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INDEPENDENT COMMUNICATIONS AUTHORITY OF SOUTH AFRICA

NO. 924 **23 September 2021**

PRICE CAP AMENDMENT REGULATIONS FOR RESERVED POSTAL SERVICES, 2021

The Independent Communications Authority of South Africa **("ICASA" or "the Authority")** hereby publishes the amendment to the Price Cap Regulations for Reserved Postal Services, 2013 to the extent reflected in the Schedule.

Dr Keabetswe Modimoeng
Chairperson

Date: 02 / 09 **/2021**

The Independent Communications Authority of South Africa has, under section 30 of the Postal Services Act, 1998 (Act No. 124 of 1998), as amended, made the regulations in the Schedule.

SCHEDULE

1. Definitions

In these Regulations "the Regulations" means the regulations published by Government Notice No. 1095 (Government Gazette No 37010) of 8 November 2013.

2. AMENDMENT OF REGULATION 1 OF THE REGULATIONS

Regulation 1 of the Regulations is hereby amended by the substitution of the following definition after the definition of "Postal Services":

> " **Price Control Period"** means the period commencing from 1 April XXXX and ending on 31 March XXXX or such period as may be determined by the Authority";

3. SUBSTITUTION OF REGULATION 3 OF THE REGULATIONS

The following regulation is hereby substituted for regulation 3 of the Regulations:

"**3. General Price Control Formula**

(1) The Licensed Operator shall ensure that in each price control year the price charged for the reserved services shall be set to satisfy the criteria in the formulae below:

Formula $[(\boldsymbol{RR_t} \div \boldsymbol{RR}_{\boldsymbol{t-1}}) - \mathbf{1}] \times \mathbf{100}$

Where -

t: is the current year in the price control period;
t-1: is the preceding year;

(2) RR_t is the reported revenue of the Licensed Operator in year "**t**" of all the reserved postal services and is calculated as follows:

[RR = (RAB x WACC) + E + D + F ± C + T]

Where:

RR	=	is the required revenue of the Licensed Operator for all the reserved postal services rendered
RAB	=	Regulatory asset base
WACC	=	Weighted average cost of capital
E	=	Expenses: operating and maintenance expenses
D	=	Depreciation and amortisation of inflation write-up: the charge
F	=	Approved revenue addition to meet debt obligations for the price control period under review
C	=	Claw back adjustment: to correct for differences between actuals and forecasts in formula elements from a preceding price control period (i.e. year t-1) in relation to the actuals for the price control period under review (i.e. year t)
T	=	Tax expense: estimated tax expense

a) The calculation of each of these components will be done in accordance with the guidelines set by the Authority and the Accounting Separation Regulations for Reserved Postal Services, 2011 (GG 34130).

(3) RR_{t-1} is the reported revenue of the Licensed Operator in year **"t-1"** of all the reserved postal services and is calculated as follows:

$$RR_{t-1} = \sum_{i=1}^{n} RR_{i,t-1}$$

Where -

n: is the number of reserved postal products and services

(4) The following formulation must be used to determine the Required Revenue:

a) The licensed operator shall ensure that in each price control year, the price charged for reserved postal services shall be set to satisfy the following conditions:

(i) recover the reasonable operational and maintenance expenses incurred in bringing services to bear in the year in which they are incurred; and
(ii) recover capital investment and make profit (based on an allowed rate of return) thereon commensurate with the risk undertaken;

b) The prices charged must relate and be traceable to investment in, operation and maintenance of, and profits arising only from those parts of the reserved activity.

c) As prices are based on computed Required Revenue for the price control period under review, the Required Revenue contemplated must include:

(i) reasonable operating expenses;
(ii) reasonable maintenance expenses;
(iii) depreciation expenses;
(iv) reasonable working capital;
(v) reasonable rate of return (i.e. WACC) on the assets employed for reserved activity; and
(vi) other applicable obligations (e.g. tax and USO, all of which must be verified by the Authority)."

4. Short title and commencement

These regulations are called the Price Cap Amendment Regulations for Reserved Postal Services, 2021 and will come into force on 1 April 2022.

ICASA

Independent Communications Authority of South Africa

REASONS DOCUMENT ON THE PRICE CAP AMENDMENT REGULATIONS FOR RESERVED POSTAL SERVICES, 2021

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1. INTRODUCTION

1.1 The Independent Communications Authority of South Africa ("ICASA/ the Authority") is mandated to regulate postal services in terms of section 2(bA) of the Independent Communications Authority of South Africa Act, 2000 (Act No 13 of 2000), read with section 8 of the Postal Services Act, 1988 (Act No 124 of the 1998) ("PSA").

1.2 An aspect of postal services regulated by ICASA is that of price controls in the reserved postal sector, through the Price Cap Regulations for Reserved Postal Services, 2013 ("the Regulations"). Regulation 10 of the Regulations requires that the Regulations be reviewed at least every three (3) years, ICASA has thus conducted a review of the same.

1.3 The purpose of this review was to consider if a new regulatory framework was needed, and to implement appropriate price control obligations that are both effective in fostering an efficient delivery of postal services and proportionate in creating an environment that promotes and encourages reliable postal services.

1.4 This reasons document sets out the Authority's reasons for the decision to amend the 2013 Price Cap Regulations for Reserved Postal Services.

2. AMENDMENTS TO THE REGULATIONS

2.1. Key Decisions

2.1.1 Given the regulatory shortcomings associated with 2013 Price Cap Regulations, the Authority has therefore decided to:

- Substitute regulation 3 of the Regulations concerning the General Price Control formula, which deals with setting an inflationary price cap and efficiency control / productivity factor; and
- Set the prices of reserved postal services in such a way that such prices are:
  - affordable;
  - cost-oriented (i.e. reflective of the costs of providing the postal service concerned);
  - uniform throughout the Republic (unless the Authority determines otherwise); and
  - transparent and non-discriminatory.

3.1. General Price Control Formula

3.1.1 The Authority has determined that the licensed operator shall have a revenue requirement that allows it to recover prudent investment, operate and maintain the postal system, and make a profit commensurate with the risk undertaken.

3.1.2 To do so, the licensed operator is compelled to ensure that the price charged for the reserved services is set to satisfy the criteria in the formulae below:

Formula $[(\boldsymbol{RR_t} \div \boldsymbol{RR}_{\boldsymbol{t-1}}) - \mathbf{1}] \times \mathbf{100}$

Where -

RR: is the reported or required revenue of the Licensed Operator of all the reserved postal services;

t: is the current year in the price control period;

t-1: is the preceding year;

RR is calculated as follows: **[RR = (RAB x WACC) + E + D + F ± C + T]**

Where:

RR	=	is the reported/required revenue of the Licensed Operator for all the reserved postal services rendered
RAB	=	Regulatory asset base
WACC	=	Weighted average cost of capital
E	=	Expenses: operating and maintenance expenses
D	=	Depreciation and amortisation of inflation write-up: the charge
F	=	Approved revenue addition to meet debt obligations for the price control period under review
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T	=	Tax expense: estimated tax expense

3.1.3 The calculation of each of these components will be done in accordance with the guidelines set by the Authority and the Accounting Separation Regulations for Reserved Postal Services, 2011 (GG 34130).

3.1.4 The licensed operator shall ensure that in each price control year, the price charged for reserved postal services shall be set to satisfy the following conditions:

- recover the reasonable operational and maintenance expenses incurred in bringing services to bear in the year in which they are incurred; and
- recover capital investment and make a profit (based on an allowed rate of return) thereon commensurate with the risk undertaken.

3.1.5 The prices charged must relate and be traceable to investment in, operation and maintenance of, and profits arising only from those parts of the reserved activity.

3.1.6 As prices are based on computed Required Revenue for the price control period under review, further details on the elements of the Required Revenue formula are given below.

3.2. Regulatory Asset Base (RAB)

3.2.1 The asset valuation method of the RAB must be based on the historical original cost, trended using an acceptable inflationary index. In instances where historical cost records do not exist, the licensed operator must provide an estimated value that the Authority accepts as most closely approximating their historical costs. Capitalised costs relating to improvements or upgrades of the RAB will be considered for inclusion in the RAB. However, only prudently incurred costs will be allowed for admission into the RAB by the Authority, after a prudence review has been conducted.

3.3. Weighted Average Cost of Capital (WACC)

3.3.1 The WACC is the average of the cost of equity and the cost of debt, weighted by the proportions of equity and debt, which an efficiently financed company can be expected to use to fund its activities. The WACC for the Licensed Operator will be the summation of weighted cost of equity and cost of debt, given its debt-equity ratio as provided in its Operator's Procedures Manual (OPM). The shareholder equity, interest bearing debt, the post-tax, real cost of equity derived from the CAPM and the post-tax real cost of debt are all deterministic components of the WACC that will be individually interrogated by the Authority for their veracity and appropriateness. Given that the WACC is a determinant for facilitating investment in the licensed operator's infrastructure and operating activities, in that it allows investors to earn profits commensurate with risk undertaken, the Authority will conduct a reasonableness check on the rationality of the returns required.

3.4. Expenses: Operating and Maintenance Expenses (E)

3.4.1 Expenses (E) relates to all expenses that are incurred in the operation of the licensed operator's reserved activities. These costs include normal operating expenditure (OPEX), repairs and maintenance costs, labour costs, and corporate overheads. These costs are to be recovered in the tariff period in which they were incurred. Allowed operational costs in any given tariff period must be based on a best forecast of costs for the tariff period under review. The licensed operator must estimate and justify its costs, providing reasonable evidence / explanations to support the projected costs, such as how the cost item relates to the regulated reserved services.

3.4.2 In terms of the Regulations, the licensed operator must provide a breakdown of expenses in its tariff application submissions, which should include the following information:

- Estimated / projected costs per line item (for example electricity, salaries, etc);
- the most recent actual costs per line item;
- explanation as to why the costs are estimated / projected to increase in the price control period (or, in some cases, justify why the costs should not decrease); and
- explicit explanation of how the operating and shared costs in the tariff application are calculated.

3.4.3 In terms of the Regulations, the Authority will only allow prudently incurred repairs and maintenance costs in the determination of the Revenue Requirement. The expenses costs should adhere to the principles outlined in the Findings Document, namely that the licensed operator will be required to demonstrate the following:

- that the decision to incur the cost is consistent with good industry practice;
- the reasonableness of the costs; and
- that due care, good judgement and compliance with sound business practices were adhered to before incurring the costs.

3.4.4 In terms of the Regulations, the licensed operator will be required to provide information on all costs related to repairs and maintenance as separate line items for labour, materials and supplies and other expenses, as well as to provide an explanation and justification for any increases in these costs. Expenses are those planned for the efficient operation and maintenance of the core business. Procurement practices must meet the criteria of being competitive, 'at arm's length' and prudent. Internal expenses must meet the criteria of being competitive in comparison to appropriate benchmarks. Research and development expenses are permitted, subject to adequate justification.

3.4.5 It is important for the Authority to encourage / enforce / incentivise efficiency in the licensed operator in the form of efficiency incentives. This would require a benchmarking exercise with historical performance and can only be applicable if the licensed operator complies with the Accounting Separation Regulations, as the verification of actuals can only be done when audited Regulatory Financial Statements have been submitted.

3.4.6 The Authority will assess the licensed operator's expenses in determining prices on an ongoing annual basis. Actual costs will be used in the assessment, as these may be audited, and are generally accepted as a true reflection of the costs incurred in the maintenance of the licensed operator's infrastructure and operations in delivering its regulated reserved services.

3.5. Depreciation and Amortisation of Inflation Write-Up (D)

3.5.1 Depreciation is an accounting method of allocating the cost of an asset over its useful life, and is used to account for a reduction in the value of an asset over time, particularly due to wear and tear. Depreciation is a return on investment over the estimated economic useful life of the asset.

3.5.2 An appropriate depreciation rate must be used by the licensed operator in computing depreciation charges to reflect the different estimated service lives of the respective assets or each class of assets. It must be based on the estimated service life of the asset, considering all relevant factors such as: variations in use; increasing obsolescence or inadequacy; engineering and economic studies; and any other information as may be available with respect to future operating conditions.

3.5.3 When 'the licensed operator compiles a tariff application, it must include information on depreciation rates for each of the assets or classes of assets, to be accompanied by a statement on their basis and the methods employed in their computation as espoused in the OPM. Amortisation as a result of inflation write-up from the trending of the asset value is treated in a similar manner to the depreciation of the historical cost and amortised over the remaining useful life of the asset.

3.6. Claw back adjustment (C)

3.6.1 Clawbacks are volume adjustments made at the discretion of the Authority, that compensate the licensed operator and its customers for differences between budgeted / forecast volumes when the tariff is approved, and the actual volumes experienced during the tariff period. As such, a clawback is calculated in retrospect, and applied in a forward-looking manner. It generally caters for differences between projected Required Revenue and actual Required Revenue within the price control period. The main reason for retaining a clawback mechanism emanates from the argument that assumptions related to costs or market conditions and volumes can change, and this risk could discourage investment if clawback is not in place.

3.6.2 However, clawbacks in favour of the licensee will be subject to a cap at the discretion of the Authority, as the onus is on the licensed operator to make accurate forecasts of the values used in its tariff applications. Considering that tariff applications are lodged approximately six (6) months before the commencement of the price control period, in line with project management principles, it is expected that, upon submission of tariff applications, the licensed operator will be in a better position to provide fairly accurate projections. Another factor giving rise to this consideration is the need to curb the perverse incentives embedded in the rate of return methodology (given the ‘guaranteed’ revenues regardless of throughput volumes).

3.7. Tax Expense (T)

3.7.1 The licensed operator must estimate the flow through taxation for the price control period under review. This tax expense will be the actual tax liability for the tariff period under review, based on the licensed operator’s net revenue before tax allowance and corporate tax rate. Tax penalties and interest on tax due will not be allowed.

3.8. Approved Revenue Additions to Meet Debt Obligations (F)

3.8.1 The Authority, at its discretion, may approve the inclusions of additional revenue to meet debt obligations in the Revenue Requirement, if it deems this necessary. The licensed operator must specifically state whether or not it wishes the Authority to consider an addition to revenue to meet debt obligations (F). If the applicant does not seek such an adjustment, the Authority will not consider such an adjustment. However, a request for such consideration by the licensed operator is not a guarantee that the additional revenue will be allowed by the Authority. Approved additional revenue will be subject to an inflation adjustment, and added to the Revenue Requirement for the period under review.

3.9. Short title and commencement

3.9.1 The Authority has deemed that the Price Cap Amendment Regulations for Reserved Postal Services, 2021 will come into force on 1 April 2022. The inclusion of this date was done to ensure that the Regulations become effective at the beginning of the licensed operator’s financial year. Not doing so would prove administratively burdensome and impossible for the licensed operator to adhere to, as it has already commenced preparing its tariff application for the next financial year under the current Price Cap Regulations.

4. CONCLUSION

4.1 The rate of return regulatory design or approach is uniquely designed to meet the regulatory challenges of the South African reserved postal sector and the needs of the licensed operator as the regulated entity.

4.2 As highlighted above, the new Amendment to the Price Cap Regulation will:

- *…consider the licensed operator's cost structure such that it allows for recovery of prudently and efficiently incurred costs. This will address the shortcoming of the current Price Cap formula which restricts revenue increases to CPI despite the licensed operator incurring above inflationary cost increases; and*
- *…allow the licensed operator to earn profit commensurate with risk as opposed to the current Price Cap formula which inadvertently causes the licensed operator to experience a shrinking profit margin annually.*[1]

[1] Findings Report on the Review of the Regulations, Government Gazette 43090, page 28. https://www.icasa.org.za/legislation-and-regulations/findings-report-on-the-review-of-the-south-african-postal-office-price-regulations