Peter John
Head of Price Control Review
Competition and Regulation Directorate
Postcomm
Hercules House
6 Hercules Road
LONDON
SE1 7DB

15 February 2002

Dear

Price Control Review for Consignia – Consultation Document

I am pleased to provide the views of Consignia plc on the above consultation paper. As with previous responses to consultation papers we have no objections to our views as set out in this paper being made available to all other interested parties.

The response to the consultation paper is set out in the form of a response, where appropriate, to the specific issues raised by Postcomm as requiring/requesting views from respondents.

Due to the significance of this issue and especially given the recent proposals on the introduction of competition set out in Postcomm's recent consultation paper, Postcomm's "Proposals for Promoting Effective Competition in UK Postal Services", January 2002, Consignia will wish to submit a number of supplementary papers to Postcomm which will set out in further detail some of the issues covered in this response and impacted by the proposals set out in the competition paper. Consignia is aware from discussions with Postcomm of its schedule for an Efficiency Review Study. Consignia has not received a detailed schedule for the price control review. Consignia will submit supplementary papers in a timely manner for Postcomm's consideration during the review.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
Tel: 0207 250 2965 Fax: 0207 250 2158
e-mail: john.b.duncan@consignia.com

RESPONSE TO POSTCOMM CONSULTATION DOCUMENT "PRICE CONTROL REVIEW FOR CONSIGNIA PLC", NOVEMBER 2001

OVERVIEW

Introduction

Consignia welcomes the opportunity to comment on Postcomm's November consultation document on the subject of Consignia's price control from April 2003. Its response to the specific questions raised by Postcomm is attached. In addition, Consignia submits this overview to context the response to the specific questions within the overall price control review.

The postal sector

The postal sector has developed over many years and is quite unique amongst the other industries of the UK. Some of the key factors relating to the UK postal sector are set out below:

a. Consignia plc is comprised of UK Mails business and a number of other businesses including Parcelforce Worldwide. Postcomm's price control review will consider, amongst other things, the appropriate overall level of prices charged by the UK Mails business from April 2003 with an annual turnover of about £5bn and customers over the whole of the UK;

b. The Government is committed to one postal operator, Consignia, maintaining a universal postal service with a uniform price throughout the UK. Hence, Consignia is constrained in its provision of service and pricing options;

c. There are economies of scale in the postal service, whereby the average cost of the service decreases with increased volume. There are also economies of scope. Hence there are considerable welfare benefits from retaining a single operator for postal services;

d. Labour is less homogeneous than capital and forms a very high proportion of overall costs. Hence, management and union matters have a particularly high profile within the industry;

e. There is strong competition from the development of electronic forms of communication e.g. fax and e-mails. Hence, the potential for growth in the sector is relatively limited;

f. Small postal operations can use low levels of technology. Hence, entry into the postal service sector is relatively easy;

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
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e-mail: john.b.duncan@consignia.com

g. Postal products are readily differentiable by service standard (e.g. the average number of days between collection and delivery) as well as price. Hence, the scope of new products is unlimited, again making entry into the postal service sector relatively easy;

h. Competition in postal products has been introduced for over 350g, with licensed entry in niche markets. The European Postal Services Directive (the "Directive") proposes further reductions in the weight-bands to introduce competition to 100g by 2003 and 50g by 2006. It supports the retention of a reserved area, where competition is excluded, and the provision of a universal service;

i. Competition has been introduced in other countries, but in each case the financial exposure of the host postal service operator has been limited by other measures or actions taken by that operator.

The Postal Services Act 2000

The Postal Services Act 2000 ["the Act"] (Part 1, Paragraph 3(1)) states that Postcomm should "*exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service*" and subsequently defines that universal postal service which includes a uniform charges obligation for the UK. Consignia is the USO provider in the UK.

Subject to this duty, the Act (Part 1, Paragraph 5(1)) states that Postcomm should "*exercise its functions in the manner which it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators" and shall have regard to the interests of specified groups of customers.*

Subject to these two duties, the Act (Part 1, Paragraph 5(3)) states that Postcomm should "*exercise its functions in the manner which it considers is best calculated to promote efficiency and economy on the part of postal operators*."

In addition, the Act (Part 1, Paragraph 5(4)) states that "*in exercising any of its functions in relation to licence holders under Part II, the Commission [Postcomm] shall have regard to the need to ensure that such licence holders are able to finance activities authorised or required by their licences*".

In summary: Postcomm has a primary duty to ensure the provision of the universal service, a secondary duty to promote effective competition where it can be shown to be in the interests of users of the postal service, including disadvantaged customer groups, and a tertiary duty to promote efficiency and economy on the part of postal operators. Finally, there is a requirement in all cases for Postcomm to have regard to the need to ensure the finance of activities authorised or required by licences.

The USO and Competition

There is no constraint akin to the provision of a universal service at uniform prices for the whole of the UK, except in the case of telecommunications. In the telecommunications sector there have been some technological barriers to entry and considerable growth, such that the entry that has occurred has not inhibited the host's growth. In comparison, in the postal sector, there are limited technological barriers to entry and limited prospects for growth. Consequently, the liberalisation of the postal sector is more likely to be effective in introducing entrants and reducing the volume of post served by Consignia.

This would expose Consignia to the risk of reduced economies of scale, increasing per unit costs and increasing prices that could further reduce volume. This would have a significant impact on Consignia's ability to provide the universal service provision at uniform and affordable prices. In such a case, liberalisation of the postal sector and the introduction of effective competition for all postal products would not be in the interest of all postal customers and, thereby, would be at odds with Postcomm's obligations under the Act. Nevertheless, Postcomm has proposed liberalisation of the postal sector from 2006[1], with a view to introducing effective competition for all postal products.

Performance

Over the last decade, the price of inland UK first class public tariff mail has reduced in real terms by over 10 per cent. Over the same period, the proportion of such letters reaching their destination within a day has averaged over 90 per cent. In addition, over the last decade, the price of inland UK second class public tariff mail has reduced in real terms by over 16 per cent.

Furthermore, while the consultation document refers to the change in prices over the last decade for gas and electricity, these reductions relate to reductions in the price of fuels and reduced capital expenditure relative to the regulatory asset base as well as efficiency improvements. In fact, the profile of the price changes for inland UK first and second class public tariff mail over the last decade is lower than that in the regulated industries of rail and water and the service sector in general.

In terms of international comparisons, the price of inland UK first class public tariff mail is amongst the lowest in Europe. The UK price is lower than the corresponding price in Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Portugal and Sweden. It is very similar to the price in the geographically much smaller Netherlands where there is also a lower service specification than in the UK. Only in Spain and Ireland is the price lower than in the UK although again, even in these two cases, the comparable product has a lower service specification than that in the UK.

[1] "Proposals for Promoting Effective Competition in UK Postal Services", Postcomm, January 2002.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
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In conclusion: in the context of the change in UK prices over the last decade and in comparison with Europe, the UK postal sector has an excellent record on efficiency and providing value to customers.

Financial position

Consignia has been running an operating loss for two years and, under its present licence, is constrained in its ability to increase prices in real terms before 2003.

Review process

In this document, Consignia responds to the specific questions of the November consultation document. During the period of the review Consignia proposes to submit a number of supplementary papers to Postcomm which set out some of the issues, touched upon in this response, in more detail.

Conclusion

Later this year Postcomm plans to come forward with final proposals for the control of Consignia's prices and/or revenue from April 2003. In reviewing these final proposals Consignia will consider, amongst other things, the overall package of the control that Postcomm proposes, the market environment in which Postcomm proposes that Consignia should operate and the financial risks entailed.

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Objectives and approach for the review

Question 2a

Postcomm welcomes views on the objectives it should have in mind when addressing options for revising Consignia's price control. In particular, Postcomm would welcome views on the above objectives and whether any additional objectives ought to be considered.

Question 2b

Postcomm welcomes views on its proposed approach to reconciling some of its potentially conflicting objectives.

The recognition of the importance of the retention of a daily delivery and collection for **ALL** postal consumers throughout the UK is confirmed by the absolute primacy of Postcomm's duty under the Act, whereby Postcomm should *"exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service"*[2] Nevertheless, Postcomm mis-represents its obligation regarding the universal service obligation by stating *"Postcomm's primary duty is to seek to ensure customers continue to be able to enjoy a universal postal service"*[3] . The obligation is more prescriptive than the statement made by Postcomm in its consultation paper. Furthermore, the requirement that there is a uniform tariff throughout the UK demonstrates the importance of postal services throughout the economy, irrespective of geographical location, rurality or urban.

The duty on Postcomm to promote effective competition between postal operators, where appropriate and having regard to disadvantaged groups, is a secondary duty. Regarding competition, the Act states that Postcomm should *"exercise its functions in the manner which it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators"*[4] *and having regard to disadvantaged groups of customers* . Nevertheless, Postcomm mis-represents its obligation regarding competition by stating*: "Postcomm's statutory duty to further the interests of customers where possible by promoting effective competition recognises that Parliament, in passing the Postal Services Act 2000, has adopted a positive stance towards competition because of the potential benefits it can give postal users"*[5] . Consignia considers that Postcomm's change of emphasis to the Act could lead Postcomm to introduce competition where it is *possible* but also *inappropriate* to do so.

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[2] The Act, Part 1, Paragraph 3(1)
[3] "Price control Review for Consignia plc", Postcomm, November 2001, paragraph 1.2.
[4] The Act, Part 1, Paragraph 5(1)
[5] "Price control Review for Consignia plc", Postcomm, November 2001, paragraph 2.6.

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Two other key duties are then conferred on Postcomm, to promote efficiency and economy on the part of postal operators and to ensure that licence holders are able to finance activities authorised or required by their licences.

Consequently, there is an obligation on Postcomm to have regard to the need to ensure continued financial viability and thereby ensure that any control it proposes for Consignia’s revenue and/or prices takes full account of the financial position and risks of the company over the control period. Otherwise, as Consignia is the USO provider, Postcomm would be failing its primary statutory duty if, as a consequence of its actions, Consignia could not finance its licensed activities.

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The Coverage of Consignia's Revised Price Control

Questions 3a, 3c

Postcomm welcomes views on the appropriate approach to assessing the coverage of Consignia's price control. In particular, Postcomm is keen to understand whether a competition based test should be preferred to the other options.

Postcomm welcomes views from respondents on the products that ought to be covered by the price control and conversely, those products that ought not to be covered by the price control. Postcomm welcomes any information or arguments from respondents that supports their recommendations using the approach and criteria outlined in this section

Consignia provides three categories of postal services.

(i) those for which a licence is required if such services are to be offered;
(ii) those where Consignia does not require a licence to operate but which it is obligated to provide as part of its licence in fulfilling the statutory requirement that there should be a universal service; and
(iii) those services where no licence is required and which Consignia is not obliged to operate.

In Consignia's view there should be no price control on any service which falls into category (iii). Consignia believes formal price control should be restricted to services which fall into category (i). In this category there are restrictions on full competition and it is sensible to ensure that the extent of competition permitted is supported by effective regulation until full competition is introduced.

In the case of services in category (ii), universal services, there is a requirement that prices should be affordable. Therefore, a test of affordability should be applied, but any price control for this category should be limited to this objective.

Supporting the regulatory framework is the Competition Act 1998. Concerns that continued dominance in a market open to competition might lead to abuse of that position and excessive prices can and should be dealt with under the provisions of the Competition Act.

In its recently published consultation paper on competition Postcomm flag the need to identify the services which should be embraced within the definition of the universal service. This task should be addressed as a matter of priority.

All other things being equal, from January 2003 across Europe the reserved area will be reduced to 100g, from January 2006 it will be reduced to 50g. If Postcomm's competition proposals are implemented full liberalisation will be implemented in the UK from April 2006 and, in the interim, bulk mail will be progressively liberalised in the UK. It may continue to be formally the case that licences are required to operate postal services below the current licensed area of 350g, albeit that they will be available to all comers, subject to a fitness to serve test, notwithstanding the progressive liberalisation arising out of Directive and Postcomm's own actions.

The categorisation of services within (i) should similarly mirror the movement in the definition of the reserved/licensed area. This would mean, assuming the competition proposals referred to above proceed, that prices for letters above 100g would be taken outside formal price control from 1st January 2003, prices for letters above 50g would be taken outside formal price control from 1st January 2006, and the formal price control would cease completely from April 2006 under Postcomm's liberalisation proposals. Given the lower barriers to entry in the postal sector and the requirement on Consignia to grant access to its networks there would be no justification for continued price control.

Similarly, the prices for bulk mail should be removed from the price control if Postcomm's proposals for these services proceed. To the extent that the services would be classified as universal services i.e. category (ii) services, they would continue to be subject to whatever price control is determined as appropriate for these services.

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e-mail: john.b.duncan@consignia.com

Question 4a: Structure

Postcomm welcomes views on the appropriate structure of Consignia's revised price control, in particular whether it should consider a price cap, total revenue, average revenue, tariff basket or hybrid approach.

The options for the structure of a control fall into three broad categories:

- a pure price control where revenue increases in proportion to volume and there is no fixed component of revenue;
- a pure revenue control where revenue is fixed and independent of volume;
- a hybrid control, where a portion of revenue is fixed independent of volume and the remaining portion depends of volume.

In most regulated industries a portion of total costs are fixed, independent of volume. The presence of fixed costs may be shown, for example, by a long-run marginal cost less than unity and the average cost of the service decreasing with increased volume, thereby implying the presence of some economies of scale.

Consignia has undertaken research over many years to understand the basis of its costs and derive marginal cost estimates. This has concluded that the overall long-run marginal cost has a value below unity and the average cost of the service decreasing with increased volume. Consequently, the postal sector has economies of scale and a proportion of its costs are fixed in the long-run. For example, Consignia's licence specifies that it must provide a network of collection boxes and post offices, defined by the distances people must travel to reach them, regardless of the volumes of mail posted. There is also evidence that the postal sector has economies of scope.

The allowed revenue for the price control of a regulated company is assessed on the basis of a single, and usually central, forecast of volume. Regulators have become increasingly aware of the financial risks to the regulated companies that arise from forecast errors of volume in the presence of fixed costs. There are several cases where the regulator of a regulated industry has applied hybrid price controls that provide some protection to the regulated industry for forecasting errors.

Consignia considers that the application of a hybrid price/revenue control provides the most direct and appropriate means of managing the financial risk associated with forecast error. Consignia considers that if this risk is not managed through the structure of the control, Postcomm will need to take account of this financial risk elsewhere within the control.

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There is considerable uncertainty relating to Consignia's postal volumes in the future. This arises from two main sources: the continuing advance of electronic substitutes such as e-mail which affect the overall level of volumes and the effect of liberalisation of the UK postal market on Consignia's market share. Consignia considers that these introduce a downside risk to Consignia's volumes that is not offset by upside. Further, they involve different degrees of financial risks and the value of lost volume from cream-skimming would exceed that of electronic substitution. Consignia considers that these financial risks are additional to the issues of volume risk discussed above and that Postcomm should take full account of these financial risks in its final proposals for any control of prices and/or revenue.

Within an increasingly competitive environment the present uniform tariff structure will come under growing pressure. The price control structure adopted will need to be able, within any overall price control, to permit Consignia individual price flexibility to respond accordingly. It is noteworthy that in responses to the June 2001 Postcomm consultation on effective competition that respondees such as the Direct Marketing Association, the Incorporated Society of British Advertisers, the Department of Work and Pensions and TNT Post Group all supported the view that Consignia should be allowed price flexibility in competitive areas.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
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Question 4b: Form

Postcomm welcomes views on the most appropriate form of price control.

Consignia considers that, in the context of the response made in this document, the most appropriate form of control would be that of a RPI-X approach. Consignia believes that RPI-X has incentive properties, as referenced by Postcomm in the consultation document. However, Consignia believes that a traditional RPI-X coverage has the potential to introduce financial risks on Consignia that Postcomm will need to consider in its review. Consignia considers that application of the RPI-X approach introduces the following financial risks:

1. Labour costs form the main cost to Consignia. Average earnings and pay settlements country-wide increase year-on-year more than RPI. The average rate of increase in UK average earnings over the last 10 years, as measured by National Statistic's average earnings index, has been 56 per cent compared with the headline rate of RPI at 35 per cent. A comparator for postal workers earnings is male manual earnings from the New Earnings Survey and over the last 10 years the average annual increase has been 45 per cent. Hence, if there is an RPI adjustment to revenue and/or prices, there is a pressure for costs to increase more than the allowed revenue/prices over the price control period and erode funding of the USO;

2. The RPI definition of inflation includes mortgage interest payments. The government's target measure of inflation, RPIX, excludes mortgage rates and the Monetary Policy committee of the Bank of England is tasked to ensure outturn RPIX inflation is within 1 per cent of its target of 2.5 per cent. Since mortgage interest payments cause the RPI figures to fluctuate and are outside of Consignia's control, a control based on the RPI-definition could lead to changes in revenue that are unrelated to its core costs.

Consignia considers that Postcomm should consider these financial risks fully within its review and final proposals.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
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e-mail: john.b.duncan@consignia.com

Question 4c: Duration

Postcomm welcomes views on the duration of price control.

Consignia's view is that the planning stability provided by a control with a duration of five years is, in principle, desirable. However, given the significant and unpredictable change which might result from liberalisation in the period it may be appropriate to include within the price control mechanisms, the provision for an interim periodic review under exceptional circumstances, commensurate with Postcomm's and Consignia's statutory obligations.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
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e-mail: john.b.duncan@consignia.com

Question 5b Service Standards

Postcomm welcomes views on the appropriate form of service quality regulation in Consignia's price control. In particular, Postcomm welcomes views on the relative merits of compensation payments*, *financial penalties related to service targets in the licence and direct links with the price control.

The link between opex/capex and quality of service has been well established within the controls of regulated industries. The opportunity to do so for Consignia is no different. The setting of quality of service targets should be based on clear principles and on customer expectations/desires with targetry based on outputs linked to appropriate capital and operational expenditure. Experience in other industries has identified the importance of output regulation rather than input regulation, but it is imperative that in determining the relevant output measures that sufficient resource has been allowed for in any price control review.

Postcomm already has the powers to fine Consignia or use Enforcement Orders in relation to quality of service, but there are drawbacks to the use of such instruments which may be offset by an alternative approach.

As quality of service and opex/capex are inextricably linked a move towards output based regulation with a link to the price control would appear to have some benefit:

1. as the quality of service measures are included within the Consignia Licence, as is the price control, the service standards set are based on the expectations of the relevant parties;
2. all customers are automatically compensated for any service standards failure by receiving lower prices, but there is no onerous process required. The failure is reflected via the price control to the price of the product.
3. the licensee has a clear appreciation of the revenues allowed and the services to be provided. Changes to the service standards only occur when there is a change to the price control, thereby enhancing the regulatory contract and providing a greater degree of predictability.
4. the price control could be set so that there is a clear financial benefit to the licensee for exceeding any performance standard. This provides incentive properties.

Whatever approach is preferred Consignia should not be subject to double jeopardy and should not be exposed to an unbalanced level of financial risk

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
Tel: 0207 250 2965 Fax: 0207 250 2158
e-mail: john.b.duncan@consignia.com

Question 6a

Postcomm welcomes views on these general approaches to setting the level of the revised price control.

Consignia considers that Postcomm's general approach should recognise its obligation to have regard to the need to ensure the continued financial viability of Consignia over any control period. Therefore, Consignia considers that Postcomm should undertake a comprehensive review of Consignia's financial risks for the control period and that this should be in the context of any proposals that Postcomm may put forward for change to the postal sector.

Consignia considers that any company should seek ways to improve efficiency and that Consignia has not only succeeded in doing so over the last decade but also continues to do so. Consignia considers that the consultation document is unbalanced in over-emphasising Postcomm's efficiency review and under-emphasising Postcomm's review of Consignia's financial risks within the context of the control and any proposals that Postcomm may put forward for change to the postal sector.

Question 6b: OPEX

Postcomm welcomes views on its general approach to assessing a target level of efficient operating costs

Consignia is a more efficient postal service operator than most of its counterparts in Europe, as is shown by a comparison of prices across Europe. The UK price is lower than the corresponding price in Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Portugal and Sweden. In addition, during the last decade, Consignia has attained high levels of service on service standards that are themselves amongst the highest in Europe.

Consignia notes that the approach to the review of operating costs that is outlined in the consultation document is similar to that used for regulatory reviews of other regulated industries. Such a review is particularly important in the context of Postcomm's proposals for liberalisation. Consignia considers that the review of operating costs depends critically on the use of the benchmark comparisons. Consignia considers that Postcomm should ensure that the benchmarks that are used for this review are appropriate for the postal sector and the changing environment that Postcomm is proposing.

Consignia also considers that much care needs to be taken if Postcomm seeks to define an efficient operator within a postal function. Labour is the main input to the postal service sector and is not as homogeneous as capital. Hence, for example, the efficient operation of one postal function may vary from place to place in a way that would not occur with capital. Consignia considers that Postcomm should ensure that any definition of an efficient operator that is used to assess the allowed level of operating costs for any control of revenue and/or price is appropriate for the postal sector.

Consignia considers that Postcomm may undertake top-down operating cost comparisons with other regulated industries and should ensure that any such comparisons in the review are appropriate to the postal sector.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ

Tel: 0207 250 2965 Fax: 0207 250 2158

e-mail: john.b.duncan@consignia.com

Question 6c: CAPEX

Postcomm welcomes views on the appropriate treatment of Consignia's capital expenditure in the revised price control. Postcomm welcomes views on the relevant approach to calculating an appropriate level of depreciation under the revised price control.

Consignia considers that Postcomm could allow for planned capital expenditure in the control period to be recovered fully either within the control period or within the control period and beyond it. Consignia considers that the recovery beyond the control period could increase the uncertainty that Consignia has over future regulatory decisions, and hence Consignia's financial risk, if it is not accompanied by sufficient commitment from Postcomm to continue to apply the same approach into the future in a consistent manner.

As an example, if the regulatory asset base (RAB) was subject to review for subsequent controls, there would be a risk that Consignia would not receive the capital spend and return on it into the future. In this case, the recovery within the control period of the planned capital expenditure for the period could be one means of addressing this financial risk. Consignia considers that Postcomm should ensure that the control takes full account of Consignia's financial risk arising from possible changes to the future regulatory treatment of capital expenditure (and the RAB).

Consignia also notes that the consultation document does not discuss detailed methods of calculation relating to the allowance for capital expenditure and treatment of the RAB. Consignia considers that these require further consideration during the review.

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
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e-mail: john.b.duncan@consignia.com

Question 6d, 6e and 6f: RAB and cost of capital

Postcomm welcomes views on the appropriate approach to calculating the opening Regulatory Asset Base. Postcomm welcomes views on the relevant approach to calculating an appropriate level of depreciation under the revised control. Postcomm welcomes views on respondents' preferred methodology for calculating Consignia's allowed return e.g. whether a weight average cost of capital would be preferable to a return on turnover, or whether some combination of options should be considered.

Consignia considers that other UK regulators have used a cost of capital and RAB approach to determine the allowed level of profit for network businesses. Consequently, the approach may assist in forming the allowed profit of any price control for Consignia, although it may be necessary to take account of profit on turnover as well. In addition, Consignia considers that such an approach should not be made in isolation from the treatment of Consignia's financial risk elsewhere within any proposed control.

Consignia notes that the consultation document states the need for a higher cost of capital in the event that the RAB value may understate the allowed profit because of the low capital intensity of the industry. Consignia considers that not only is this true but also the levels of RAB and cost of capital should take account of Consignia's financial risks which are not treated elsewhere within the final proposals of the control on price and/or revenue later in the year.

Consignia considers that, on the assumption that the issues relating to Consignia's financial risk and raised in this document are adequately dealt with elsewhere within the control, the HCA asset value would understate the opening value of the RAB. To form an appropriate opening RAB in this case, the HCA asset value would need to be adjusted up by factors for modern equivalent assets, intangible assets and market valuation of the assets.

Consignia also considers that, on the assumption that the issues relating to Consignia's financial risk and raised in this document are adequately dealt with elsewhere within the control, the weighted average cost of capital could form the basis for consideration of the appropriate level of the cost of capital.

Consignia notes that Postcomm states "The tendency in recent years has been for a cost of capital of between 6% (real, pre-tax) chosen for Scottish electricity transmission companies in 1997 and the 8.1% (real, pre-tax) on the basis of which Railtrack's price control was set in October 2000" [6]. This appears to ignore the nominal, pre-tax cost of capital of over 13 per cent (i.e. real, pre-tax cost of capital of over 10 per cent) used for British Telecom in 2001.

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[6] "Price control Review for Consignia plc", Postcomm, November 2001, paragraph 6.36.

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e-mail: john.b.duncan@consignia.com

Yours sincerely

John Duncan
Regulatory Strategy Manager

Group Centre, Consignia plc, Room 223, 148 Old Street, LONDON, EC1V 9HQ
Tel: 0207 250 2965 Fax: 0207 250 2158
e-mail: john.b.duncan@consignia.com