

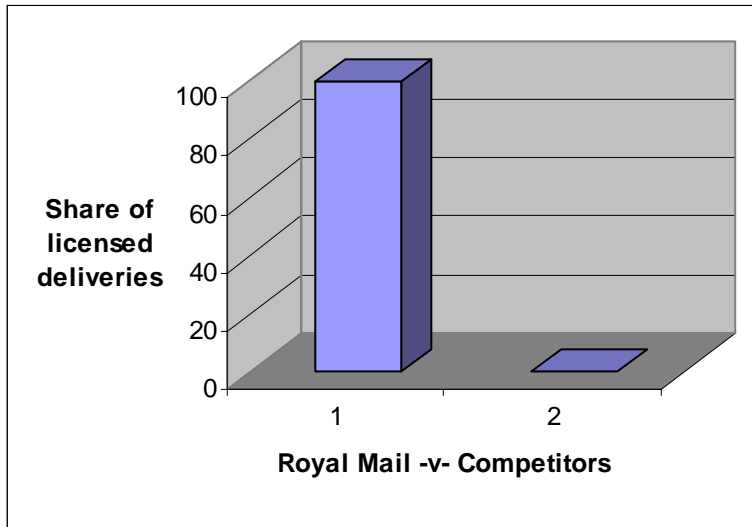
Price Control – interim review

Margin squeeze protection

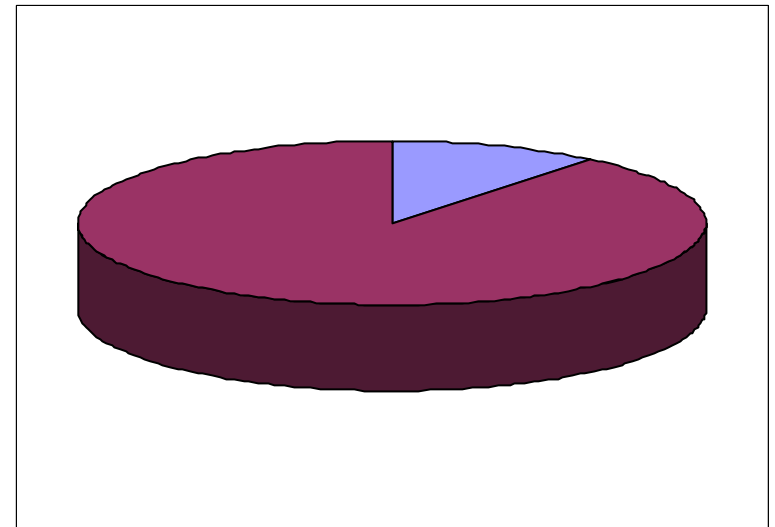
Joint presentation by TNT Post
UK Limited and UK Mail Limited

Access – the new competition

New competition since 2001 almost entirely from downstream access



Delivery competition



Downstream access competition

2.4 Billion items 06/07 inc. CDA

(Source: Royal Mail)

Access – future growth

- 4 billion items 2007/08? (Source: Royal Mail)
- Growth will not continue at same pace
- Likely to flatten in future years

Effect of price control

- Royal Mail price control sets conditions for entire market
- Context for medium term business decisions by competitors and major mail users
- Competition is good for customers and the market - price control a surrogate for competition
- Needs to recognise Royal Mail's (super) dominance; VAT distortion; benefit of incumbency

Why control access prices?

- Past pricing changes (e.g. lowering of volume discount thresholds) in 2005 raised concerns about margin squeeze
- “Postcomm’s key objective in regulating access is to facilitate competition” (Source: Postcomm)
- Benchmark (Mailsort 2 “family”) products “would implicitly provide information to the market as to what [Postcomm] broadly considered to be the appropriate margin for other products” (Source: Postcomm)
- Regulatory certainty for market entrants in newly opened market – and for the foreseeable future
- Gives customers some certainty in a developing competitive market

Impact of price control

- Price control crucial to business development and investment by competitors
- Price control crucial to competition in the UK mail market
- Access prices directly impact customers with access agreements (CDA customers) – about half of access volumes
- Change to price control affects the whole market
- 2008 review is our sole, direct right to influence the price control and critical Postcomm heeds the concerns

Why the access price is too high

- Initial Access 1400 price based on historical costs - headroom was 5.1 pence
- Since then Royal Mail has benefited from extra efficiencies:-
 - More mail arriving at IMC's at quiet times (e.g. no night duty allowance)
 - Forecasting per IMC (by format and service) allows more accurate staffing / machine utilisation
 - Reduced bad debt / reduced invoicing and collection costs / improved cash flow / single customer contact instead of hundreds
 - Close to 100% revenue protection – through docket change process and rigorous bag fill requirements
 - Assumed stranded upstream costs were included in 2004 access price but have actually been avoided (e.g. 25% scale down of RDC network)
 - Cost of yorks and trays borne by operators but agreement contemplates this to be a Royal Mail cost
 - Higher compliance with cost saving specification than retail
 - High proportion of good quality machineable mail
 - Royal Mail has failed to pass on downstream efficiencies (e.g. move to single delivery should have decreased – not increased – costs and thus prices)

Why the access price is too high

“Ops strategy and design director Alan Barrie says that it currently costs us about 8p to deliver a single letter” *The Courier, January 2007*

Why access price is too high

Postwatch – August 2003

9.91 pence for DO access

RPI – 3% reduction per annum

Why the access price is too high

11.46 pence for IMC access sorted to delivery office (i.e. Access 1400)

“would allow Royal Mail to cover an appropriate part of its costs together with a reasonable return”

(Postcomm, May 2003)

Why headroom is too low

- April 2004 price included 6% margin for Royal Mail – considered to be an acceptable profit
- Historical margin squeeze in April 2005 (e.g. VRD changes) not corrected when headroom fixed on March 2006 headroom e.g. 120 OCR down 0.33 pence; 120 CBC down 0.34 pence; 700 CBC down 0.36 pence
- Decrease in headroom in real terms due to inflation – February 2004 – February 2007 RPI rose 10.5% (nominal headroom rose 2.0 - 4.1% i.e. an 8.5 – 6.4% headroom reduction in real terms)
- Absorbed VAT to win VAT- exempt customers
- Fuel price increase affected upstream disproportionately (fuel costs represent +/-20% of costs)
- Customers demand significant discounts off retail price to switch
- Mailing house payments not taken into account in reference retail price – 1.5% QMP payments
- Growing concerns of proposed replacement scheme with 3% payments

Why headroom is too low

- First headroom was for 1400 - 5.1 pence
- Investments made on this basis
- 700 CBC headroom was only 3.00 pence (>100k items)
- 120 OCR headroom - 3.45 pence and 120 CBC was 3.35 pence
- Upstream operator has to cover same costs from much lower headroom
- No realistic option to seek Postcomm's determination due to lack of time
- Interim review is first opportunity to redress inadequate margin squeeze protection

Why scope needs to be wider

- Upstream services compete against services other than Mailsort 2 e.g. unsorted services, first and third class services, packet services
- Squeeze has been seen from a number of services e.g. Mailsort 3, Cleanmail Advance and Packetpost
- What are Royal Mail's internal transfer prices – widespread condition 10.5 breach?
- Extend margin squeeze protection to all relevant retail services (i.e. virtually all services except stamped mail)

Why scope needs to be wider

Using a limited set of Mailsort 2 “family” benchmark products

“would implicitly provide information to the market as to what [Postcomm] broadly considered to be the appropriate margin for other products” (*Source: Postcomm*)

Experience shows that it does not and this needs to be explicit and applied *ex ante*.

Effect on an increase in access prices

Access 700 CBC / Mailsort 2 700 CBC

Retail price	16.43p (April 2007)
Access price	<u>13.23p</u>
Theoretical headroom	3.20p
Discount (10%)	(1.64)p
Proposed Mailing House Commission (intended max 3%)	(0.49)p
Real headroom	1.07p

Effect of an increase in access prices

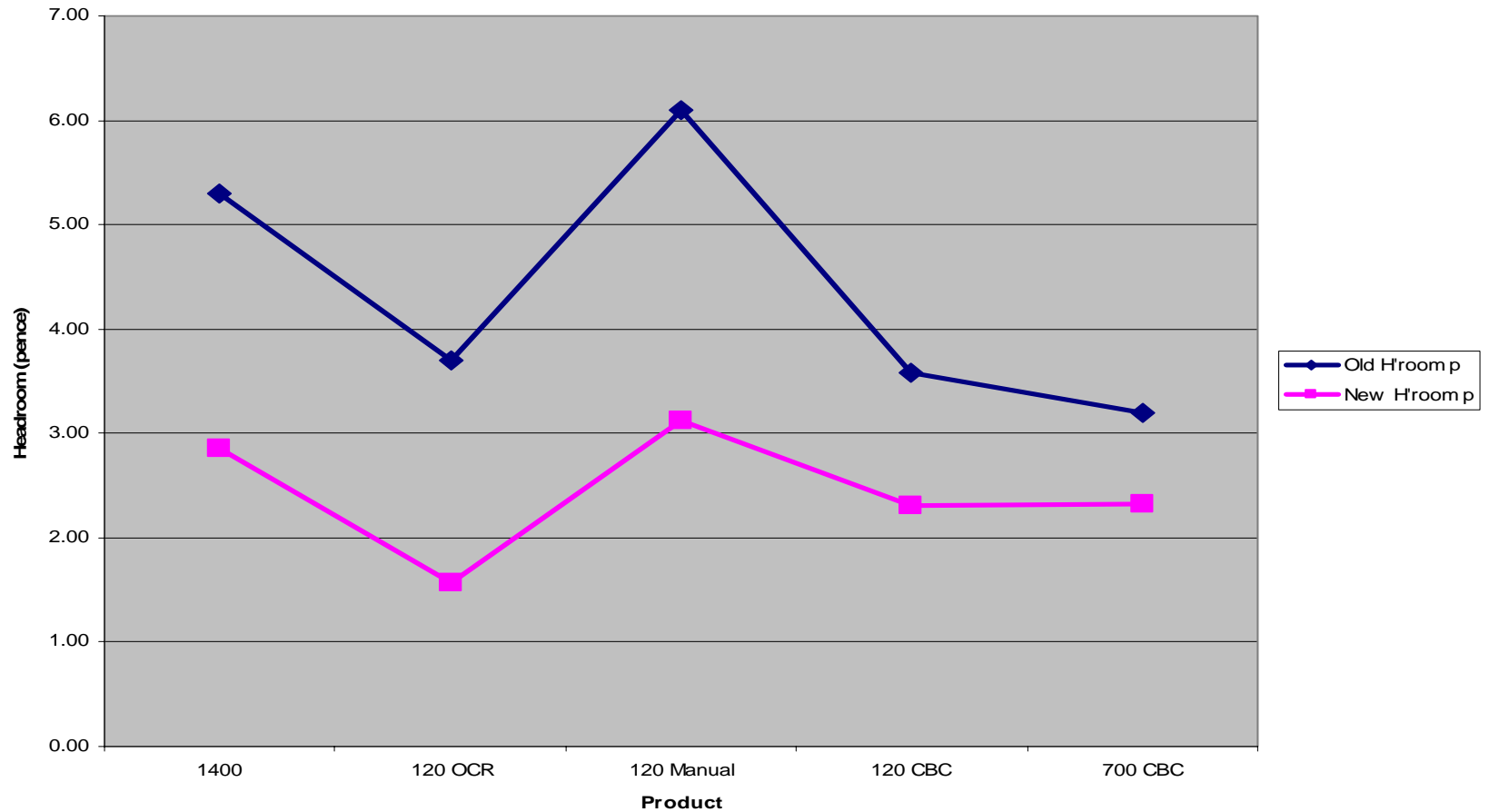
3.2 – 6.10 pence to cover:

- Discount from Royal Mail retail
- Effect on customer of mailing house loss of Royal Mail commissions
- Upstream operating costs e.g. collection, sorting and trunking to IMCs, handling of returns, administration
- Share of overheads and other joint costs
- Costs of cash-flow, guarantees to Royal Mail, start-up loss recovery, interest and tax
- Discount to win the business from upstream competitors
- Future investment funding
- Profit for shareholders for return on investment
- VAT not passed on to VAT exempt customers
- Surcharges for mis-sorts / under size bags at STL 1st class rate
- Risk of NGPP surcharges

Effect of an increase in access prices

- A small Royal Mail margin squeeze / access price increase would severely harm our businesses.
- Royal Mail's proposed margin squeeze of 49 – 51% (headroom reduction from 3.20-6.10p range down to 1.57-3.13p range) would force withdrawal from upstream services.
- If proposed access prices passed on to customers, no customers will have a price benefit from using competition
- Customers would no longer have any choice = Royal Mail recreates monopoly

Effect of an increase in access prices



Regulatory context

- New competition has come in the form of access – delivery competition has reversed from 0.3% market share to 0.2%
- No incentive to decrease downstream costs if competition removed
- Original headroom based on commercial compromise to reflect required headroom for efficient operator to be able to compete (5.1 pence)
- Lower access prices will drive efficiency where most needed – i.e. in final delivery
- Lower access prices will benefit customers and ensure efficient entry by delivery competitors
- Downstream savings would go straight to Royal Mail bottom line
- No material competition in mail delivery expected for many years so competition and customer choice will be confined to upstream services
- If no prospect of a profitable upstream business, no competition and no customer choice
- If no upstream operators, end of customer direct access

Conclusion

- Postcomm proposed lower access price (11.46 pence) included 6% margin - what changed so dramatically that access prices need to increase?
- Efficiencies from access and other downstream efficiencies not reflected in current access prices
- Need to recover historical squeeze and erosion of margin.
- Headroom for all services should reflect original April 2004 DSA 1400 headroom level (5.1 pence), increased year on year by RPI and fuel price increases (approx 14% since February 2004)
- No material difference in upstream costs for different bulk mail services (120, 700 and 1400) so no justification for material headroom differences (3.2 – 5.95 pence)
- Upstream competition and keen access prices give Royal Mail incentive to create further downstream efficiencies
- Extra headroom needed to cover costs of sorting and processing unsorted mail
- Extend margin squeeze protection to all business services to avoid margin squeeze from other services
- Access price increases:
 - do not reflect the reality of efficiencies in cost of downstream delivery
 - aimed at forcing efficient competitors out of the market
 - Force significant increases in retail prices (condition 10.5 internal transfer price)