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INDEPENDENT COMMUNICATIONS AUTHORITY OF SOUTH AFRICA

NO. 274 **26 March 2021**

DRAFT PRICE CAP AMENDMENT REGULATIONS FOR RESERVED POSTAL SERVICES, 2021

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

The Authority hereby invites interested parties to make written representations on the Draft Price Cap Amendment Regulations for Reserved Postal Services, 2021 set out herein as **("Draft Regulations")**.

A copy of the Draft Regulations will be made available on the Authority's website at http://www.icasa.org.za and in the Authority's Library at No. 350 Witch-Hazel Avenue, Eco Point Office Park, Centurion between 09h00 and 16h00, Monday to Friday.

Written representations must be submitted to the Authority by no later than 16h00 on **31 May 2021** by post, hand delivery or electronically and marked specifically for the attention of:

Mr. Ruvengano Mandebvu.

Delivery address: Block B, 350 Witch-Hazel Avenue, Eco Point Office Park, Centurion;
or
by email at rmandebvu@icasa.org.za
or
telephonically on (012) 568 3495 between 10h00 and 16h00, from Monday to Friday.

Written representations received by the Authority pursuant to this notice, will be made available for inspection by interested persons at the Authority's library and such copies will be obtainable upon payment of the prescribed fee.

When a person submits information to the Authority, such person may request that specific information be treated as confidential information in terms of section 4D of the ICASA Act. The request for confidentiality must be accompanied by a written statement, in line with section 4D (4) of the ICASA Act, explaining why the specific information should be treated as confidential.

The Authority may determine that such specific information or any portion thereof is to be treated as confidential in terms of section 4D of the ICASA Act. Where the request for confidentiality is refused, the person who made the request will be granted an opportunity to withdraw such representations or portion(s) thereof.

Persons submitting written representations are further invited to indicate, as part of their representations, whether they require an opportunity to make oral presentations to the Authority should public hearing be held in this regard.

Dr. Keabetswe Modimoeng
Chairperson

Date: **25/03/2021**

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.

1. 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";

2. 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.

(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:

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

(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."

3. Short title and commencement

These regulations are called the Price Cap Amendment Regulations for Reserved Postal Services, 2021 and will come into force upon publication thereof in the Gazette.

Independent Communications Authority of South Africa

EXPLANATORY NOTE ON THE REVIEW OF THE PRICE CAP REGULATIONS FOR RESERVED POSTAL SERVICES

Table of Contents

1. Introduction

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").

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 same.

This review of the Regulations was preceded by a Regulatory Impact Assessment ("RIA") on the Regulations. The RIA determined that a new regulatory framework is urgently needed. One of the observations made from the RIA is that the current price control obligation is no longer effective or proportionate. It should be noted that a RIA is not a requirement in terms of the PSA but is viewed as regulatory best practice.

Additionally, an assessment on existing legislation and Regulations of the postal sector in the Southern African Development Community by the Communications Regulators' Association of Southern Africa, found that while South Africa has a clear legal mandate in the law to support postal market reforms, its Regulations were not adequate in fostering effective and efficient delivery of postal services. The Authority concurs with this sentiment, and the review of the Regulations will contribute to creating an environment that promotes and encourages reliable postal services.

2. An outline of the process followed

2.1. Phase 1: Commencement of the review and publication of a questionnaire

On 23 August 2019, the Authority gazetted an Intention to Review the Price Cap Regulations Notice (GG 42657) ("the Notice"). The Notice was also published on ICASA's website alongside a Questionnaire requesting information and opinions from stakeholders and/or interested parties. Stakeholders were invited to submit written responses to the Questionnaire within thirty (30) working days from the date of publication of the Notice, the closing date for submissions was Monday 07 October 2019.

The information and opinions obtained from stakeholders covers several issues including, but not limited to, the South African Postal Office's financial sustainability and efficiency, competition in the parcels and letters segments, and the appropriateness of past and proposed regulatory conditions.

2.2. Phase 2 (Findings Report)

On 07 October 2019, the Authority received responses to Phase I (the Questionnaire) from the following two (2) stakeholders:

a. South African Express Parcel Association ("SAEPA"); and
b. South African Post office ("SAPO").

In conjunction with responses received to the Questionnaire, the Authority developed the Findings Report on the Review of the Regulations. This Findings Report was published on 13 March 2020 in Government Gazette 43090. The Report is also available on the ICASA website.[1]

[1] https://www.icasa.org.za/legislation-and-regulations/findings-report-on-the-review-of-the-south-african-postal-office-price-regulations

2.3. Phase 3 (amendment of the Regulations)

The Authority will amend the Regulations in line with the provisions of sections 2(a), 8(a) and 30(2) of the PSA, regulation 10 of the Regulations read with section 4 of the Electronic Communications Act, 2005 (Act No. 36 of 2005).

2.4. Phase 4 (Publication of the Reasons Document)

After publishing the amended Regulations, the Authority will publish the reasons document in the Government Gazette to provide reasons regarding the effected amendments in the Regulations.

3. Review of the Regulations

3.1. Regulation 3: General Price Control Formula

Regulation 3 of the Regulations specified the methodology used to determine the prices charged for reserved postal services in accordance with a set general price control formula. The formula is based on the Consumer Price Index ("CPI") and makes provision for a productivity factor which together act as a constraint to annual revenue growth (and therefore price increases), that SAPO may pursue in the provision of reserved postal services.

3.2. Drawbacks of the General Price Control Formula

Over the years, the implemented price control approach has resulted in the following effects:

a. price increase restrictions that are not cost oriented;
b. ineffective productivity factor applications; and
c. additional entry from private players into the regulated/reserved space.

Whilst the current CPI-based price cap formula provides strong incentives to cut costs in the pursuit of increasing efficiency, it is silent on the matter of cost recovery and financial sustainability.

Additionally, since embarking on its mandated review of the Regulations, the Authority has determined that the general price control formula is no longer effective nor proportionate as a regulatory tool in ensuring that SAPO can recover prudently and efficiently incurred costs to maintain the long term financially sustainable provision of reserved postal services. The theoretical and intended benefits of the general price control formula regulatory approach have not manifested since its implementation in 2011. By continually imposing the Regulations in accordance to its current design parameters, irrespective of the outcome in terms of financial sustainability on SAPO, constraints on excess profits morphed into catalysts for SAPO's cashflow problems as evidenced by their financial statements.

3.3. Way forward

Given the regulatory shortcomings associated with the price/revenue cap approach to date, 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 ICASA, with the prior consent of the Minister, decides otherwise); and
    - transparent and non-discriminatory.

4. Recommended Regulatory Approach to Replace Price Control Formula

4.1. Context for Effective Postal Price Regulation of SAPO

Price regulation has traditionally not been a major issue in postal service, but with liberalisation of markets and the onslaught of technological advancement, greater analysis is required to expend regulation. For South Africa, regulation of its postal public enterprise (SAPO) under price cap formulation and X-efficiency has not yielded the results originally sought. This is particularly important to highlight as the PCR approach tends to provide little leeway for the misrepresentation of costs of service provision, when compared to other regulatory approaches like ROR.

Practical experience has now shown that the application of PCR to a public enterprise (i.e. SAPO) results in the following:

a. operating in an increasingly liberalised market (due to convergence); and
b. offering services in both a reserved (non-competitive) and unreserved (competitive) space, is neither appropriate nor effective.

It has been established, through the Findings Report, that SAPO's productivity and demand for its reserved services are slow growing (and in some cases declining). This, coupled with an aggressive enforcement of an onerous USO, has had dire consequences on SAPO's financial viability. The current PCR has been shown to have serious problems in its application to the point that it has been rendered inoperable.

5. Regulatory Option Identified by the Authority

OPTION	DESCRIPTION	FORMULA	ADVANTAGES	DISADVANTAGES
Rate of Return	Replace Price Cap Control formula entirely with another form of regulation i.e. Rate of Return i.e. define RR according RoR methodology	Formula: $[(RR_t \div RR_{t-1}) - 1] \times 100$ Where: [RR = (RAB x WACC) + E + D + F ± C + T]	• Allow for the inclusion of SAPO's costs with respect to providing reserved postal services i.e. cost reflective • Can identify and ringfence USO specific costs • closely tracks year on year growth of SAPO's largest expenses i.e. cost reflective benchmark • limits cost drivers impact on expenses i.e. creates a ceiling that can be easily computed and traced to an objective and consistent source e.g. STATSSA and/or SARB • Allows for the interrogation of SAPO's prudently incurred costs with respect to providing reserved postal services	• No comparison to a benchmark (i.e. CPI or API) to limit RR increases for year to year • Complicated and lengthy and therefore resource intensive • Will require retraining of SAPO stakeholders

5.1. Regulatory Approach Adopted (Rate of Return)

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

To do so, SAPO 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

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.

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 profit (based on an allowed rate of return) thereon commensurate with the risk undertaken.

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.

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.

5.1.1. The Regulatory Asset Base (RAB)

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.

5.1.2. The Weighted Average Cost of Capital (WACC)

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 SAPO's infrastructure and operating activities, in that it allows investors to earn profits commensurate with risk undertaken, the Authority will conduct a sanity check on the rationality of the returns required.

5.1.3. Operating and Maintenance Expenses (OPEX)

OPEX relates to all expenses that are incurred in the operation of SAPO reserved activities. These costs include normal 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. SAPO 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.

In terms of the Regulations, SAPO must provide a breakdown of OPEX in its tariff application submissions, which should include the following information:

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

In terms of the Regulations, the Authority will only allow prudently incurred repairs and maintenance costs in the determination of the Revenue Requirement. The OPEX costs should adhere to the principles outlined in the Findings Document, namely that SAPO 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.

In terms of the Regulations, SAPO 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 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.

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

The Authority will assess SAPO's OPEX 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 SAPO's infrastructure and operations in delivering its regulated reserved services.

5.1.4. Depreciation and Amortisation of Inflation Write-Up

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 of investment over the estimated economic useful life of the asset.

An appropriate depreciation rate must be used by SAPO 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.

When SAPO compiles a tariff application, it must include information on depreciation rates for each of the assets or classes of assets and 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.

5.1.5. Clawback

Clawbacks are volume adjustments made at the discretion of the Authority, that compensate SAPO 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 it is calculated in retrospect and applied in a forward-looking manner. It generally caters for differences between projected Required Revenue and actual Required Revenue resulting in the tariff 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.

However, clawbacks in favour of the licensee will be subject to a cap at the discretion of the Authority, as the onus is on SAPO 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 tariff period, in line with the project management principles, it is expected that upon submission of tariff applications, SAPO 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).

5.1.6. Taxation

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

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

The Authority, at its discretion, may approve the inclusions of additional revenue to meet debt obligations in the Revenue Requirement if it deems it necessary. SAPO 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 SAPO is not an indication that the additional revenue will be allowed by the Authority. Approved additional revenue will be subject to inflation adjustment and added to the Revenue Requirement for the period under review.

6. Conclusion

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

As highlighted above, the new regulation will:

- *…consider SAPO'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 SAPO incurring above inflationary cost increases; and*
- *…allow SAPO to earn profit commensurate with risk as opposed to the current Price Cap formula which inadvertently causes SAPO to experience a shrinking profit margin annually.*[2]

[2] 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

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