer to our earlier opening general comments for context'.

6.73 *CICRA analysis*

CICRA notes that PoJL's submission is not explicit about its use of its existing cash reserves other than that 'utilising either a cashflow vehicle [...] or longer term enterprise debt vehicles could be used in addition to cash reserves to fund [its] LTCP investments'.

CICRA expects PoJL, in its submission for the 'price control proper' to explain how it proposes to utilise its existing cash reserves.

6.74 *CICRA conclusion*

CICRA does not require PoJL to generate further high-level assumptions beyond those discussed within this document at this stage, although a number of more detailed assumptions will be required in the course of setting the pricing framework including how its proposes to utilities its existing cash reserves.

Question 20: Do you have any further comments regarding any part of PoJL's submission which may have a bearing on the development of a long-term pricing framework?

6.75 Summary of responses

One response (from Blue Islands) answered this question directly. It suggested that there should be a mechanism for the benefits of significantly greater revenue generation than expected to be passed to service users. Further, it considered review over the period of the pricing mechanism to be appropriate (see Question 18 above), and that SoJ should act as shareholder to ensure that PoJL's pricing takes account of the economic and social wellbeing of Jersey. Blue Islands also expressed concern that the detail of how charges are calculated can affect actual charges paid, even where the headline rates stay the same.

CICRA also here notes the response from the St Helier Boat Owners' Association which stated 'We do not see any reason to disagree with any of the Ports of Jersey long term pricing framework assumptions and consequently have no alternatives to put forward.'

6.76 CICRA Analysis

The form of the pricing framework and any incentives and adjustment mechanisms are to be determined in the course of the second phase of this process, during which CICRA will consult over the pricing framework submission of PoJL before coming to decisions regarding those and other elements of how the pricing framework will operate. The issue of the term of the pricing framework has been considered above at Question 18.

CICRA has taken the St Helier Boat Owners' Association general agreement with PoJL's submission into account in its draft decisions as set out above.

7. How to Respond

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

CICRA
2nd Floor, Salisbury House
1-9 Union Street
St Helier
Jersey JE2 3RF
Email: *info@cicra.je*

7.2 All responses should be clearly marked 'POJ1395J – Ports of Jersey Long Term Pricing Framework - Assumptions: Draft Decision' and should arrive no later than 5pm on 18 January 2018.

7.3 If for any reason special provisions are required, please contact CICRA by telephone: 01534 514990 or via email: info@cicra.je and arrangements will be made to ensure that your views are recorded and can be taken into consideration.

7.4 In line with CICRA's consultation policy, it intends to make responses to this Draft Decision available on its website www.cicra.je. Any material that is confidential should be put in a separate annex and clearly marked as such so that it may be kept confidential. CICRA regrets that it is not in a position to reply individually to responses to this Draft Decision.

8. Next Steps

8.1 CICRA will consider the responses it receives to this Draft Decision and after its own assessment will issue its Decision on the assumptions PoJL is proposing to use for its business plan. The process will then continue as set out in Section 3 above, towards setting a pricing framework.

8.2 While CICRA considers any Decision made as part of the pre-statutory process to be the starting point for later parts in the process and as a statement of its current expectations, no Decision is binding on CICRA or on PoJL until such time as it has been included in the statutory process of Initial and Final Notice.

Appendix 1 – Legal Framework

The States of Jersey enacted the Air and Sea Ports (Incorporation) (Jersey) Law 2015 (the **Law**) on 2 June 2015. This requires that any person carrying out Port Operations (as defined in Article 2 of the Law) must have a licence issued by the Jersey Competition Regulatory Authority (JCRA) (which is one of the two entities which together form CICRA).

The following extract from the Law shows the duties of the JCRA, in the context of which CICRA will set a pricing framework:

26 Duties of both Minister and JCRA

> *(1) In relation to port operations, the Minister and the JCRA shall each have a primary duty to perform their respective functions under this Law –*
>
> > *(a) so as best to protect and further the interests of users of port operations, in the short and long term, and to do so where appropriate by promoting competition in the provision of port operations; and*
> >
> > *(b) so as best to ensure –*
> >
> > > *(i) that provision is made to satisfy all reasonable demands, both current and prospective, for port operations, Article 27 Air and Sea Ports (Incorporation) (Jersey) Law 2015*
> > >
> > > *(ii) that port operations are provided efficiently and effectively, and*
> > >
> > > *(iii) that a company (in particular including PoJL), to the extent that it is or is to be licensed under this Law, has sufficient financial resources to discharge its liabilities under securities issued by the company to the States.*
>
> *(2) In relation to lifeline services, the Minister and the JCRA shall each have a primary duty to perform their respective functions under this Law so as best to ensure that such services are provided–*
>
> > *(a) efficiently, effectively and without interruption; and*
> >
> > *(b) so far as consistent with sub-paragraph (a), with due regard to –*
> >
> > > *(i) any relevant policies of the States,*
> > >
> > > *(ii) the interests of persons using or likely to use such services, and*
> > >
> > > *(iii) the special needs of persons who are disabled.*
>
> *(3) So far as consistent with paragraphs (1) and (2), the Minister and the JCRA shall each have duties to perform their respective functions under this Law –*
>
> > *(a) so as best to encourage sustainable growth in the economy of Jersey in the medium to long term;*
> >
> > *(b) so as to impose a minimum of restriction on persons engaging in commercial activities;*

(c) with due regard to any relevant policies of the States;

(d) with due regard to preserving and maximizing the benefits of Jersey's resources; and

(e) with due regard to the special needs of persons who are disabled.

CICRA issued a Principal Port Operator's Licence (the Licence) to PoJL on 1 November 2015, licensing it to carry out Port Operations in Jersey (the "Licence"). Article 15(1)(i) of the Law provides that the Competition Authority may impose licence conditions including requirements for "*the levels of prices, premiums and discounts which may be charged or (as the case may be) allowed by a licensee having a dominant position in the conduct of port operations*".

Under Condition 22.2 of the Licence, the JCRA may determine the maximum level of charges that PoJL may apply for Port Operations within a relevant market in which it has been found to be dominant.

Condition 22.2 of the Licence provides that:

The JCRA may determine the maximum level of charges the Licensee may apply for Port Operations within a relevant market in which the Licensee has been found to be dominant. A determination may:

(a) provide for the overall limit to apply to such Port Operations or categories of Port Operations or any combination of Port Operations;

(b) restrict increases in any such charges or to require reductions in them whether by reference to any formula or otherwise; or

(c) provide for different limits to apply in relation to different periods of time falling within the periods to which any determination applies.

In its Final Notice 'Ports of Jersey – Assessment of Market Power' issued in October 2016 (CICRA 16/41), CICRA made determinations as to market definitions and market power regarding a number of markets within which PoJL operates, finding them dominant in five separate markets. Full details of the determinations can be found in the above document. Given that PoJL is dominant in these markets, and under the licence condition noted above, CICRA may impose a pricing framework on PoJL.

The pricing framework which is anticipated to result from this process will not apply either to PoJL's Public Service Obligations (as defined in Article 6 of the Law) or to services which are not Port Operations. The issue by CICRA of a decision regarding the levels of charges by PoJL is considered to be the exercise of a regulatory function under Article 23 of the Law.

This Draft Decision constitutes part of a preliminary process which is intended to make the exercise of a regulatory function by CICRA as appropriate as possible by soliciting the views of interested parties in advance of the determination of the content of the Initial Notice required by Article 23(2) of the Law. It does not, however, constitute Initial Notice. The position of CICRA is liable to change until such time as Final Notice of the pricing framework has been given. Any statements or decisions related to this process issued up to that point will not be binding on either CICRA or PoJL.