Office of Utility Regulation

Guernsey Post's Proposed Tariff Changes

Draft Decision and Report on the Consultation

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1. Introduction

In September 2006 the Director General of Utility Regulation ("DG") launched a public consultation on an application for tariff changes from Guernsey Post Limited ("GPL"). GPL wished to amend its postal tariffs with effect from 1st April 2007 with proposals for further changes out to 31st March 2010.

This document sets out the DG's Draft Decision on GPL's proposed tariff increases taking into account the responses to the consultation, a detailed efficiency review of the company and the Office's own modeling of GPL's business plan. The proposed decision covers the tariffs that is intended will apply to a range of postal services from April 2007 through to March 2010. The proposed decision is being framed against a background of continuing change in the postal market, particularly with regard to the continuing liberalisation of the UK postal market and following a consideration of the scope of postal services Islanders wish to receive as highlighted from the review of the Universal Service Obligation carried out earlier this year.

The DG is proposing to set a three year price control to enable postal users to have greater certainty on tariffs for a sustained period and to enable GPL to focus on strategic issues facing its business. The DG is now inviting interested parties to comment on his Draft Decision and interested parties are requested to submit responses to the issues raised in this paper by Friday 1st December 2006. The DG intends to publish a final decision before the end of December 2006 so that the market has three months notice prior to any changes in postal tariffs.

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

2. Structure and Comments

2.1. *Structure of the Consultation Paper*

The rest of this paper is structured as follows:

Section 3: presents the economic approach the DG has taken to inform the Draft Decision;

Section 4: summarises the DG's calculation of GPL's Revenue Requirements including its operating costs informed by an efficiency review of GPL and its demand forecasts.

Section 5: contains the DG's Draft Decisions on each of the tariff changes sought by the company; and

Section 6: outlines the next steps in the process which will culminate in the introduction of any new prices in April 2007.

This Draft Decision also contains a number of separate annexes, some of which are confidential to GPL. Annex A describes the legislative framework and licensing arrangements which give the DG power to price control certain areas of GPL's postal activities. Annex B sets out the DG's view on the appropriate cost of capital for GPL (i.e. the basis for determining a reasonable return for the shareholder, the States of Guernsey).

Annex C is a full copy of the Efficiency Review undertaken by Brockley Consulting Ltd over August to September 2006. The DG is grateful for the co-operation and assistance provided by GPL management and staff to the OUR's consultants which enabled the completion of this element of the price control work within an exacting timetable. This document is commercially confidential and has been provided solely to GPL.

Annex D which is a confidential annex presents the demand assumptions the DG has used in coming to his Draft Decision.

2.2. *Responses to the Consultation Paper*

The DG received responses to the consultation paper from:

- Healthspan;
- Offshore Distribution and Fulfilment Ltd;
- Postwatch Guernsey;
- Sigma Group; and
- Thompson & Morgan;

The DG wishes to thank those who have responded to the consultation for their contributions. In accordance with the OUR's policy on consultation set out in Document OUR 05/28 – "Regulation in Guernsey; the OUR Approach and Consultation Procedures", non-confidential responses to the consultation are available on the OUR's website (www.regutil.gg) and for inspection at the OUR's offices during normal working hours.

2.3. Comments on the Draft Decision

Interested parties are invited to submit comments in writing on the matters set out in this Draft Decision paper to the following address:

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

All comments should be clearly marked "**Comments on Guernsey Post's Proposed Tariff Changes – Draft Decision**" and should arrive before **5pm on 1st December 2006**.

As before and in accordance with the OUR's policy on consultation set out in Document OUR 05/28 – "Regulation in Guernsey; the OUR Approach and Consultation Procedures", non-confidential responses to the draft decision will be published on the OUR's website (www.regutil.gg) and made available for inspection at the OUR's Office during normal working hours. Again any material that is confidential should be put in a separate annex and clearly marked so that it can be kept confidential. However the DG regrets that he is not in a position to respond individually to the responses to this consultation.

3. OUR's Approach to Reviewing Tariff Change Application

3.1. Need for a Price Control

The DG believed that in order to protect consumers' interests, it is necessary to price control those areas of the postal market in GPL is dominant and invited views on this position.

The one respondent who commented on this issue agreed that it was appropriate for the DG to price control certain aspects of GPL's postal activities. The DG welcomes this support for this position.

Draft Decision 1

The Director General proposes to price control those areas of the postal market in which Guernsey Post Limited is dominant.

3.2. Scope for Price Control

At the current time GPL has been found to be dominant in the Reserved Area and regular letter and parcel services market; priority (SD) letter and parcel services and outbound bulk mail services. Products within these relevant markets are subject to condition 18 of GPL's licence. The DG intended to continue price controlling GPL's prices for postal services within these relevant markets and sought views from interested parties.

Of the two respondents to the consultation who addressed this issue one agreed fully with the DG's position and the other agreed that the DG should price control GPL's services in the Reserved Area. The second respondent however did not provide any reasons as to why the price control should only be limited to the Reserved Area.

The DG however remains of the view that it is appropriate to price control GPL's products and services in those markets in which the company has been found as being dominant. In the DG's view price controls provide the means to protect customers' interests and prevent a dominant operator from abusing its market power by setting excessive prices.

Draft Decision 2

The Director General proposes to price control Guernsey Post Limited's tariffs in the Reserved Area, the regular letter and parcel services, the priority letter and parcel services and the outbound bulk mail service markets.

3.3. Form and Duration of Price Control

The DG believed setting prices for a three year period from April 2007 to March 2010 to be in the interest of the market and GPL.

Three of the respondents welcome the proposed three year price control commenting that a longer price control period would provide certainty to both GPL and its customers for a reasonable length of time.

One respondent considered that a three year control would protect GPL from changes in the market place and in particular represent a "*fait accomplie*" that rates would increase over the next three years irrespective of what may take place in terms of change in the market over the coming three years. The respondent therefore considered that the stability and certainty to GPL would allow GPL to become complacent at a time when it should be looking to force down their own costs.

The DG acknowledges that the three year price control would lock GPL into certain price increases going forward. However the purpose of the efficiency review, which was undertaken as part of the price control process, was to ensure that the prices reflected the efficient costs incurred by the business. The 'efficient costs' being used by the DG in determining the price control reflect the operational changes required of GPL over this period in order. The proposed price control has therefore been designed to reflect challenging yet achievable cost savings over the proposed three year period. The OUR's experts advisers had thoroughly reviewed and challenged the costs which GPL had included within its Business Plan Model ("BPM") in support of its tariff application. The findings of that review are summarized in section 4 of this draft decision document.

In relation to market changes the DG notes that GPL is free to respond to changes in its commercial environment and is able to bring new products to market to satisfy customers' reasonable needs should the opportunity arise. The price control should not be considered a constraint on GPL's ability to respond to customers' needs and innovate.

The DG therefore intends to implement a three year price control for GPL on this occasion.

Draft Decision 3

The Director General proposes to apply a three year price control for Guernsey Post Limited from 1st April 2007 to 31st March 2010.

3.4. Criteria for Assessing GPL's Proposals

The DG invited views on the methodology he intended to adopt in assessing GPL's tariff proposals by allowing efficient operating costs, capital expenditure (through regulatory deprecation) and a return on the company's Regulatory Value.

The one respondent who addressed this issue agreed with the DG's proposed approach. The DG welcomes this support and intends therefore to adopt this standard regulatory approach to setting price controls.

Draft Decision 4

The Director General's proposes to apply the standard regulatory approach to assessing Guernsey Post Limited's revenue requirements under the price control.

3.5. OUR's Methodology

The DG proposed to adopt a methodology which comprised forecasting efficient operating and capital expenditure, including a reasonable rate of return, and setting prices accordingly. This meant that the DG's determination on GPL's allowed prices would be set so that if GPL is managed efficiently, it could be expected to cover all its costs, including the costs of its capital employed, over the period of the control.

Postwatch Guernsey suggested that the company's cash reserves should be used to absorb some of the increases in costs being passed on by RM. The DG believes it is appropriate for the interest earned on cash reserves to be apportioned to the postal business to be used to offset some of the revenue requirement so that customers benefit from the temporary cash reserves held by the company over the duration of the price control.

One respondent agreed with the DG's proposed methodology. The DG welcomes this support and intends therefore to adopt this methodology, subject to the treatment of interest received contributing towards the company's revenue requirements for the purpose of setting GPL's prices.

Draft Decision 5

The Director General proposes to forecast efficient operating and capital expenditure and allow for a reasonable rate of return in determining Guernsey Post Limited's prices. Interest earned by the company and apportioned to the price controlled business will be offset against the estimated revenue requirements.

The DG's consideration of a reasonable rate of return is set out fully in Annex B. GPL's cost of capital has been derived assuming a gearing level of 0% and hence the Weighted Average Cost of Capital ("WACC") is simply derived from the cost of equity and level of taxation. Assuming a corporation tax rate of 20%, and the assumptions for inputs to the Capital Asset Pricing Model ("CAPM") given in Annex B generates a range of real pre-tax WACC results.

Table 5.2 GPL Real Pre-tax WACC

	Low Case	Middle Case	High Case
Risk Free Rate	2.5%	2.5%	2.5%
Gearing	0.0%	0.0%	0.0%
Equity Risk Premium	2.5%	4.25%	5.0%
Asset Beta	0.60	0.65	0.70
Equity Beta	0.60	0.65	0.70
Cost of Equity	4.00%	5.26%	6.00%
WACC (real pre-tax)	**5.00%**	**6.58%**	**7.50%**

The DG proposes to take a mid-range value of 6.17% as the real pre-tax cost of capital for GPL for the duration of the price control period.

Draft Decision 5

The DG intends to use real pre-tax cost of capital of 6.58% in reviewing the company's tariff application.

3.6. Additional Issues Raised by Respondents

Respondents to the consultation document also raised a number of other issues not covered directly by the questions posed by the DG which related to GPL's product offerings. These additional issues can be categorized as those relating to:

- enhancements to GPL's existing product portfolio; and
- general pricing principles.

Product Portfolio

Two respondents commented that the Bailiwick's Bulk Mail sector had geared up expecting GPL to introduce tariffs on the basis of Pricing in Proportion ("PiP") akin to the model which was introduced in the UK and Isle of Man in August 2006. GPL's failure to introduce PiP may have the effect of reducing customers' confidence in GPL's ability to compete in the market place.

Another respondent commented that the lack of insurance for bulk mail is a contentious issue with clients. One bulk mailer requested bulk postage rates with discounts for Europe and rest of the world would be beneficial and help the industry expand into new markets.

Postwatch Guernsey also considered that there may be given the increasing prices, interest for a second class service for mail to the UK.

GPL's product portfolio is a matter for GPL to consider in the first instance. Any decision needs to reflect what costs savings and revenue implications, if any, might be achieved by the introduction of such new services and whether, on balance, such services would represent an enhanced service for customers in terms of price and quality of service.

PiP was introduced in UK, at Royal Mail's ("RM") request, following a lengthy consultation process with all interested parties. There are clearly those who are benefiting and those who are losing out through the introduction of PiP in UK, although the majority of customers have not seen any change in postage prices. The Isle of Man took the opportunity to benefit from RM public awareness campaign and also introduced PiP in August 2006. Both Guernsey and Jersey's postal operators chose not to implement PiP at this time. Any change in the current pricing mechanism would require GPL to consider the implications for its customers based on their mail profiles and to consult appropriately before any such change could be introduced.

Insurance for bulk mail to the UK is clearly an issue directly related to the commercial relationship with RM. It remains the responsibility of GPL to ensure it provides postal services which satisfy all reasonable demands of users within the Bailiwick. Clearly any insurance for bulk mail may necessitate an additional premium to the price charged by RM which would have to be reflected in the prices for end-users.

Similarly the DG expects GPL to consider how it meets all reasonable demand for products and services and would expect the company to engage with its customers to identify their specific needs and consider how these can be satisfied.

Similarly 2nd Class mail is a demand management tool to manage high volumes. This again remains a GPL Board issue, but the Director General is aware that the arguments for the provision of 2nd Class mail may not actually generate any savings for the company to justify a lower price. It may in fact even drive costs upwards.

Prices

Postwatch Guernsey observed that following the USO Review earlier in the year and in the absence of comments received by Postwatch Guernsey during the current price control consultation Postwatch believes that customers are prepared to accept higher prices to maintain the existing levels of service. Postwatch Guernsey expressed its disappointment with Commerce & Employment's decision not to refer the USO proposals to the States as Postwatch Guernsey believed that maintaining the status quo would have an inflationary impact. The review would also have given the States an opportunity to consider the issue of how to fund the retail network.

One respondent expressed the view that GPL should provide discounts on the basis of volumes. In this regard GPL has a specific licence condition in relation to the provision of discounts to its customers. Specifically Condition 18.4 requires that:

> *"All published prices, discount schemes and special offers of, or introduced by, the Licensee for Licensed Services shall be transparent and non-discriminatory;* ***all discount schemes shall be cost-justified*** *and all special offers shall be objectively justifiable." (emphasis added)*

GPL is allowed to offer volume discounts provided these discounts are cost justified i.e. the higher volumes generate operational cost savings which can be shared with customer's on a non-discriminatory basis.

4. GPL's Revenue Requirements

4.1. Efficiency Review

Brockley Consulting Ltd was appointed by the DG to perform a detailed efficiency review of GPL. A confidential version of the resultant report is included as Annex C and has been provided to GPL. The report details the results of the consultant's review of the efficient level of operating expenditure for GPL over the 3 year period 1 April 2007 to 31 March 2010.

The majority of the review was carried out during August and September 2006. Projects of this nature generally require a considerable amount of co-operation between the regulated company and the regulator. The consultants were particularly impressed with GPL's helpfulness in responding to the consultants' questions and the DG would like to express his thanks to the entire team at GPL for their open and positive assistance throughout the review.

GPL has forecast an annual level of operating expenditure of between £xxm and £xxm during the three years of the forthcoming price control period (2007/08 to 2009/10). This is between £xxm and £xxm higher than the level of operating expenditure in the last full year, 2005/06.

The table below analyses the level of operating expenditure, by year and by function[1]:

Table 4.1 GPL Operating Expenditure per Submission

Operating expenditure (£m)	04/05	05/06	06/07	07/08	08/09	09/10
Total	21.4	25.1	29.3	xx	xx	xx
Increase in						
Postal operations payroll		5%	10%	2%	2%	4%
RM charges		47%	24%	17%	10%	12%
Conveyance costs		11%	12%	(1%)	5%	5%
Other postal operations costs		(43%)	9%	17%	4%	4%
Retail costs		2%	(1%)	(11%)	2%	4%
Philatelic		18%	13%	16%	4%	4%
Overheads		(4%)	20%	2%	1%	5%
Total		17%	17%	8%	6%	8%

Brockley Consulting has reviewed each major cost category in order to assess what opportunities exist for GPL to realise efficiency savings and outperform these forecasts. The consultant's approach has been to identify a standard that is challenging but achievable. The consultants have attempted to incorporate reasonable rather than extreme assumptions in their estimates upon which the DG's Draft Decision is based.

[1] GPL's revised tariff application of 6 September 2006, for entire business

The consultants were impressed with the performance of postal operations staff who show a positive attitude, knowledge and willingness to get the job done. However Brockley Consulting believed that in many instances there is a poor linkage between the volume of work that exists, and the level of staffing made available to process that work and opportunities exist to improve productivity within the operations.

The current RM contract for the delivery of UK mail runs from 1 April 2006 to 31 March 2009, and thus covers the first two years of the price control, 2007/08 and 2008/09. The consultants benchmarked the costs for various mail streams under the RM contract with publicly available RM products, with offerings from new entrants, and with rates under the Universal Postal Union (UPU) arrangements and identified potential savings in this area.

Conveyance costs primarily relate to the costs air and sea transport between Guernsey and the UK. The consultant's analysis did not reveal any quantifiable opportunities for cost savings in this area.

GPL has forecast a slight decline in the cost of the retail network. The consultants have identified some potential additional savings in the company's retail network.

Brockley Consulting benchmarked the level of GPL's overheads against comparable data from other companies. This exercise suggested that on the whole, GPL's overhead levels are fairly well managed. There were however a limited number of specific opportunities for savings.

The total savings identified as a result of Brockley Consulting's review amount to £[x]m over the price control period, as detailed in the table below:

Table 4.2: Director General's Proposed Operating Cost Assumption Assumptions[2]

Operating expenditure (£m)	07/08	08/09	09/10	Total
Per submission	xx	xx	xx	xx
After reductions	xx	xx	xx	xx
Saving	xx	xx	xx	xx

Draft Decision 6

The DG intends to assume the operating cost forecasts shown in Table 4.2 prior to any demand forecast changes for the purposes of determining Guernsey Post Limited's revenue requirements.

[2] Prior to any demand forecast adjustments and forecasts for GPL in its entirety.

4.2. Demand Forecasts

The DG has reviewed the demand forecasts within GPL's BPM which supported its tariff application. The DG is proposing in a number of areas different assumptions within his own economic modeling and the rationale and description of those differing assumptions are set out in detail in Annex D which has been provided on a confidential basis as it contains commercially sensitive information

Table 4.3 Director General's Demand Forecasts

Volumes (m)	04/05	05/06	06/07	07/08	08/09	09/10
Total	44.3	49.5	50.2	50.3	50.7	51.3
Local	7.6	7.4	7.0	7.0	6.8	6.6
Inward	16.2	17.3	18.1	18.0	17.8	17.6
Outward	20.4	24.8	25.0	25.4	26.1	27.0

Draft Decision 7

The DG intends to assume the demand forecasts shown in Table 4.3 for the purpose of informing Guernsey Post Limited's price control.

4.3. Financial Forecasts

The resultant financial forecasts for GPL's price controlled business based on the opex and demand forecasts given in this section and reflecting the prices set out in the draft decision in section 5 are summarized in Table 4.4 for information.

Table 4.4 DG's Financial Forecasts for GPL's Price Controlled Business

Nominal Prices (m)	04/05	05/06	06/07	07/08	08/09	09/10
Revenue	18.2	22.1	26.1	28.3	30.7	32.9
Opex	(17.8)	(21.4)	(25.3)	(27.4)	(29.0)	(30.6)
Depreciation	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)	(0.7)
Trading Profit	**(0.3)**	**(0)**	**0.1**	**0.2**	**1.0**	**1.6**
Interest	0.6	0.5	0.4	0.4	0.4	0.5
Profit/(Loss) before tax	**0.3**	**0.5**	**0.5**	**0.6**	**1.4**	**2.1**

5. Draft Decision on GPL's Tariffs

As a consequence of the draft decisions presented in sections 3 and 4 of this document the DG intends to set tariffs for GPL's price controlled postal services through to 31st March 2010.

Draft Decision 8

The DG proposes to set the maximum prices at 1st April of each year for each of the postal services set out in sections 5.1 to 5.12.

5.1. Local Letters

Weight (g)	Proposed **2007**	Proposed **2008**	Proposed **2009**
	£	**£**	**£**
60	0.32	0.34	0.36
100	0.32	0.34	0.36
150	0.46	0.48	0.50
200	0.60	0.62	0.64
Each additional 50g	0.14	0.14	0.14

5.2. Letters to UK & Jersey

Weight (g)	Proposed **2007**	Proposed **2008**	Proposed **2009**
	£	**£**	**£**
60	0.37	0.40	0.43
100	0.37	0.40	0.43
150	0.93	1.00	1.08
200	1.06	1.14	1.22
Each additional 50g	0.13	0.14	0.14

5.3. Local parcels

Weight (not over Kgs)	Proposed **2007**	Proposed **2008**	Proposed **2009**
	£	**£**	**£**
1	2.74	2.84	2.94
2	3.21	3.32	3.44
4	3.98	4.12	4.26
6	4.55	4.71	4.87
8	5.12	5.30	5.49
10	5.69	5.89	6.10
15	9.42	9.75	10.09
20	11.39	11.79	12.20
30 (max)	13.66	14.14	14.63

5.4. Parcels to UK & Jersey

Weight (not over Kgs)	Proposed **2007**	Proposed **2008**	Proposed **2009**
	£	**£**	**£**
1	4.45	4.61	4.77
2	5.43	5.62	5.82
4	7.40	7.66	7.93
6	8.90	9.21	9.53
8	10.35	10.71	11.08
10	11.75	12.16	12.59
15	13.71	14.19	14.69
20	15.21	15.74	16.29
30 (max)	16.30	16.87	17.46

5.5. Recorded Delivery

	Proposed **2007**	Proposed **2008**	Proposed **2009**
The fee for Recorded Delivery in addition to the appropriate postage	£1	£1	£1

5.6. Postcards

Location	Proposed **2007**	Proposed **2008**	Proposed **2009**
Europe (outside UK)	0.45	0.48	0.51
Worldwide	0.48	0.51	0.54

5.7. Airmail

	2007		
Weight (not over grams)	Europe (incl Eire)	Rest of World Zone 1	Rest of World Zone 2
	£	£	£
10	0.45	0.50	0.50
20	0.45	0.71	0.71
40	0.63	1.08	1.15
60	0.81	1.45	1.59
80	0.99	1.84	2.03
100	1.17	2.21	2.47
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

	2008		
Weight (not over grams)	Europe (incl Eire)	Rest of World Zone 1	Rest of World Zone 2
	£	£	£
10	0.48	0.53	0.54
20	0.48	0.74	0.74
40	0.66	1.11	1.18
60	0.84	1.48	1.62
80	1.02	1.85	2.06
100	1.20	2.22	2.50
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

	2009		
Weight (not over grams)	Europe (incl Eire)	Rest of World Zone 1	Rest of World Zone 2
	£	£	£
10	0.51	0.56	0.56
20	0.51	0.77	0.77
40	0.69	1.14	1.21
60	0.87	1.51	1.65
80	1.05	2.88	2.09
100	1.23	2.25	2.53
Each additional 20g	0.18	0.37	0.44
Max weight	2kg	2kg	2kg

5.8. International Signed for

	Proposed **2007**	Proposed **2008**	Proposed **2009**
The fee for International Signed For service in addition to the appropriate postage	£3.42	£3.54	£3.66

5.9. Airsure

	Proposed **2007**	Proposed **2008**	Proposed **2009**
The fee for Airsure service in addition to the appropriate postage	£4.14	£4.28	£4.43

5.10. International Standard Parcel

International Standard Parcel Charges 2007

Weight in kgs	Zone 5	Zone 6	Zone 7	Zone 8	Zone 9	Zone 10	Zone 11	Zone 12
0.5	5.85	17.6	17.6	17.6	19.56	16.3	22.51	22.51
1	7.14	19.25	19.25	19.25	21.94	20.34	26.44	27.84
1.5	8.38	20.86	20.86	20.86	24.37	24.37	30.43	33.22
2	9.57	22.51	22.51	22.51	26.81	28.41	34.47	38.5
2.5	10.82	24.12	24.12	24.12	29.24	32.5	38.4	43.88
3	11.95	25.31	25.31	25.31	31.41	36.28	41.97	48.96
3.5	13.04	26.44	26.44	26.44	33.64	40.16	45.44	54.08
4	14.13	27.63	27.63	27.63	35.86	43.99	48.96	59.1
4.5	15.27	28.82	28.82	28.82	38.09	47.87	52.47	64.22
5	16.35	30.02	30.02	30.02	40.31	51.75	56.05	69.35
5.5	17.03	31	31	31	41.87	54.75	58.94	74
6	17.65	31.93	31.93	31.93	43.42	57.8	61.89	78.66
6.5	18.32	32.91	32.91	32.91	44.97	60.91	64.84	83.42
7	18.94	33.9	33.9	33.9	46.58	63.96	67.74	88.08
7.5	19.61	34.88	34.88	34.88	48.13	67.07	70.69	92.79
8	20.29	35.86	35.86	35.86	49.68	70.12	73.64	97.5
8.5	20.91	36.85	36.85	36.85	51.23	73.12	76.54	102.15
9	21.58	37.83	37.83	37.83	52.84	76.23	79.49	106.86
9.5	22.2	38.81	38.81	38.81	54.39	79.28	82.44	111.57
10	22.87	39.8	39.8	39.8	55.99	82.39	85.39	116.28
10.5	23.6	40.42	40.42	40.42	57.18	84.71	88.23	120.22
11	24.32	41.09	41.09	41.09	58.43	87.04	91.08	124.1
11.5	25.46	41.71	41.71	41.71	59.67	89.37	93.93	128.03
12	25.77	42.38	42.38	42.38	60.91	91.7	96.82	131.91
12.5	26.44	43.06	43.06	43.06	62.15	94.13	99.72	135.84
13	27.17	43.68	43.68	43.68	63.34	96.46	102.57	139.78
13.5	27.95	44.35	44.35	44.35	64.58	98.79	105.41	143.66
14	28.62	44.97	44.97	44.97	65.88	101.12	108.31	147.59
14.5	29.34	45.64	45.64	45.64	67.12	103.45	111.16	151.47
15	30.07	46.32	46.32	46.32	68.36	105.83	114.06	155.41
per 0.5kg	0.57	0.36	0.36	0.36	0.93	1.86	2.74	3.36

International Standard Parcel Charges 2008

	Zone 5	Zone 6	Zone 7	Zone 8	Zone 9	Zone 10	Zone 11	Zone 12
weight in kgs	**ROI**	**Belgium, Netherlands, Luxembourg**	**France, Denmark, Germany**	**Italy, Spain, Portugal, Greece**	**Rest of Europe**	**USA, Canada**	**Far East, Australia**	**Rest of World**
0.5	6.05	18.22	18.22	18.22	20.24	16.87	23.3	23.3
1	7.39	19.92	19.92	19.92	22.71	21.05	27.37	28.81
1.5	8.67	21.59	21.59	21.59	25.22	25.22	31.5	34.38
2	9.9	23.3	23.3	23.3	27.75	29.4	35.68	39.85
2.5	11.2	24.96	24.96	24.96	30.26	33.64	39.74	45.42
3	12.37	26.2	26.2	26.2	32.51	37.55	43.44	50.67
3.5	13.5	27.37	27.37	27.37	34.82	41.57	47.03	55.97
4	14.62	28.6	28.6	28.6	37.12	45.53	50.67	61.17
4.5	15.8	29.83	29.83	29.83	39.42	49.55	54.31	66.47
5	16.92	31.07	31.07	31.07	41.72	53.56	58.01	71.78
5.5	17.63	32.09	32.09	32.09	43.34	56.67	61	76.59
6	18.27	33.05	33.05	33.05	44.94	59.82	64.06	81.41
6.5	18.96	34.06	34.06	34.06	46.54	63.04	67.11	86.34
7	19.6	35.09	35.09	35.09	48.21	66.2	70.11	91.16
7.5	20.3	36.1	36.1	36.1	49.81	69.42	73.16	96.04
8	21	37.12	37.12	37.12	51.42	72.57	76.22	100.91
8.5	21.64	38.14	38.14	38.14	53.02	75.68	79.22	105.73
9	22.34	39.15	39.15	39.15	54.69	78.9	82.27	110.6
9.5	22.98	40.17	40.17	40.17	56.29	82.05	85.33	115.47
10	23.67	41.19	41.19	41.19	57.95	85.27	88.38	120.35
10.5	24.43	41.83	41.83	41.83	59.18	87.67	91.32	124.43
11	25.17	42.53	42.53	42.53	60.48	90.09	94.27	128.44
11.5	26.35	43.17	43.17	43.17	61.76	92.5	97.22	132.51
12	26.67	43.86	43.86	43.86	63.04	94.91	100.21	136.53
12.5	27.37	44.57	44.57	44.57	64.33	97.42	103.21	140.59
13	28.12	45.21	45.21	45.21	65.56	99.84	106.16	144.67
13.5	28.93	45.9	45.9	45.9	66.84	102.25	109.1	148.69
14	29.62	46.54	46.54	46.54	68.19	104.66	112.1	152.76
14.5	30.37	47.24	47.24	47.24	69.47	107.07	115.05	156.77
15	31.12	47.94	47.94	47.94	70.75	109.53	118.05	160.85
per 0.5kg	0.59	0.37	0.37	0.37	0.96	1.93	2.84	3.48

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International Standard Parcel Charges 2009

Weight in kgs	Zone 5	Zone 6	Zone 7	Zone 8	Zone 9	Zone 10	Zone 11	Zone 12
0.5	6.26	18.86	18.86	18.86	20.95	17.46	24.12	24.12
1	7.65	20.62	20.62	20.62	23.5	21.79	28.33	29.82
1.5	8.97	22.35	22.35	22.35	26.1	26.1	32.6	35.58
2	10.25	24.12	24.12	24.12	28.72	30.43	36.93	41.24
2.5	11.59	25.83	25.83	25.83	31.32	34.82	41.13	47.01
3	12.8	27.12	27.12	27.12	33.65	38.86	44.96	52.44
3.5	13.97	28.33	28.33	28.33	36.04	43.02	48.68	57.93
4	15.13	29.6	29.6	29.6	38.42	47.12	52.44	63.31
4.5	16.35	30.87	30.87	30.87	40.8	51.28	56.21	68.8
5	17.51	32.16	32.16	32.16	43.18	55.43	60.04	74.29
5.5	18.25	33.21	33.21	33.21	44.86	58.65	63.14	79.27
6	18.91	34.21	34.21	34.21	46.51	61.91	66.3	84.26
6.5	19.62	35.25	35.25	35.25	48.17	65.25	69.46	89.36
7	20.29	36.32	36.32	36.32	49.9	68.52	72.56	94.35
7.5	21.01	37.36	37.36	37.36	51.55	71.85	75.72	99.4
8	21.74	38.42	38.42	38.42	53.22	75.11	78.89	104.44
8.5	22.4	39.47	39.47	39.47	54.88	78.33	81.99	109.43
9	23.12	40.52	40.52	40.52	56.6	81.66	85.15	114.47
9.5	23.78	41.58	41.58	41.58	58.26	84.92	88.32	119.51
10	24.5	42.63	42.63	42.63	59.98	88.25	91.47	124.56
10.5	25.29	43.29	43.29	43.29	61.25	90.74	94.52	128.79
11	26.05	44.02	44.02	44.02	62.6	93.24	97.57	132.94
11.5	27.27	44.68	44.68	44.68	63.92	95.74	100.62	137.15
12	27.6	45.4	45.4	45.4	65.25	98.23	103.72	141.31
12.5	28.33	46.13	46.13	46.13	66.58	100.83	106.82	145.51
13	29.1	46.79	46.79	46.79	67.85	103.33	109.88	149.73
13.5	29.94	47.51	47.51	47.51	69.18	105.83	112.92	153.89
14	30.66	48.17	48.17	48.17	70.58	108.32	116.02	158.11
14.5	31.43	48.89	48.89	48.89	71.9	110.82	119.08	162.26
15	32.21	49.62	49.62	49.62	73.23	113.36	122.18	166.48
per 0.5kg	0.61	0.38	0.38	0.38	0.99	2	2.94	3.6

5.11. International Economy Parcel

International Economy Parcel Charges 2007

	Zone 9	**Zone 10**	**Zone 11**	**Zone 12**
weight in kgs	Rest of Europe	USA, Canada	Far East, Australia	Rest of World
0.5	16.25	14.59	20.34	15.78
1	17.96	17.23	23.55	18.22
1.5	19.61	19.82	26.75	20.6
2	21.32	22.46	29.96	23.03
2.5	23.03	25.05	33.12	25.41
3	24.53	27.32	35.86	27.84
3.5	26.03	29.6	38.55	30.27
4	27.48	31.88	41.35	32.65
4.5	29.03	34.16	44.09	35.09
5	30.53	36.48	46.83	37.52
5.5	31.88	38.71	49.32	39.54
6	33.28	40.88	51.91	41.66
6.5	34.62	43.11	54.44	43.73
7	35.97	45.33	56.98	45.85
7.5	37.36	47.56	59.56	47.92
8	38.76	49.78	62.05	49.99
8.5	40.11	51.96	64.58	52.11
9	41.45	54.18	67.17	54.18
9.5	42.8	56.41	69.71	56.3
10	44.25	58.63	72.29	58.37
10.5	45.54	60.65	74.36	60.55
11	46.83	62.67	76.54	62.67
11.5	48.13	64.69	78.66	64.84
12	49.42	66.71	80.83	66.96
12.5	50.77	68.72	83.01	69.14
13	52.06	70.74	85.13	71.31
13.5	53.35	72.76	87.3	73.43
14	54.65	74.78	89.42	75.61
14.5	55.99	76.85	91.6	77.73
15	57.29	78.87	93.77	79.8
per 0.5kg	1.09	1.97	2.07	2.07

International Economy Parcel Charges 2008

	Zone 9	Zone 10	Zone 11	Zone 12
weight in kgs	Rest of Europe	USA, Canada	Far East, Australia	Rest of World
0.5	16.82	15.1	21.05	16.33
1	18.59	17.83	24.37	18.86
1.5	20.3	20.51	27.69	21.32
2	22.07	23.25	31.01	23.84
2.5	23.84	25.93	34.28	26.3
3	25.39	28.28	37.12	28.81
3.5	26.94	30.64	39.9	31.33
4	28.44	33	42.8	33.79
4.5	30.05	35.36	45.63	36.32
5	31.6	37.76	48.47	38.83
5.5	33	40.06	51.05	40.92
6	34.44	42.31	53.73	43.12
6.5	35.83	44.62	56.35	45.26
7	37.23	46.92	58.97	47.45
7.5	38.67	49.22	61.64	49.6
8	40.12	51.52	64.22	51.74
8.5	41.51	53.78	66.84	53.93
9	42.9	56.08	69.52	56.08
9.5	44.3	58.38	72.15	58.27
10	45.8	60.68	74.82	60.41
10.5	47.13	62.77	76.96	62.67
11	48.47	64.86	79.22	64.86
11.5	49.81	66.95	81.41	67.11
12	51.15	69.04	83.66	69.3
12.5	52.55	71.13	85.92	71.56
13	53.88	73.22	88.11	73.81
13.5	55.22	75.31	90.36	76
14	56.56	77.4	92.55	78.26
14.5	57.95	79.54	94.81	80.45
15	59.3	81.63	97.05	82.59
per 0.5kg	1.13	2.04	2.14	2.14

International Economy Parcel Charges 2009

	Zone 9	Zone 10	Zone 11	Zone 12
weight in kgs	Rest of Europe	USA, Canada	Far East, Australia	Rest of World
0.5	17.41	15.63	21.79	16.9
1	19.24	18.45	25.22	19.52
1.5	21.01	21.23	28.66	22.07
2	22.84	24.06	32.1	24.67
2.5	24.67	26.84	35.48	27.22
3	26.28	29.27	38.42	29.82
3.5	27.88	31.71	41.3	32.43
4	29.44	34.16	44.3	34.97
4.5	31.1	36.6	47.23	37.59
5	32.71	39.08	50.17	40.19
5.5	34.16	41.46	52.84	42.35
6	35.65	43.79	55.61	44.63
6.5	37.08	46.18	58.32	46.84
7	38.53	48.56	61.03	49.11
7.5	40.02	50.94	63.8	51.34
8	41.52	53.32	66.47	53.55
8.5	42.96	55.66	69.18	55.82
9	44.4	58.04	71.95	58.04
9.5	45.85	60.42	74.68	60.31
10	47.4	62.8	77.44	62.52
10.5	48.78	64.97	79.65	64.86
11	50.17	67.13	81.99	67.13
11.5	51.55	69.29	84.26	69.46
12	52.94	71.46	86.59	71.73
12.5	54.39	73.62	88.93	74.06
13	55.77	75.78	91.19	76.39
13.5	57.15	77.95	93.52	78.66
14	58.54	80.11	95.79	81
14.5	59.98	82.32	98.13	83.27
15	61.38	84.49	100.45	85.48
per 0.5kg	1.17	2.11	2.21	2.21

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5.12. Logistics Tariffs

	Price per item at 60g (p)		
	2007	**2008**	**2009**
Bulk Air unsorted (flowers)	71.60	78.80	88.00
Bulk Air 120 way sort (flowers)	56.20	63.29	72.38
Bulk Sea Priority (4-way sort) <500g	43.60	46.16	48.58
Bulk Sea Priority (4-way sort) >500g	43.60	46.16	48.58
Bulk Sea Priority 120 way sort	30.10	32.93	34.77
Bulk Sea Economy 120 way sort	28.60	31.46	33.35
Bulk Sea Unsorted (non MOU)	37.16	39.58	42.94

	Price per g above 60g (p)		
	2007	**2008**	**2009**
Bulk Air unsorted (flowers)	0.260	0.280	0.300
Bulk Air 120 way sort (flowers)	0.237	0.255	0.273
Bulk Sea Priority (4-way sort) <500g	0.225	0.232	0.233
Bulk Sea Priority (4-way sort) >500g	0.225	0.232	0.233
Bulk Sea Priority 120 way sort	0.216	0.224	0.233
Bulk Sea Economy 120 way sort	0.216	0.224	0.230
Bulk Sea Unsorted (non MOU)	0.274	0.295	0.313

6. Next Steps

This is the second public stage of the regulatory review of GPL's tariff application. The consultation on the Draft Decision concludes on 1st December 2006. Interested parties are invited to comment on the specific draft decisions set out in this paper and on any other issue raised in the paper. As with the original consultation the DG and his staff are available for separate meetings with interested parties to discuss any issues arising from the Draft Decision paper.

Following consideration of all responses to the Draft Decision, the DG intends to issue a Final Decision towards the end of December 2006 with any new tariffs arising from that decision coming into effect on 1st April 2007.

ENDS/

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Annex A Legislative and Licensing Background

Legislation and States Directions

The Post Office (Bailiwick of Guernsey) Law, 2001 provides that a range of postal activities do not require licensing, ranging from personal private delivery to the delivery of court documents and banking instruments[3]. In addition, any postal services that are provided for a price greater than £1.35 (the "non-reserved services") can also be provided by any person or business without a licence. All services that are provided for a price of less than £1.35 are deemed to be reserved services and this is set out in an Order made by the DG in accordance with section 9 of the Postal Law[4].

The Regulation of Utilities (Bailiwick of Guernsey) Law 2001 provides for the States of Guernsey to issue States Directions to the DG in relation to:

- the scope of the universal service that should be provided in the postal sector in the Bailiwick;
- the extent of any exclusive privileges or rights in the postal sector;
- the identity of the first licensee in the postal sector; and
- any obligations arising from international agreements.

The Universal Service Obligation

In September 2001, the States issued Directions to the DG that required the DG to issue the first licence to provide universal services to GPL. At the same time the States set out the universal service obligation that should be imposed on GPL which is:

> *"… throughout the Bailiwick of Guernsey at uniform and affordable prices, except in circumstances or geographical conditions that the Director General of Utility Regulation agrees are exceptional:*
>
> - *One collection from access points on six days each week;*
> - *One delivery of letter mail to the home or premises of every natural or legal person in the Bailiwick (or other appropriate installations if agreed by the Director General of Utility Regulation) on six days each week including all working days;*
> - *Collections shall be for all postal items up to a weight of 20Kg;*
> - *Deliveries on a minimum of five working days shall be for all postal items up to a weight of 20Kg;*
> - *Services for registered and insured mail."*

Having defined the universal service, the States directed that GPL should be provided with the exclusive right to provide reserved services insofar as this is needed to enable and ensure the universal postal service is delivered. The relevant States Direction states:

> *"The Regulator shall reserve services to be exclusively provided by the Universal Service Provider to the extent necessary only to ensure the*

[3] Section 1(2) of the Post Office (Bailiwick of Guernsey) Law, 2001
[4] The Post Office (Reserved Postal Services) Order, 2001

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maintenance of universal service, and shall review and revise the reserved services from time to time with a view to opening up the Guernsey postal market to competition consistent with the need to maintain the Universal Service".

This legislative structure provides the DG, GPL and the States of Guernsey with a framework similar to that in neighbouring jurisdictions, within which:

- States policy can be articulated in more detail in the form of States Directions; and
- Licence conditions can be developed to provide more detail on the operation of the market.

Earlier in 2006, as recommended in the NAO report on Commercialisation[5], the OUR conducted a review of the original USO within the Bailiwick in light of the changes in the company's operating environment[6]. The DG recommended a number of changes in the USO in light of the responses to the consultation, the most significant being the reduction in the number of daily deliveries from six days a week to five days a week. The full set of recommendations are set out in Document OUR 06/11 which was been submitted to the Department of Commerce & Employment ("C&E").

In June 2006 C&E issued a Briefing Paper[7] with its views on the OUR recommendations. In short C&E found no compelling case to justify recommending to the States changes to the USO and therefore believed that there would be little purpose served by laying the matter before the States for debate. C&E invited views on this approach by 14th July and would take into account any feedback before coming to a final decision. However for the purposes of this consultation the OUR will assume no changes in the scope of the existing USO through to March 2010.

Statutory Functions and Powers

In exercising his functions and powers, the DG has a duty to promote (and, where they conflict, to balance) the following objectives[8]:

a. protect the interests of consumers and other users in the Bailiwick in respect of the prices charged for, and the quality, service levels, permanence and variety of, utility services;
b. secure, so far as practicable, the provision of utility services that satisfy all reasonable demands for such services within the Bailiwick, whether those services are supplied from, within or to the Bailiwick;
c. ensure that utility activities are carried out in such a way as best to serve and contribute to the economic and social development and well-being of the Bailiwick;
d. introduce, maintain and promote effective and sustainable competition in the provision of utility services in the Bailiwick, subject to any special or

5 NAO Review of Commercialisation & Regulation in the States of Guernsey- September 2005, referred to in the Billet D'Etat X, 2006 Wednesday 31st May 2006
6 OUR 06/06 Reviewing Guernsey Post's Universal Service Obligation – Consultation Document
7 C&E Briefing Paper Guernsey Post Limited – Universal Service Obligation
8 The Regulation of Utilities (Bailiwick of Guernsey) Law, 2001

exclusive rights awarded to a licensee by the DG pursuant to States' Directions;

e. improve the quality and coverage of utility services and to facilitate the availability of new utility services within the Bailiwick; and

f. to lessen, where practicable, any adverse impact of utility activities on the environment;

States Directions[9] to the DG also require him:

- to ensure that the licensee (i.e. GPL) charged with providing the universal service in the postal sector does so throughout the Bailiwick of Guernsey at uniform and affordable prices; and
- to award the exclusive right to provide postal services in the Bailiwick to the extent that such exclusive right is necessary to ensure the maintenance of the universal postal service.

Licence Conditions

GPL was awarded a licence on 1st October 2001 in accordance with States Directions and was designated by the DG as being dominant in the market for reserved services in the Bailiwick of Guernsey[10].

Condition 18 of GPL's licence was amended early in 2005 to allow for the DG to price control GPL's USO services (outside the reserved area) where it has been found by the DG to be dominant.

Therefore in accordance with Condition 18.3 of GPL's postal licence, the DG may regulate the prices of a postal licensee where GPL is dominant. The relevant licence condition states:

> *"The Director General may determine the maximum level of charges the Licensee may apply for Licensed Services Services and/or Universal Services 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 Licensed Services and/or Universal Services or categories of Licensed Services and/or Universal Services or any combination of Licensed Services and/or Universal Services;*
> >
> > *(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.*

9 States Resolutions 2001, pages 78-80 (item no 14)

10 Document OUR 01/16 Decisions under the Post Office (Bailiwick of Guernsey) Law 2001 – Decision Notice and Report on the Consultation Paper.

In conclusion the DG has the power to directly regulate the prices that GPL charges for services provided within its USO.

In September 2005 the OUR published a draft decision[11] concerning market definitions, market power and dominance in the postal sector of the Bailiwick of Guernsey. In that Draft Decision, the DG set out his views on the nature of the postal sector in the Bailiwick, the degree to which clearly separate markets might be identified and the degree to which competition does, or is likely to, exist in those markets.

Following the consultation of the Draft Decision the DG designated GPL as being dominant[12] in the following markets:

- the market for regular letter and parcel services;
- the market for priority (SD) letter and parcel services; and
- the market for outbound bulk mail services

[11] Document OUR 05//21 Review of Market Dominance in the Guernsey Postal Market – Proposed Decision: Statutory Invitation to Comment, September 2005
[12] Document OUR 05/26 Review of Market Dominance in the Guernsey Postal Market – Report on the consultation and Decision Notice, November 2005

Annex B - GPL's Cost of Capital

Introduction

Capital is like any other scarce resource: where demand exceeds supply companies must compete for capital from shareholders (in the form of equity or retained profit) or in the form of debt. For an economic perspective, the cost of capital is in effect an "opportunity" cost i.e the value that is foregone by the best alternative option. In practice, the best alternative option depends on the range of sources of capital from which a particular firm opts to chose (the "choice set")[13].

In general, the majority of companies adopt a wide choice set and obtain their capital from various sources including different types of debt and equity, as well as retained profits. In such instances, the cost of capital is considered to be the level of return required by the financial markets in order to provide capital to a firm. For a given level of return, rational investors will select the investment with the minimum risk; also for a given level of risk rational investors will select the project that maximises returns. Risk, in its simplest form, is caused by the possibility of different outcomes, which results in uncertainty. With regard to a specific business it is the risk element that cannot be diversified which is of significance.

By contrast, in other instances companies may choose to restrict their choice set for particular company specific reasons. For instance, rather than become involved in complex forms of financing, a company can place their retained profits in deposit accounts or provide them as loans rather than investing them in the business. In these circumstances the decision choice for that company has been deliberately simplified, with the cost of capital effectively being the interest received on a deposit or that received on the loan provided.

Given the wide range of uses to which capital can be put in modern markets, a sophisticated body of analysis has developed on methodologies for calculating the opportunity cost of capital when faced with a large choice of various alternative sources of capital. These methodologies rely on a large number of data inputs and assumptions that are designed to consider, inter alia, the economic conditions that prevail, the industry sector concerned and the company's position in that sector.

In the two previous price controls the OUR has taken GPL's cost of capital simply to be the interest that could be earned on States' Treasury Deposits. As a State owned enterprise funding its activities entirely through cash which was held on deposit by the States of Guernsey, the DG considered that GPL had chosen to restrict its choice set. In other words, the interest that the company could receive from the States was value that was foregone if GPL used the funds instead to invest in capital expenditure in the company. OUR was advised the interest rate earned on States Treasury Deposits was 3.8% which gave a pre-tax cost of capital of 4.75%. The OUR took this figure as the company's opportunity cost of capital with which to discount future cost and revenue streams.

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[13] If a business consciously restricts its choice set for various reasons then the opportunity cost can be interpreted as relating to the set of alternatives considered, rather than the global set faced

However the cost of capital is a critical input to future capital investment decisions. Using a cost of capital that is too low will lead to excessively capital intensive expansion choices. It is therefore important from an investment perspective that the weighted average cost of capital ("WACC") is set at an appropriate level[14].

When considering the cost of capital that should apply to GPL, the OUR initially turned to the internationally accepted methodology of setting the cost of capital using the WACC approach. This is described in detail later in this section.

GPL have proposed a real pre-tax cost of capital of 7.5% assuming zero debt. In the following sections the DG sets out his views on the inputs to the WACC calculation in order to determine an appropriate cost of capital for GPL.

Weighted Average Cost of Capital

The WACC is the most commonly used approach for estimating a company's opportunity cost of capital.

Companies can raise capital either through equity or debt, both of which have a cost. The WACC therefore has two key components, the cost of equity and the cost of debt; the WACC is equal to the weighted average of the two components, based on the debt to equity ratio (known as the gearing). The WACC (pre-tax) equation is defined as follows:

$$WACC = (R_e * (1-g))/(1-T) + (g * R_d)$$

where:

- R_e = cost of equity;
- g = debt / (debt and equity);
- T is the tax rate; and
- R_d= cost of debt.

To calculate the WACC formula therefore requires the cost of equity, cost of debt, tax rate and capital structure as inputs. The traditional approach to estimating a company's cost of equity is to use the Capital Asset Pricing Model ("CAPM").

OUR 04/11 sets out a discussion of this area. Full descriptions of the WACC and CAPM used for estimating a company's cost of capital are provided in publicly available documents on other regulators' websites and respondents may also wish to refer to these for background information[15].

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[14] This point regarding investment decisions was contained in a report from an independent expert panel set up to examine a range of issues relating to the price control of Guernsey Electricity, including the appropriate cost of capital.

[15] The following two documents by Oftel and the Civil Aviation Authority in particular provide good introductions to the topic; www.ofcom.org.uk/static/archive/oftel/publications/1995_98/pricing/pri1997/contents.htmH and www.caa.co.uk/erg/ergdocs/annexcc.pdfH.

These components in the CAPM calculation are discussed in turn below.

Cost of Equity

The cost of equity term, Re, captures the returns shareholders would require in order to invest in a company. It is made of two components, the risk free rate, and the extra return above that risk free rate that is required to reflect the company risk, relative to the market.

$$R_e = R_f + \beta(R_m - R_f)$$

where:

R_e = the cost of equity;

R_f = the anticipated return available from risk free investment;

R_m = the anticipated returns available from risky investments in the market generally; and

β = the anticipated correlation between movements in the share price of the company concerned compared with movements in the

Risk free rate, R_f

The risk free rate is the rate of return that would be earned on an asset that carries no risk. Government bonds are considered to be the closest thing in practice to a risk free investment. In considering what the return is on government bonds, regulators typically look back at the average yield of such bonds over the medium and the long term, while also trying to identify if any fundamental changes in trends have taken place which would deem one approach preferable to the other. Bond yields are currently extremely low (below 2%), and may not be sustainable at such a rate in the longer term. Since 2004 UK regulators have estimated the risk free rate as lying between 2.25% - 3.0%, reflecting a view that current rates will rise slightly in the longer term.

Postcomm has recently used 2.5% as the risk free rate for Royal Mail's 2006 price control decision[16], and the DG therefore proposes to also use 2.5% as the risk free rate.

A more detailed discussion of the cost of capital prepared by Smithers & Co on behalf of the UK economic regulators and the Office of Fair Trading is available at www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/2012_jointregscoc.pdfH

[16] Royal Mail Price and Service Quality Review, Final Proposals for Consultation, December 2006.

Equity Risk Premium, R_m - R_f

The equity risk premium reflects the difference between returns on equities in general and the risk free rate. This additional return reflects the additional risk of equities, above non-risk investments (i.e. bonds). Recent estimates for the equity risk premium from Ofgem, Ofwat, CAA (Civil Aviation Authority) and Postcomm range from 2.5% to 5.0%. This range was also proposed by the OUR as inputs for the WACC calculation for GEL; the OUR also now proposes this range for GPL.

Equity beta, β

The equity beta measures the relative "riskiness" of a company against the equity market as a whole, in terms of the variability in investment returns. If the value of beta is greater than 1, this means that returns for this company are more risky than those of the market. Conversely, a beta of less than 1 reflects less risk compared to the market as a whole. In simple terms, beta in effect captures the reliance of the company returns on the general market conditions. Typically, regulated utilities have low beta values, reflecting the fact that their size, monopoly status and provision of essential goods or services makes them less vulnerable to market volatility than other businesses.

The level of financial risk associated with debt needs to be excluded when comparing the equity betas of different companies. Once this factor is removed, the remaining measure is known as the "asset beta":

$$\beta_e = \beta_a / (1 - g)$$

UK regulators have estimated asset betas for the regulated companies in the electricity, water, airports, telecoms, rail and postal sectors. Recent determinations for asset betas for regulated companies in these sectors have ranged from 0.5 to 0.65, if BAA is excluded (0.75).

Table A.1 Comparison of Asset Betas

National Reg. Authority or Competition Commission	Sector	Date	Equity Beta	Gearing	Asset beta
Ofgem	Electricity Distribution	2004	1.0	57.5%	0.43
Ofwat	Water & Sewerage	2004	1.0	55.0%	0.45
Comp. Commission	Airports	2002	1.0	25.0%	0.75
Ofcom	BT copper access	2005	0.9	35.0%	0.59
ORR	Rail	2000	1.3	50.0%	0.65
CAA	Air traffic control	2005	1.54	61.0%	0.60
Postcomm	Post	2006			0.65 – 0.75

In its recent consultation paper[17], Postcomm examined the asset betas of a number of listed UK companies, and specifically reviewed the asset betas of three delivery service companies.

Postcomm estimated an asset beta for Royal Mail of between 0.65 and 0.75. The OUR considers that a slightly lower range is appropriate for GPL, in light of the fact that the control period is for 3 years, and therefore suggests a range of 0.60 to 0.70.

The gearing levels on which the risk-based discount for GPL is derived is proposed as zero given the absence of debt by GPL. This is consistent with the OUR's proposals for calculating the WACC for GEL. The proposed equity beta is therefore simply equal to the asset beta, $\beta_e = \beta_a$.

Cost of Debt

The gearing levels on which the risk-based discount for GPL is derived is proposed as zero given the absence of debt by GPL. For the purpose of calculating the WACC the cost of debt term, R_d, is redundant and no further investigation into the cost of debt is required.

This reflects the States' policy with regard to the sources of funding adopted by the Bailiwick's State-Owned Enterprises ("SOE").

Summary

As outlined above, the OUR proposes to assume a gearing of 0% for GPL. The WACC is thereby simply equal to the cost of equity:

$$WACC = (R_e * (1-g))/(1-T) + (g * R_d)$$

and where g=0,

$$\Rightarrow WACC = R_e/(1-T)$$

and substituting for R_e

$$\Rightarrow WACC = \frac{(R_f + \beta_e(R_m - R_f))}{1-T}$$

Using this formula, and assuming a corporation tax rate of 20%, the following range of real pre-tax WACC results.

[17] Royal Mail Price and Service Quality Review, Final Proposals for Consultation, December 2006.

Table A.2 GPL Real Pre-tax WACC

	Low Case	**Middle Case**	**High Case**
Risk Free Rate	2.5%	2.5%	2.5%
Gearing	0.0%	0.0%	0.0%
Equity Risk Premium	2.5%	4.25%	5.0%
Asset Beta	0.60	0.65	0.70
Equity Beta	0.60	0.65	0.70
Cost of Equity	4.00%	5.26%	6.00%
WACC (real pre-tax)	**5.00%**	**6.58%**	**7.50%**

The DG proposes to take a mid-range value of 6.17% as the real pre-tax cost of capital for GPL for the duration of the price control period.

Annex C – Efficiency Review of GPL

Provided in separate document to GPL only.

Annex D – Demand Forecasts

Provided in confidence to GPL only.