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29 April 2014

Senator Alan Maclean
 Minister
 Economic Development Department
 Cyril Le Marquand House
 The Parade
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Dear Alan

Proposed Regulatory Framework for Ports of Jersey Limited

In advance of the States of Jersey debating the *Air and Sea Ports (Incorporation) Jersey Law 201- (ASP Law)*, you have asked the Jersey Competition Regulatory Authority (*JCRA*) to detail the manner in which it anticipates that it would regulate Ports of Jersey Limited (*PoJL*) after incorporation. Set out below are some high-level principles that the JCRA would expect to follow in undertaking the regulatory functions conferred on it by the draft Law. In general, the JCRA will be guided by the six principles of good regulation shown in Annex to this letter. In particular, it must be emphasised that the format of the regulation undertaken by the JCRA will necessarily depend on a range of factors, including the eventual form that the ASP Law will take. As such, the contents of this letter can only provide an indication of the direction that the JCRA's regulation would take after incorporation.

The framework described below concerns economic regulation, which is where the JCRA's expertise lies. However, it must be stressed that a regulatory framework must provide for effective interaction between economic regulation and other forms of regulation; for example, the regulation concerned with safety at sea and in the air, the safe operations of ports, and international regulation concerning communications and other standards matters. Good and timely interactions between regulatory entities will provide a consistent framework for PoJL's operations, which should support PoJL in the effective discharge of its duties.

This letter also makes observations regarding the governance of PoJL. The experience of CICRA in the Channel Islands and regulators in other jurisdictions is that the effectiveness of economic regulation of state-owned enterprises can be significantly affected by these enterprises' governance structures. This structure is a responsibility of government, with its policy-setting authority and its shareholding

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 The Ports of Jersey
 The Case for Incorporation

role. In our view, for reasons explored below, these roles – shareholder and policy-setter - need to be clearly distinguished from each other, with separate decision-making responsibilities.

Future direction of ports regulation

In developing our thinking on an appropriate economic regulatory framework for PoJL, we have been mindful of the objectives that the States have for incorporation and PoJL itself. The objectives in the original Proposition can be summarised as follows:

- to enable Jersey Harbours and Jersey Airport to continue to be the provider of essential, lifeline, public services to the Island,
- to do so in a commercial and sustainable manner (including increased efficiencies and greater commercial discipline) that will
 - improve services for customers, and
 - generate a positive return to the States (taxation, rates as any utility company and, possibly, dividends) - the Ports are expected to be self-sustaining contributors to the States for the long term,
- to allow them to meet capital requirements beyond those provided from their current cash-flows without drawing on States funding,
- to do so by following a well-established model for incorporation, as exemplified by Jersey Post and Jersey Telecom, which transfers the businesses to a limited company wholly-owned by the States, but led by a Board of Executive and Non-Executive Directors, with the relationship with the States as shareholder governed by a formal shareholder agreement

We note that PoJL's principal objects, as defined in the March 2014 draft of the ASP Law (latest draft we saw), are well in keeping with the objectives above, namely:

- (1) *The primary object of POJL shall be to provide, or ensure the provision of, safe, secure, efficient and effective port operations for Jersey, whether by itself or by any other person acting as its agent, employee or sub-contractor.*
- (2) *Without derogation from the primary object stated in paragraph (1), in carrying out all commercial port operations POJL shall act in the manner best calculated to secure sustainable growth in the economy of Jersey in the medium to long term.*
- (3) *In paragraph (2), "commercial port operations" means any port operations licensed under Part 3 of this Law, but does not include harbour operations which form part of POJL's public service obligations as expressed in Article 6.*

In view of the objectives pursued with the incorporation of the Ports of Jersey, CICRA believes that the objectives of economic regulation should be, in consumers' interest, to maximise the efficiency of PoJL, both in its commercial activities and its lifeline and heritage protection roles.

The main mechanisms available to an economic regulator such as the JCRA to maximise PoJL's efficiency are provided by legislation. The ASP Law would provide the JCRA with licensing and direction powers in relation to PoJL, while PoJL would continue to be subject to the application of the general competition law (i.e. the *Competition (Jersey) Law 2005*).

The combination of the powers under these two pieces of legislation would enable the JCRA:

- To obtain information from PoJL, through which the JCRA can scrutinise the effectiveness of PoJL's operations, apply benchmarking standards and set price-caps – a range of activities that tend to stimulate efficiency improvements, especially when associated with good shareholder governance
- To introduce competition where feasible, meaning where PoJL's activities can be identified, separated from others and opened up to competitors
- To improve accountability to customers - both immediate customers such as airlines and shipping companies and ultimate customers such as passengers and freight dispatching companies
- To provide incentives for the structuring of PoJL's operations so as to facilitate the extension of competition to some of its activities and, thus, increase pressures for greater efficiency.

As PoJL is likely to be a monopoly company with no prospect of direct competition to its core role (as described by its draft objectives above), the role of competition legislation is limited. The ports regulatory framework will be largely determined by the licensing powers which the JCRA must exercise. A licence is not negotiated in the way a contract or a Memorandum of Understanding is negotiated between two equal parties, because a licence is determined by a regulator to translate the States' intentions, expressed by law, into a more detailed prescription. The regulator's licensing process therefore cannot be negotiated even if it has to be consultative.

In the case of a single operator like PoJL, the purpose of the licence the JCRA issues is mainly to determine how PoJL performs, as if it were a performance contract between the JCRA and PoJL unilaterally determined by the JCRA to reflect legislation enacted by the States. The central objective of increasing a licensee's efficiency and protecting customers would be achieved by setting a price control. The licence would therefore need to include conditions that enable the JCRA to set either maximum prices for particular services or (as seems more likely, given the broad range of services supplied) an overall capped revenue requirement, or a combination of the two. Related licence conditions would require the provision of information to the JCRA.

Other licence conditions would prescribe various standards of behaviour towards customers. In particular, licence conditions could provide that PoJL should support the establishment of a strong independent representative body of the main PoJL customers, including airlines and shipping companies, and should consult it regularly on a range of relevant issues. This approach builds on the model adopted by the Civil Aviation Authority in the UK, and is particularly suited to a small society such as Jersey by increasing transparency and accountability. It would add to shareholder and regulatory pressures on PoJL to ensure that PoJL is effective and efficient. As with other utilities, the licence(s) for PoJL might also include requirements for complaint/dispute handling and setting of minimum service standards.

PoJL's licence would also introduce certain competition-related prescriptions, such as the prohibition of undue discrimination. Moreover, the JCRA could interpret its duty to ensure services are 'effective and efficient' as requiring it to open up some of PoJL's activities to competition, by definition those that are 'contestable' (i.e. able to be provided by a number of other entities).

For contestable activities, as for the other PoJL activities, the JCRA may not be able to make use of competition legislation, because contestable activities (say, maintenance and operation of cranes at the harbour) are most likely to be open to competition 'for' the market but not 'in' the market. In such cases, it would be open to the JCRA to issue a licence under the ASP Law to an operator that

obtained the contract to maintain and manage cranes on behalf of PoJL. Such licences, like PoJL's licence, could prescribe certain performance standards, including standards of interaction with PoJL. These licences might be useful in ensuring that new entrants competing for contestable activities and, if successful, carrying out these activities, do so in ways that lead to efficient competition – and not corner-cutting or unintended arbitrage. A serious breach of conditions could lead to a licence for contestable activities being removed from a particular licensee and conferred on another. The promotion of competition in contestable activities cannot be left to chance when one of the parties – PoJL – is a vertically-integrated monopoly. In order to promote efficiency in customers' interests and alongside its work to enforce licences, the JCRA will need to promote competition actively where competition is feasible. To this end, it would be likely to advocate a separation – functional, at a minimum – within PoJL to distinguish its contestable activities from those that are at the 'core' of the unique PoJL role. With functional separation, or deeper forms of separation, the management of the 'core' PoJL, when subject to efficiency pressures, could become a body with a strong incentive to use competitive processes, in order to ensure that contracts for contestable services are struck with the best providers in terms of efficiency and innovation.

Governance

As noted above, the States of Jersey have two roles with respect to the governance of PoJL:

- In its shareholder role, government holds PoJL's Board and executive to account, essentially to ensure good stewardship of the assets entrusted to PoJL's care. The shareholder also determines how the policies set by the States in its policy-setting role translate into strategies for the PoJL's executive.
- In its policy-setting role, the States determine the main long-term objectives for PoJL, particularly as they relate to their overall policies for transport and, perhaps, tourism and other sectors. For instance, government must determine whether returns from PoJL should be in the form of maximised profits, or of lower profits associated with lower prices and greater stimulus to the economy from cheap transport links.

If these two roles are not properly carried out by the States of Jersey – if there is a vacuum where States governance should be – the benefits of incorporation, including of economic regulation, are diminished and the objectives pursued by PoJL may conflict, lead to unintended consequences and fail to focus PoJL's resources in sufficiently productive directions.

Moreover, good governance is essential to ensure the effectiveness of regulation. Regulatory powers, as outlined below, are only half of the pressures that need to be applied to a regulated company in order for it to behave in the most efficient and customer-focused way. Pressures from shareholders are essential in ensuring that a regulated company's executive responds effectively to regulatory pressures and incentives. There must be a strong governance framework within the States to ensure roles are clear (shareholder, executive, economic regulator, safety and operations regulators, etc.), accountability is transparent and effective, strategic directions are provided and, through this accountability and strategic direction, the shareholder obtains a high quality stewardship of PoJL's assets transferred to it from the public sector.

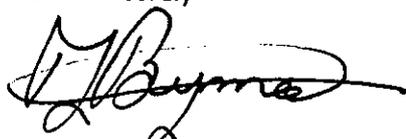
It may be that the States wishes to pursue particular economic goals with respect to harbour or airport operations. For instance, it might be decided that PoJL should use some of the profits generated from its activities at Elizabeth Harbour to cross-subsidise the historic harbours or

operations at the airport. Alternately, a policy of providing subsidies to new airlines or new air routes might be adopted, so as to encourage tourism or other commerce. In both of these examples, the relevant policy decision might need to be taken into account by the JCRA in setting economic regulation for PoJL. This can be done relatively easily if the policy direction is set by the States – it can be treated as an exogenous factor that must be accommodated by regulation. On the other hand, if such policy directions are less transparent, or are left to PoJL itself, then the task of economic regulation can become more difficult, and the likelihood increases of regulation being seen to conflict with policy objectives. We would add that where the States intends to pursue particular economic goals through policy setting affecting PoJL, it would, of course, be prudent to take advice - from the Chief Economic Advisor but also, if the policy would affect regulation, from the JCRA.

While the JCRA's success in regulating PoJL depends on how effective the States' governance is and on how transparently government carries out its two separate roles, the JCRA does not have a view as to how the States should organise their functions so to determine policy and carry out their shareholder role.

We would be happy to assist with any queries that you or the Department might have regarding these observations on future regulation and governance.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M Byrne', with a long horizontal flourish extending to the right.

Michael Byrne
Interim Chief Executive

Six Principles for Economic Regulation¹

Accountability

- independent regulation needs to take place within a framework of duties and policies set by a democratically accountable Parliament and Government
- roles and responsibilities between Government and economic regulators should be allocated in such a way as to ensure that regulatory decisions are taken by the body that has the legitimacy, expertise and capability to arbitrate between the required trade-offs
- decision-making powers of regulators should be, within the constraints imposed by the need to preserve commercial confidentiality, exercised transparently and subject to appropriate scrutiny and challenge

Focus

- the role of economic regulators should be concentrated on protecting the interests of end users of infrastructure services by ensuring the operation of well-functioning and contestable markets where appropriate or by designing a system of incentives and penalties that replicate as far as possible the outcomes of competitive markets.
- economic regulators should have clearly defined, articulated and prioritised statutory responsibilities focussed on outcomes rather than specified inputs or tools
- economic regulators should have adequate discretion to choose the tools that best achieve these outcomes

Predictability

- the framework for economic regulation should provide a stable and objective environment enabling all those affected to anticipate the context for future decisions and to make long term investment decisions with confidence
- the framework of economic regulation should not unreasonably unravel past decisions, and should allow efficient and necessary investments to receive a reasonable return, subject to the normal risks inherent in markets

Coherence

- regulatory frameworks should form a logical part of the Government's broader policy context, consistent with established priorities
- regulatory frameworks should enable cross-sector delivery of policy goals where appropriate

Adaptability

- the framework of economic regulation needs capacity to evolve to respond to changing circumstances and continue to be relevant and effective over time

Efficiency

- policy interventions must be proportionate and cost-effective while decision making should be timely, and robust

¹ These principles are presented in the 2011 publication by the Department for Business, Innovation and Skills on behalf of the whole UK government. See <http://bis.gov.uk/assets/biscore/better-regulation/docs/p/11-795-principles-for-economic-regulation.pdf>