

ALLOWED PROFIT II: REGULATORY ASSET BASE – FOR THE UK INLAND MAILS BUSINESS OF CONSIGNIA

Paper 4 of a series of papers prepared by Consignia in June 2002 for Postcomm’s review of the price control for 2003

Summary

This paper considers the evaluation of the Regulatory Asset Base (RAB) of the UK inland mails business of Consignia which, when combined with the pre-tax, real weighted average cost of capital (WACC), can be used to estimate the allowed pre-tax profit for the price control.

The general approach of UK regulators to the initial evaluation of the RAB value is for the RAB value to reflect the trading value of the regulated business. The trading value of a company is the sum of the market value of equity and debt.

For the companies that have been privatised and regulated, the level of equity can be determined by the value or price in the stock market at the close on the day of sale. The opening RAB of the regulated businesses for use in setting the price control can then be set consistent with the combined level of debt and equity that is reflected in the market value at that time. This approach has been used by most of the UK regulators to estimate the RAB of the regulated businesses of privately owned regulated companies, including the airport authority (BAA), telecommunications (BT), electricity distribution, electricity transmission, gas transportation, rail and water and sewage industries.

For publicly owned regulated companies, there is no public quotation in the stock market to determine the trading value. However, a trading valuation of the regulated business can be determined from the trading value of a comparable business in the stock market and the value of net assets¹ of both the regulated business and its comparator. The trading value divided by the net asset value of the comparator derives a factor (“TVA”²) which, when applied to the net asset value of the regulated business, provides an estimate of the trading value of the regulated business.

For this paper, the TVA is based on the TPG postal operator in the Netherlands that, unlike other operators with a trading value in the stock market, focuses on a mails business and the universal service provision and, like Consignia, is one of the leading postal companies in the world. It uses an estimate of the TPG Group TVA rather than the TPG mails business TVA. It also uses an estimate for the latest 1-year average market valuation that is below the 3-year average market valuation. Hence, the TVA value for the UK inland mails business should be at least the figure of 2.5 presented in this paper.

At the time of writing (May 2002) the coverage of the price control is unknown. The Regulatory Accounts state the asset values for separate areas of the UK inland mails business of Consignia, including the “Licensed USO³” area, the “Non-licensed USO”

¹ Total asset value less current liabilities.

² Trading value adjustment.

³ Universal service obligation.

area and “Non-licensed, non-USO” area⁴. In this paper, the combination of the first two areas is referred to as “Total USO” area and the combination of all three is referred to as “Combined” area. For the purpose of this paper, the RAB value is estimated for these areas. The appropriate coverage of the control is not dealt with in this paper.

The results of this approach are as follows:

- For the Licensed USO area, the RAB value is estimated to be at least £3.5bn and the WACC applied to this value yields an allowed profit of at least £0.36bn.
- For the Total USO area, the RAB value is estimated to be at least £3.7bn and the WACC applied to this value yields an allowed profit of at least £0.39bn.
- For the Combined USO area, the RAB value is estimated to be at least £4.1bn and the WACC applied to this value yields an allowed profit of at least £0.43bn.

In conclusion, this paper sets out an approach to estimate the regulatory asset base for the price control of the UK mails business using a market comparator that is a universal service provider. The WACC is applied to the RAB value, based on a Group TVA for 2001, to form an estimate of the allowed profit for the mails business. The values of the RAB and allowed profit for the mails business should be at least, and therefore potentially greater than, those presented in this paper.

⁴ Other non-postal services and excluded items in the regulatory accounts are not part of the UK inland mails business of Consignia.

1. Introduction

This paper sets out the case for evaluating the RAB of Consignia's UK inland mails business. It has been prepared with the assistance of OXERA Consulting Ltd, an experienced economic and regulatory consultant. A separate, but related, paper⁵ sets out the case for use of the WACC as a means of estimating the cost of capital, which, when applied to the RAB, is a means of assessing the allowed profit for the price control.

The general approach used to evaluate the RAB in the price controls of UK regulated companies under private and public ownership is discussed in section 2. For regulated industries the opening RAB value used in setting the price control reflects the trading value. The estimation of the RAB value of the UK inland mails business follows the approach to adjust the asset value to reflect the trading value. This section also indicates how the approach can be applied for the UK inland mails business of Consignia.

The remaining sections of the paper set out the details of estimating the RAB and allowed profit for the UK inland mails business of Consignia. Section 3 discusses estimates of the net asset value for different regulated areas of the UK inland mails business. Section 4 discusses the adjustment to the net asset value needed to estimate the trading value for the UK inland mails business of Consignia. Section 5 combines the net asset value and adjustment to the trading value to estimate RAB values for the areas of the UK inland mails business of Consignia. It then applies each RAB value and the WACC estimate derived from the approach set out in a separate paper (see above) to estimate the allowed profit for each area.

⁵ "Allowed profit I: cost of capital - for the UK inland mails business of Consignia", Consignia, May 2002.

2. The approach to estimate the regulatory asset base

2.1 General approach

The general approach of UK regulators to the evaluation of the RAB value is for the RAB value to reflect the initial trading value of the regulated business. The initial trading value of a company reflects the initial market value of equity and company debt.

For the companies that have been privatised and regulated, the level of equity can be determined by the value or price in the stock market at the close on the day of sale, with an additional uplift in some cases. The initial RAB of the regulated businesses for use in setting the price control can then be set consistent with the combined level of debt and equity that is reflected in the trading value at that time. This approach has been used by most UK regulators to estimate the RAB of the regulated businesses of the privately owned regulated companies in industries including telecommunications, electricity distribution, electricity transmission, gas transportation, rail and water and sewage⁶.

For publicly owned regulated companies, there is no day of sale in the stock market to determine the market or trading value. However, a trading valuation of the regulated business can be determined from the trading value of a comparable business in the stock market and the value of net assets of both the regulated business and its comparator. The trading value divided by the net asset value of the comparator derives a factor which, when applied to the net asset value of the regulated business, provides an estimate of the trading value of the regulated business.

In the case of water only companies, there was insufficient trading data or equity to directly evaluate the trading value. In this case the approach outlined above was used by OFWAT to estimate the RAB for water only companies using water and sewage companies as a comparator⁷. It is consistent with the general approach to estimating the RAB for privatized industries and is relatively straightforward to apply.

⁶ For the Scottish electricity network businesses and BAA the RAB value was set equal to the CCA asset value and was close to the estimated trading value.

⁷ In the case of National Airport Traffic Service (NATS) there was no comparable company in the market and so the initial RAB value was set by the CCA asset value. In 2002, NATS submitted an application to review the price control. The issue of whether the RAB should reflect the bid price for the operation of NATS rather than the CCA asset value could form part of this review. The regulator is currently reviewing the application by NATS. The case of NATS was also discussed in the Appendix A of "*Volume risk I: forecasting errors – for the UK inland mails business of Consignia*", Consignia, May 2002.

2.2 *Application for the UK inland mails business*

For this paper, the specific application of the approach outlined in subsection 2.1 to the UK inland mails business of Consignia also takes account of the following:

- i. At the time of writing (May 2002) the coverage of the price control is unknown. The Regulatory Accounts state the asset values for separate areas of the UK inland mails business of Consignia, including the “Licensed USO⁸” area, the “Non-licensed USO” area and “Non-licensed, non-USO” area⁹. In this paper, the combination of the first two areas is referred to as “Total USO” area and the combination of all three is referred to as “Combined” area. The “Combined” area includes services provided by the UK inland mails business to other businesses within the Consignia Group and international mails and therefore does not coincide with the UK inland mails business. For the purpose of this paper in illustrating the general approach to the evaluation of the RAB, the RAB value is estimated for each of these areas. The appropriate coverage and asset value for use in the setting of the control UK inland mails business are outside the scope of this paper.
- ii. For the publicly owned regulated companies, there is no listing in the stock market to determine the level of equity or market value and therefore no defined day or period over which to estimate the trading value. The market value on any single day or year could be influenced by market fluctuations and the business cycle. This would suggest that the market value should be based in the range of a 1-year to 5-year average. For this paper, the market valuation looks at 1 and 3-year averages¹⁰.

⁸ Universal service obligation.

⁹ Other non-postal services and excluded items in the regulatory accounts are not part of the UK inland mails business of Consignia.

¹⁰ For some of postal comparators, data on market value is limited to less than 5-years.

3. Historic Cost Accounting Asset Value

The net asset values by area for March 2002 will be included in the Regulated Accounts for 2001/02. This will be available before the final proposals for the price control. Provisional and unaudited estimates of the net asset value by area for March 2002 areas shown in Table 2. The net asset value is estimated provisionally at £1.34bn for the Total USO and £1.48bn for the Combined area.

In addition, items with a small value (i.e. under £2500) are not capitalized and are not treated as fixed assets within the regulatory accounts. These items include sorting frames and post boxes that are predominantly in the Licensed USO area. Consignia considers that these items form a fundamental part of postal network investment and should be included in the asset value for evaluation of the RAB. These assets have net replacement value of approximately £0.15 bn.

The net asset value and the value of non-capitalised items can be combined in each area to estimate the corresponding total net asset value. The total net asset value is estimated provisionally at £1.49bn for the Total USO and £1.63bn for the Combined area.

The figures in Table 2 are indicative of the HCA net asset values that are appropriate for use in establishing the RAB value in each area. The final figures for setting the price control should take account of, amongst other information, the HCA asset values for March 2002 that will be available within the regulatory accounts for 2001/02 before the final proposals are published later this year.

Table 2: Provisional and unaudited HCA net asset value (£bn) by area in March 2002

Area	HCA net asset value £bn	Non-capitalised items £bn	Total HCA net asset value £bn
Licensed USO	1.23	0.15	1.38
Non-Licensed USO	0.11	-	0.11
Total USO	1.34	0.15	1.49
Plus Non-licensed, non-USO	0.14	-	0.14
Combined	1.48	0.15	1.63

4. Trading value adjustment

The most appropriate market comparator for the UK inland mails business is a large postal operator that is a universal service provider (USP) for mail. Most private operators in the postal sector with market values focus on express and parcel services and are not USPs. The main exception is the TPG Post Group in the Netherlands which operates in a market with a reserved area of 100grams and fully liberalised market for direct mail. This is below the present reserved area of 350grams in the UK, but consistent with the reserved area under the EU Directive for Postal Services (the “Directive”) for January 2003.

TPG Group is a large postal operator that is a USP and operates in a market that is liberalised to a similar extent to that for the UK under the Directive. Like the Consignia Group, TPG Group is involved predominantly in mail services with supplementary businesses in parcels and logistics.

The UK inland mails business is one of the leading postal companies in the world and it will need to be able to compete on similar terms with other leading postal operators to retain and improve upon this status. TPG Group is amongst the leading postal companies in the world. Consequently, Consignia considers that it is particularly appropriate to use TPG as a benchmark for deriving the appropriate RAB value for the UK inland mails business.

For the period 1999 to 2001, the TPG Group average ratio of the TVA (the trading value to net asset value) was 3.2 and for 2001 was 2.5. The TVA relates to TPG Group and not specifically to the TPG mails business. The TVA for the TPG mails business could be estimated by netting off the value of the other TPG businesses from the market value of the Group. Since 1998, the return on turnover was about 20 per cent for TPG’s mails business and less, at about 9.5 per cent, for TPG Group as a whole. This would suggest that the TPG businesses outside of the mails business earn a lower return than the mails business and thereby have a lower TVA than the mails business. Consequently, the TVA of TPG’s mails business is at least the value of TPG Group at 2.5 and the TVA for the UK inland mails business should be at least this figure.

5. Conclusions

5.1 Regulatory Asset Base Value

Table 4 shows the total net asset values in March 2001 from Table 2 and the corresponding RAB values from application of a TVA of 2.5. The TVA should be at least the figure of 2.5. The results are as follows:

- For the Licensed USO area, the RAB value is estimated to be £3.5bn.
- For the Total USO area, the RAB value is estimated to be £3.7bn.
- For the Combined USO area, the RAB value is estimated to be £4.1bn.

Table 4: HCA and RAB value estimates for Consignia's UK mails business in March 2002

Area	Total net asset value £bn	RAB £bn
Licensed USO	1.38	3.45
Non-Licensed USO	0.11	0.28
Total USO	1.49	3.73
Plus Non-licensed, non-USO	0.14	0.35
Combined	1.63	4.08

5.2 Annual Allowed Profit

Table 5 takes the RAB value from Table 4 and applies a WACC of 10.5 per cent, derived from the approach set out in a separate paper¹¹, to yield estimated allowed profit levels for each area. The results are as follows:

- For the Licensed USO area, the RAB value is estimated to be £3.5bn and the WACC applied to this value yields an allowed profit of £0.36bn.
- For the Total USO area, the RAB value is estimated to be at least £3.7bn and the WACC applied to this value yields an allowed profit of £0.39bn.
- For the Combined USO area, the RAB value is estimated to be £4.1bn and the WACC applied to this value yields an allowed profit of £0.43bn.

¹¹ See "Allowed profits I: cost of capital - for the UK inland mail business of Consignia", Consignia, May 2002.

The WACC is applied to the RAB value using Group data to form an estimate of the allowed profit for the mails business. The values of the RAB and allowed profit for the mails business should be at least, and therefore potentially greater than, those shown in Table 5.

Table 5: Annual allowed profit estimates for Consignia's UK mails business in March 2002

Area	RAB value £bn	Allowed profit £bn
Licensed USO	3.45	0.36
Total USO	3.73	0.39
Combined	4.08	0.43