

Review of Royal Mail's pricing flexibility and the level of access headroom (the 'Interim Review' of the price control)

Postcomm's proposals

August 2007

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Foreword

Royal Mail's financial position is challenging but the company has to take responsibility for securing its success

1. This Interim Review of Royal Mail's price control has been undertaken primarily at the company's request, because its financial position is now weaker than it, and we, had envisaged when the control was finalised in May 2006. Part of our work has been to identify the key reasons for this deterioration in Royal Mail's financial performance in the year ending March 2007. Its very high cost base and the customer reaction to being asked to pay higher prices because of this are the two major contributory factors; mail competition and regulation have had a far smaller impact. In some key market segments where Royal Mail has a dominant position, volumes have declined over the past two years because customers are increasingly choosing lower priced mail items which better suit their needs (such as moving away from overnight services to cheaper second class or access services) or are choosing to move to other communications media.
2. Royal Mail's success in addressing these serious trends depends mainly on the actions of its management and employees. How quickly, and in what ways, it responds to these challenges will be crucial. Although Royal Mail is seized of the urgency for change, much more needs to be achieved given the scale of the challenges. Our Interim Review has identified some significant concerns. For example, Royal Mail has not capitalised on opportunities in growing segments of the mail market such as fulfilment of online packet orders and unaddressed mail. In addition, in traditional addressed mail segments, the company's high cost base – it admits itself that its costs are 40% higher

than rivals' and it is 25% less productive¹ – is putting upward pressure on prices that may trigger more volume decline.

3. Nonetheless, we are determined to secure a universal service and have regard to Royal Mail's ability to finance its licensed activities. We will also do everything possible to ensure that regulation does not frustrate a successful and radical transformation of Royal Mail, provided that doing so is consistent with our statutory duties. We are conscious that a successful Royal Mail is necessary for a healthy overall mail market. For example, we recently provided Royal Mail with an important assurance to assist in the implementation of its modernisation.
4. Postcomm has agreed to Royal Mail's request to suspend until the end of its current financial year the payment of compensation to bulk mail customers, and to ensure that the company is not subject to a downward adjustment to its allowed revenues (known as the 'C factor'), where industrial action has taken place and quality of service figures have dropped. In making its final decision on this matter next year, Postcomm will expect Royal Mail to be able to demonstrate that the industrial action (a) arose as a result of carrying out its transformation plans and not for some other reason, and (b) had a direct causal link to quality of service failures.
5. We believe that in making the further proposals that result from our Interim Review, we are going as far as we can to help Royal Mail's financial situation in the context of the current price control. This ensures that we can fulfil our statutory duty in relation to an affordable universal postal service and we can make progress towards our other duties, including furthering the interests of users of postal services wherever appropriate by promoting effective competition between postal operators, and the promotion of efficiency and economy.

¹ Royal Mail news release (07/06/07).

We propose more pricing flexibility for Royal Mail from April 2008, which Royal Mail has indicated will result in further increases in second class stamp prices

6. Postcomm is proposing to accept elements of Royal Mail's request to modify the price control from April 2008 in a way that will grant it more pricing flexibility for certain products, which should enable it to receive a cost reflective price for those products in relation to the cost of providing them. Royal Mail will, however, have to balance any price increases with price cuts on other products to ensure that it complies with the overall average price caps that were agreed under the price control – which remain unchanged.
7. Royal Mail already has the ability to reduce prices without the need for regulatory approval². However, the decision on whether to use this additional pricing flexibility will rest with Royal Mail, based on its assessment of the market, customers' interests, and the likely effect on mail volumes. We are also keen to see regulation evolve, with the degree of regulatory intervention lightened as competition takes hold, especially in the business mail market.
8. Specifically, this greater pricing flexibility will allow Royal Mail, if it so chooses, to raise prices on certain loss-making products in both April 2008 and April 2009, such as second class stamps, by more than was permitted when the price control was set. The second class letter stamp price (0-100g) could have risen to 26p by 2010 under the existing arrangements. With the changes proposed after our Interim Review, it could now rise to 29p by 2010³. The limit on the first class letter stamp price (0-100g) is unaffected by these proposals, although under the provisions of the price control this would still allow Royal Mail

² Subject to *ex post* regulation including protection that low prices are neither predatory nor discriminatory.

³ This depends on actual inflation over the period and other technical factors, such as the adjustment within the price control for changes in volume mail volume levels - the 'G' factor.

to increase these prices to 37p by 2009/10. We are confident, on the basis of our market research, that these products will remain affordable to the public, including vulnerable user groups.

9. We also agree to Royal Mail's request for additional pricing flexibility for bulk mail products (Basket B⁴) used by large commercial, public sector and voluntary sector mailers where some competitive alternatives now exist. On Basket A products, we have ensured that any price increases on products used mainly by the public and small businesses can be used to improve their cost reflectivity and do not result in Royal Mail making excessive margins from customers who have very limited alternative choice of postal operator at present.
10. We are, therefore, proposing to allow Royal Mail commercial flexibility to increase some prices more than originally allowed in the price control, which Royal Mail will have to balance with price cuts on other products to ensure that it complies with the overall average price caps that were agreed under the price control. Royal Mail has indicated that it will use this greater flexibility to reduce the prices of some products where its costs are lower and it faces more competition. As a consequence of all this, it should retain more volume and earn more profit overall than would otherwise have been the case. Competitors have the safeguard that any price reductions on certain bulk mail products will have to be matched by corresponding reductions on the equivalent access products. In addition, we will continue to enforce rigorously the provisions of our anti-competitive powers under Royal Mail's licence.

⁴ Royal Mail's price control is structured into two sets of products (called Baskets), which face different levels of competition. Each has a separate RPI-X control to reflect the difference in volume levels and mix of the products in each basket.

Royal Mail, UK Mail and TNT Post have not proved the case for changes in access headroom, but a further review is possible but with changes no earlier than April 2009

11. We have consistently maintained that Royal Mail should receive, and other operators pay, a cost reflective price for the use of its delivery network through downstream access arrangements. However, to protect access operators from margin squeeze tactics by Royal Mail, the minimum 'headroom' levels (the difference between the price that Royal Mail charges third parties for delivery over the 'final mile' and its equivalent end-to-end retail prices) are fixed by licence provisions within the 2006-10 price control. It is perhaps not surprising that, whilst Royal Mail argues that the current headroom levels⁵ are too high and they are carrying access mail at a loss, the two major access operators, TNT Post and UK Mail, take the opposite view - that the headroom levels are insufficient for new entrants seeking to establish themselves in the market.
12. Royal Mail's application sought to reduce the current levels of access headroom by between 7% and 57% (for letters format) from April 2008, depending on the product involved. Given that relatively small changes in access headroom could lead to dramatic differences in competitive conditions, Postcomm has to ensure that any changes to access headroom are supported by a compelling justification, especially from Royal Mail's cost data.
13. Unfortunately, the quality and reliability of the data that Royal Mail has submitted in support of its application has been a very significant limitation. This is a major pricing decision that would, if agreed by Postcomm, take effect from April 2008. We were disappointed that to support its application Royal Mail could only provide detailed access product cost data for 2005/6, which seems unlikely to be a

⁵ On average.

representative year going forward, since access volumes were relatively low in that year⁶. Between submitting its application and the final stages of our work on it, Royal Mail made a downward revision of 0.8p per item to its costing of 'final mile' delivery; this is a major variance when put in the context of the margins available to access operators.

14. We have reviewed the data provided by Royal Mail and made several adjustments that we felt were needed to correct for errors, inconsistencies and judgements on Royal Mail's allocation of costs with which we disagreed. Subject to the caveat about the poor quality of the underlying data, these adjustments indicate that Royal Mail's reported losses on access could, potentially, be overstated. However, on Royal Mail's own figures, Postcomm estimates⁷ that access made a c.£200m⁸ contribution to its fixed costs in 2006/7. On a fully allocated cost basis, Royal Mail reports a loss of 1.8p per item (£43m in total). After applying the adjustments to Royal Mail's costings that Postcomm believes to be appropriate⁹, the loss on access products falls to around 0.5p per item, or about £12m in total for 2006/7.

15. Furthermore, we observe that there are certain actions that Royal Mail could be taking of its own accord to reduce the loss on access further. For example, certain access prices are below what is currently allowed by Royal Mail's licence. On other access prices, Royal Mail is also making a loss (or very low profit) on the equivalent retail products. Royal Mail could remove or reduce this loss on access by raising both prices to retain the headroom margin. In addition to the cost adjustments that Postcomm considers appropriate, we note that Royal Mail imposes additional operational requirements on access operators

⁶ Access volumes were 1.2bn in 2005/6 compared with a Royal Mail forecast of c.4bn in 2007/8.

⁷ Based on Royal Mail's current estimate of variable costs of about 40% of its total costs.

⁸ 8.3p per item for 2.4bn items in 2006/7.

⁹ In both 2006/7 and 2007/8, Postcomm's view is that access lost 0.5p per item on average albeit based on data with a high degree of uncertainty.

such as forecasting of access volumes. However, Royal Mail claims that there is no offsetting cost saving from imposing on access operators these extra requirements. Given that access operators find such provisions onerous and they argue that they are imposed to frustrate the development of access competition, we propose that Royal Mail either justify the cost/benefit of such requirements or discontinue them.

16. The other operators have argued that the access regime acts against them in that they believe access headroom is too low and that access headroom protection does not cover all products. Our analysis suggests that, whilst access margins may be tight, we do not have clear evidence at this stage to suggest they are too tight – especially against a backdrop of rapidly increasing access volumes.
17. These observations do, however, have to be seen in the context of our assessment that, given the limitations of Royal Mail's costing methodology, the margin of error on access costs for individual products is currently between plus and minus 1p per item. Furthermore, we still feel that it could be the case that the majority of our estimate of Royal Mail's 2007/8 access loss of 0.5p per item could be addressed by Royal Mail's own actions without any change to the provisions of the price control.
18. For all these reasons, we have concluded that insufficiently compelling evidence has been submitted by either Royal Mail, or by TNT Post and UK Mail, to justify proposing changes to the levels of access headroom from April 2008. That said, we do not believe we should simply rule out any changes until the next price control, which is due to begin from April 2010. We expect to receive detailed access product cost and volume data for 2006/7 from Royal Mail within the next few months. Using this data, we intend to ensure that we are able to respond quickly to any future requests from Royal Mail or other operators on the matter of access headroom, to take effect no earlier than April 2009.

However, given the increasing customer resistance to higher prices, Royal Mail needs to ensure that it has fully explored other ways of addressing this situation, particularly by trying even harder to modernise and become efficient.

19. We are proposing not to accept the request from TNT Post and UK Mail that the scope of access headroom protection ought to be extended beyond the products used in setting the price control. In the event that Royal Mail and TNT Post or UK Mail cannot agree terms for new access products, there is an access price determination provision within Royal Mail's licence, which could be invoked by TNT Post or UK Mail. However, it is our preference that Royal Mail and the access operators try to find a mutually satisfactory outcome without regulatory intervention.

Some broader issues highlighted by this Interim Review will be further discussed in our Strategy Review

20. Experience from the US Postal Service (USPS) suggests that if there were to be a fundamental change in Royal Mail's attitude towards access operators, this could improve the attractiveness of mail as a communications medium, to the benefit of all postal operators and customers. Our perspective is that Royal Mail remains reluctant to embrace the concept of access and appears still to regard access operators as competitors. This is in sharp contrast to the approach adopted by USPS which has taken advantage of work-sharing arrangements (similar to access agreements) with upstream third party operators to increase the overall efficiency of its operations. Four out of every five mail items in the USA are handled at some stage upstream by a third party and USPS works closely with these work-share operators and mail preparation companies. It considers these organisations to be partners in the process, with the aim of getting mail to the customer at the lowest cost, so that mail remains attractive in relation to other communications media. With this strong emphasis on

innovation and lowering mailing costs, direct mail volumes are growing at 5% to 6%¹⁰ per annum in the USA, sufficient to offset the drop in volumes of transactional mail, which is very different from recent experience in the UK.

21. Royal Mail may argue that the situation in the USA is different because USPS has a statutory monopoly of the 'final mile'¹¹. However, others would focus on the fact that the key driver to the success of Royal Mail's business going forward is to maintain mail volumes at the highest possible level. Given the increasing evidence of customer resistance to price increases and their apparent appetite for access services, it is crucial that Royal Mail embraces fully any options that can minimise further increases in mail prices.
22. We well understand that Royal Mail greatly dislikes the current form of regulation for access, which fixes 'headroom'. We will be exploring ways in which this mechanism might be changed in the context of the next price control review, but there is very little evidence at the moment to suggest that *ex ante* regulation of access can be removed at this early stage of a fully liberalised mail market. Some of the key considerations are the degree of assurance new entrants can have about Royal Mail not engaging in damaging anti-competitive practices, the degree of transparency of its costs, and the attitude that Royal Mail adopts towards access seekers.
23. In the absence of a significant change in Royal Mail's attitude towards access as a way of potentially ensuring mail remains an attractive communications medium, some would argue that greater ring-fencing, the introduction of an access code or functional separation of Royal Mail's business could provide a better route by which to satisfy the objectives of cost transparency and fair competition. These measures

¹⁰ According to Ramseh Ratan, Executive VP and Chief Operating Officer of the US DMA, at the Triangle World Mail and Express Conference, May 2007, Direct Mail volume in the US is growing at between 5-6%.

¹¹ Though Royal Mail still retains over 99% of 'final mile' delivery.

could remove the need for headroom regulation and also, potentially, open up a faster route towards deregulation of Royal Mail's business. These issues will, therefore, be discussed in detail as part of our forthcoming Strategy Review consultation, due to be published later this month.

NIGEL STAPLETON
CHAIRMAN

1. Postcomm's proposals and next steps

Introduction

1.1. This document explains Postcomm's proposals for responding to requests, received in March 2007 from Royal Mail, TNT Post and UK Mail, for Postcomm to amend certain aspects of Royal Mail's price control. It also sets out the reasons for making these proposals. This section summarises what Royal Mail and the other operators requested from Postcomm, our proposals by way of response, and details of how interested parties can provide comments in order for us to consider them prior to making a final decision in November 2007.

What we were asked to review

1.2. The requests we received in March 2007 relate specifically to the degree of Royal Mail's pricing flexibility (the rebalancing sub-caps) and the level and scope of access headroom. We had envisaged reviewing these issues at the time we agreed the price control with Royal Mail in 2006, with the aim of concluding matters by November 2007 so any changes could be implemented in revised prices by Royal Mail from April 2008 – half way through the current four year price control.

Postcomm's proposals

(a) Royal Mail's request for greater pricing flexibility

1.3. As set out in detail in Section 4, Postcomm proposes to issue a direction under Royal Mail's licence containing the following key provisions:

- An increase in the price rebalancing sub-cap from 3% per year to 8.5% per year on all products in Basket B – the ‘non-captive’ basket, as requested by Royal Mail; and
- An increase in the price rebalancing sub-cap from 3% per year to 8.5% per year on all products in Basket A – the ‘captive’ basket as per Royal Mail’s request but subject to the following restriction: that it can only be applied to product prices that are currently at least 6% below fully allocated costs as indicated by Royal Mail’s 2006/7 cost data¹². Under this proposal the main change to the public stamp prices will be to enable the maximum second class 0-100g letter price to increase from 24p in 2007/8 to 29p by 2009/10¹³.

(b) Royal Mail’s, TNT Post’s and UK Mail’s requests to review the level of access headroom

- 1.4. For the reasons set out in detail in Section 5, Postcomm proposes that it should not allow any changes in access headroom to be implemented from April 2008.
- 1.5. Postcomm does not, however, think it is appropriate to rule out any changes before the price control arrangements are due to be replaced in April 2010. We would expect the data to be of substantially better quality for Postcomm to consider a further application by Royal Mail or another operator to review the levels of access headroom. This will be facilitated by the provision of volume and access cost per product data for 2006/7 from Royal Mail later this year. However, this data would require substantial analysis by Postcomm and a consultation period that means any potential changes could not take effect before April

¹² 6% is the maximum extent to which Royal Mail could address the gap between prices and costs by the end of the price control without any regulatory changes (i.e. 3% per year for two years).

¹³ This depends on actual inflation over the period and other technical factors, such as the adjustment within the price control for changes in volume mail volume levels - the ‘G’ factor.

2009. Such a review would take into account our observations about the current uneven distribution of headroom across individual products and any justifications Royal Mail can put forward to support its request to be able to offer discounts on retail bulk mail without having to reflect them in the structure of access products.

- 1.6. Postcomm proposes not to extend the scope of headroom regulation to more products as requested by TNT Post and UK Mail. Postcomm believes that it is the provisions for access in the current licence that ought to be used for this purpose for the foreseeable future and urges all parties to work together to this end.

Next steps

- 1.7. Postcomm would welcome comments from stakeholders on any aspect of its proposals before we make a final decision in November. The closing date for the consultation is 9 October 2007. Please provide any comments by that date to:

Tony Spencer
Deputy Director, Competition and Regulation
Postcomm
Hercules House
London
SE1 7DB

tony.spencer@psc.gov.uk

020 7593 2141

- 1.8. If you would not like your response to be seen and discussed with others please mark it clearly as 'confidential'. All non-confidential responses will be posted on our website.

2. Postcomm's approach to the 'Interim Review'

Introduction

- 2.1. This section sets out the regulatory context in relation to the provisions governing Royal Mail's pricing flexibility and the level of access headroom. It then explains how Postcomm has conducted this review process. It also sets out Postcomm's approach to dealing with issues regarding cost reflectivity.

Regulatory context

- 2.2. Postcomm had planned, in setting Royal Mail's 2006-10 price control package, that certain aspects of it could be reviewed part way through its four year period. In particular, Postcomm had envisaged that the scope of Royal Mail's pricing flexibility on individual regulated products and the level of access headroom could be reviewed. Both were contingent on a review being triggered by a request in accordance with conditions set out in Royal Mail's licence.

Royal Mail's pricing flexibility

- 2.3. At present the price control sets an overall limit on average price increases (a so called 'price cap'). In addition, it limits any increase in the price of regulated products to no more than the average price control price cap (RPI-X) plus 3% per year. This provision is known as the rebalancing 'sub-cap' because if Royal Mail decides to raise some individual prices up to 3% above the average it must reduce some other prices in order not to exceed its overall price control average price rise. The 3% sub-cap thus acts to regulate the speed at which Royal Mail can bring certain prices into line with its costs. Postcomm's

intention was to treat these sub-caps as a threshold, so that price rises in excess of 3% per year above average price rises could occur, subject to specific *ex ante* regulatory approval. Accordingly, the price control contains a provision for Postcomm to issue a direction to increase the sub-caps, thus enabling Royal Mail to have greater pricing flexibility¹⁴.

- 2.4. During the last price control review, Postcomm consulted on a range for the rebalancing sub-cap of plus 2.5% to plus 4% per year. Postcomm acknowledged Royal Mail's argument that the sub-cap threshold should be set to allow Royal Mail to achieve cost reflective pricing for its major products, such as the public tariff first class stamp. Postcomm concluded on this basis to allow a 3% sub-cap¹⁵.
- 2.5. Significantly, Royal Mail is not constrained by its licence from making price reductions (though the anti-competitive provisions of its licence and general competition law apply). For some products it would, however, need to make corresponding reductions in access prices in order to maintain current access 'headroom'.

Level of access headroom

- 2.6. Under Royal Mail's 2006-10 price control, the minimum margins (headroom) between access prices and the prices of a benchmark set of analogous Royal Mail retail products were established to ensure that Royal Mail could not engage in 'margin squeeze'¹⁶ tactics against access operators.
- 2.7. The price control package, which Royal Mail agreed in May 2006, includes a provision to review the levels of access headroom from April

¹⁴ Condition 21(16) in Royal Mail's licence.

¹⁵ The 3% figure was sufficient for Royal Mail to achieve cost reflective first class standard stamp prices by 2009/10.

¹⁶ Margin squeeze may occur if Royal Mail were to set its prices for access and retail such that the difference between these two prices (i.e. the margin available to competitors) is reduced below the level which allows them to trade profitably.

2008 upon an application from either Royal Mail or from any person to whom Royal Mail provides an access service.

Summary of the applications Postcomm received

2.8. In March 2007, Postcomm received three requests to amend certain aspects of the price control. Royal Mail asked for changes to enable greater pricing flexibility (see Section 4 for more details). Royal Mail, TNT Post and UK Mail asked for changes to the level of access headroom (see Section 5 for more details). In addition, TNT Post and UK Mail asked for access headroom to be extended to other products (see Section 5).

Postcomm's process for reviewing the three requests

2.9. Upon receiving the three applications, Postcomm issued a consultation letter to all interested stakeholders on 22 March 2007. This invited views on the key issues. Non-confidential responses are available on our website.

2.10. Postcomm asked all three operators to provide a business case to support their requests by 31 March 2007. Non-confidential versions are available on our website. Postcomm has carefully reviewed these business cases with assistance from a number of expert consultants.

2.11. In addition, Postcomm hosted a workshop on 24 April 2007 at which all three operators presented their case for change and took questions from those present. The presentations used by the operators are available on our website.

2.12. This document sets out Postcomm's proposals in relation to the requests received from the three operators. These proposals are subject to a consultation period that will end on 9 October 2007.

- 2.13. After considering responses to this document, Postcomm will make a final decision in November 2007. This should enable any resulting Royal Mail price changes to be implemented from April 2008.
- 2.14. Postcomm's subsequent full periodic review of the Royal Mail price control, due to come into effect from April 2010, will lead to a first consultation in the first half of 2008.

Postcomm's overall approach to cost reflectivity

- 2.15. Postcomm's approach has to be seen in the context of our statutory duties and our vision for the development of the mail market. Subject to our universal service duty, Postcomm has a duty to further the interests of postal users, wherever appropriate through the promotion of effective competition among postal operators. Postcomm has consistently judged that effective competition is a better safeguard for customers' long-term interests than a continued monopoly and/or long-term regulation. This is especially so in a market where the need for innovation and entrepreneurial activity is particularly important to ensure mail remains an attractive medium of communication and distribution for the public, commerce and government.
- 2.16. Postcomm has, therefore, sought to promote effective competition where it can and to regulate only those areas where competition cannot be relied upon to protect customers over a reasonable time period. However, in applying regulatory controls, Postcomm recognises that they have costs as well as benefits. In particular, it must take into account how such controls on prices may encourage or frustrate the future attainment of effective competition.
- 2.17. In opening the postal market to competition and tackling other barriers to entry, Postcomm has sought to encourage a market environment where operators can compete on fair and equal terms.

- 2.18. Tackling barriers to entry recognises that merely opening the market to competition does not lead to effective competition, especially when Royal Mail has several incumbent advantages such as its economies of scale and unique VAT exemption¹⁷.
- 2.19. On the other hand, Postcomm has also recognised that Royal Mail starts with incumbent disadvantages owing to its pricing structure being out of line with its fully allocated costs and inefficient work practices. The price misalignments result partly from the many years when its prices were influenced by political factors (e.g. headline stamp prices) and other non-commercial issues.
- 2.20. With the advent of liberalisation, Postcomm supported Royal Mail's desire for more cost reflective pricing for those products that continue to be regulated. Postcomm has consistently maintained that it should avoid long-term market entry signals that are based purely on taking advantage of unsustainable historical distortions in Royal Mail's pricing structure. Postcomm has therefore agreed to several recent Royal Mail initiatives aimed at achieving this, such as Pricing in Proportion and higher stamp prices, facilitated by successive price control reviews. For some products Postcomm's, and Royal Mail's, discretion is limited by the requirements of the Postal Services Act 2000 that universal service products are affordable and have a geographically uniform price.
- 2.21. With regard to access pricing, notwithstanding the fact that access operators are significantly disadvantaged by Royal Mail's unique VAT exemption, Postcomm has maintained that other operators should pay a cost reflective price for use of Royal Mail's downstream delivery network.

¹⁷ Royal Mail is currently the only UK mail provider with a VAT exemption.

- 2.22. In assessing the degree to which prices are cost reflective, Postcomm expects Royal Mail to provide information and data that is fit for purpose. Consistent with the Cabinet Office's principles of Better Regulation, the extent of the information and its robustness required by Postcomm is proportional to the risks arising from agreeing to Royal Mail's applications. Applications of the nature of Pricing in Proportion, Retail Zonal Pricing and changes to access headroom, therefore, require a higher level of assurance than applications with less significant customer or competitor implications and risks.
- 2.23. In assessing Royal Mail's cost information, Postcomm must also have regard to its duty to promote efficiency and economy on the part of postal operators. An assessment of a level of 'efficient costs' for Royal Mail's operations is usually undertaken by Postcomm in setting the periodic price control but it can also be taken into account at other times. In assessing any application for change by Royal Mail, Postcomm may also make such other adjustments to Royal Mail's data as seems reasonable, for example in the allocation of overheads to various regulated products.
- 2.24. Finally, Postcomm's approach to the regulation of cost reflective pricing will evolve as competition develops. For example, for those products where Royal Mail's behaviour is more influenced by market forces (and outside the scope of the price control) no prior regulatory approval is required for price changes. Customers and other operators do, however, have the safeguards of *ex post* anti-competitive provisions by virtue of Condition 11 of Royal Mail's licence (where it applies) and general competition law enforced by the Office of Fair Trading. Over time, as competition develops in the mail market, Postcomm would expect a greater proportion of Royal Mail's products to be regulated by the provisions of these *ex post* measures rather than by specific regulatory controls where Royal Mail requires approval for change.

3. Royal Mail's financial context

Introduction

- 3.1. This chapter sets out a summary of Postcomm's analysis of Royal Mail's financial situation, which provides important context for Postcomm's proposals on the Interim Review.

Background

- 3.2. Royal Mail presented its Interim Review application against a background of declining total mail volumes and adverse changes in its volume mix. Royal Mail has argued that its cash flow is less than that anticipated by Postcomm (and Royal Mail) when the present price control was agreed and that its profitability has decreased sharply over the last year.
- 3.3. At the same time, other licensed operators have taken market share from Royal Mail, in terms of access volumes, at a faster rate than anticipated when the price control was finalised. For each item of access mail, Royal Mail retains about 13p of a total price of about 17.5p¹⁸. These contracts were agreed commercially between the parties. Royal Mail has suggested as recently as November 2005 that the access price was 'about right', however it now argues that the commercially negotiated price no longer reflects its (higher) underlying costs.
- 3.4. Conversely, rival end-to-end delivery networks have not been established to anything like the extent that was predicted as part of the price control. Such end-to-end competition has the potential for a greater adverse effect on Royal Mail's finances, as rivals would control

¹⁸ The actual difference between the end-to-end and access price for an average access item on Postcomm's adjusted calculations in 2007/8 is 4.5p

the entire value chain. In effect Royal Mail would 'lose' all 17.5p in revenue from each item of such mail.

- 3.5. Postcomm's analysis is based on Royal Mail's unaudited 2006/7 regulatory accounts¹⁹ and so, where possible, our observations are based upon full year results, whereas Royal Mail's Interim Review application was formulated on a projection that was developed part way through the year²⁰.
- 3.6. To assess Royal Mail's Interim Review business case, Postcomm engaged expert consultants to identify the key differences between Postcomm's price control forecasts and Royal Mail's actual outturn data for 2005/6 and 2006/7.
- 3.7. We asked our consultants to consider whether Royal Mail had met the efficiency targets that it was set in the price control and whether the adjustments made by Postcomm to actual costs in the base year (i.e. 2004/5, which were used to project Royal Mail's future costs over the price control period) were appropriate. These adjustments are often referred to by Royal Mail as Postcomm's 'base year adjustments'.
- 3.8. As part of this analysis, Postcomm requested that Royal Mail provide sufficient support for its application, in a format and at a level of detail consistent with the models used during the price control determination. Royal Mail has not provided such information, and consequently a comparison of costs and cash flows on a line-by-line basis has not been feasible. Our consultants, therefore, have performed their analysis at a high level of aggregation, using unaudited 2006/7 Royal Mail data and the 2006/7 financial projections included in the Strategic Planning Model that supports Royal Mail's Interim Review business case.

¹⁹ Royal Mail only provided Postcomm with its finalised audited 2006/7 Regulatory Accounts on 31 July 2007.

²⁰ Royal Mail's Interim Review business case comprised financial projections that were based on actual data up to the end of October 2006.

- 3.9. Our consultants have reviewed the submitted information in detail. To ensure the consistency between datasets, our consultants adjusted the projections made by Postcomm for the price control for actual volumes, actual inflation, and for differences in product scope. However, differences between the detail and composition of the models that Royal Mail used to support its Interim Review business case and the models used for the price control project made like-for-like comparisons very complex²¹.
- 3.10. The tables below reconcile Postcomm's final price control forecasts with Royal Mail's Interim Review business case. Table 1 compares operating costs, Table 2 compares cash flows. Both tables cover Royal Mail's Letters business. A number of differences can be accounted for by costs that were specifically disallowed by Postcomm for price control purposes.

²¹ For the price control project, Royal Mail used a model called the Business Planning Model (BPM). For its Interim Review project it used a new model called the Strategic Planning Model.

Table 1: Reconciliation of actual Royal Mail Letters business operating costs for 2005/6 and 2006/7 with Postcomm's final price control forecasts

| £m (nominal terms) | 2005/6 | 2006/7 |
|--|---------------|---------------|
| Postcomm's final price control forecast costs | 6,050 | 5,905 |
| Adjustments for inflation, actual volumes and scope of business | 69 | 19 |
| Wage inflation above Postcomm forecast | 12 | 12 |
| Adjustments for non-cash costs and disallowed costs (such as Share in Success bonuses) | 282 | 366 |
| Lower achieved savings from implemented efficiency initiatives ²² | 2 | 121 |
| Inability to remove costs as volumes decline and volumes switch to access | (1) | 189 |
| Cost shocks ²³ | - | 14 |
| Unexplained differences/potential one-off costs | 82 | (61) |
| Royal Mail's actual costs | 6,496 | 6,565 |

Source: Postcomm Final Proposals and Royal Mail's Strategic Planning Model.

Table 2: Comparison of actual Royal Mail Letter business cash flows for 2005/6 and 2006/7 with Postcomm's Final Proposals

| £m (nominal terms) | 2005/6 | 2006/7 |
|--|---------------|---------------|
| RML actual excluding Share in Success | 325 | 91 |
| Final proposals excluding Share in Success | 189 | 289 |
| Difference | 136 | (198) |

Source: Postcomm Final Proposals and Royal Mail's Strategic Planning Model.

²² The difference of £121m in Table 1 for 2006/7 is derived by comparing the nominal cost savings from initiatives in Postcomm's Final Proposals (December 2005) with those included in Royal Mail's Strategic Planning Model.

²³ "Cost shocks" is a term used by Royal Mail which refers to what is considered to be unforeseen events and unexpected cost rises above the rate of inflation (RPI).

Commentary on Royal Mail's 2005/6 results – The 'base year'

- 3.11. Central to Royal Mail's concerns about its finances is that its cash flows are weaker than Postcomm forecast in proposing the current price control. Royal Mail claims that in forecasting Royal Mail's future costs, Postcomm used a base year set of costs that were too low. If this claim were true, it would have led to Postcomm understating Royal Mail's costs for each of the four years of the control.
- 3.12. Our consultants have considered this matter in detail and have concluded that there is no obvious basis for this claim. However, based on the analysis that has been performed, we can make a number of important observations.
- 3.13. When formulating the price control, Postcomm considered Royal Mail's cash costs (not its accounting costs). Clearly, accounting costs can differ significantly from cash costs. For example, pension accounting costs, as treated in company accounts, are significantly different from the cash cost of funding the pension scheme. Much of the difference between Postcomm's price control forecasts and Royal Mail's 2005/6 actual operating costs relates to non-cash costs (such as pensions and depreciation of £219m), and costs that were specifically disallowed by Postcomm for price control purposes (such as compensation²⁴ of £63m in 2005/6).
- 3.14. Based on the information that our consultants have reviewed, we have been unable to identify any significant cost items that would suggest the base year assumptions Postcomm used for the price control were inappropriate. Our consultants are unable, however, to explain around £82m²⁵ of the cost differences in 2005/6. This difference appears to be

²⁴ Compensation is a categorisation used by Royal Mail, which includes payments for work place accidents and its estimate of Postcomm imposed fines and quality of service penalties.

²⁵ The £82m is included in Table 1 as "unexplained differences/potential one-off costs".

one-off in nature (or a non-cash cost) as it does not appear to flow into Royal Mail's 2006/7 cost base.

- 3.15. For the price control, Postcomm forecast that Royal Mail would generate positive cash flow of £120m in 2005/6 (or £189m excluding Share in Success payments). Royal Mail actually achieved cash flows of £127m (or £325m excluding Share in Success). Our analysis shows that whilst at a line item level cash flows may have been higher or lower than forecast, Royal Mail's actual cash flows were £7m higher (or £136m higher when Share in Success payments are excluded from the analysis) in 2005/6.
- 3.16. We also note that in 2005/6 Royal Mail under spent against its capital expenditure forecast by £158m, but this was offset by higher Share in Success employee bonus payments of £129m²⁶.
- 3.17. Overall, given that Royal Mail achieved its cash flow forecasts in 2005/6, we believe that this is evidence that the baseline forecasts and adjustments made by Postcomm for the price control were appropriate.

Commentary on Royal Mail's 2006/7 results

- 3.18. Again, much of the difference between Postcomm's price control forecast and outturn operating costs in 2006/7 relates to non-cash costs (such as pensions and depreciation of £324m) and costs that were specifically disallowed (such as compensation of £42m).
- 3.19. Our analysis shows that Royal Mail has failed to reduce costs to the extent planned. When agreeing the price control with Royal Mail, we said that costs must be taken out of the business if volumes declined and the mix of business changed from end-to-end to access. Royal Mail claims that its costs are now less variable than they argued in

²⁶ Postcomm estimated that Royal Mail would make Share in Success payments in 2005/6 of £69m.

2004/5 (i.e. 40% against a previous claim of 60%). If true, this suggests that, as mail volumes fell in 2006/7, Royal Mail failed to remove costs to the same extent as it previously argued it could when it agreed the price control. Royal Mail claims that it takes up to two years to remove variable costs as mail volumes fall. Implicit in the price control, the target was for costs to be removed within the year of the volume change.

- 3.20. We estimate that Royal Mail's failure to address volume related changes in 2006/7 increased its outturn costs against plan by up to £189m²⁷.
- 3.21. In summary, we have been unable to find any evidence that our 2006/7 forecasts and adjustments were inappropriate.

Royal Mail's 2006/7 achieved efficiency

- 3.22. Royal Mail has stated that it outperformed the efficiency targets that it was set by Postcomm in the first year of the current price control period (i.e. 2006/7). Royal Mail's view is that it achieved efficiency improvements of 4.8% in 2006/7 compared with Postcomm's target of 3%. It contends that this level of efficiency coupled with the fact that it has become less profitable means that the current price control is not rewarding the company appropriately for its achievements. For this reason, it is important for Postcomm to assess whether it agrees with Royal Mail as to the degree to which it has achieved efficiency improvements.

²⁷ Our consultants have been able to account for most cost movements between 2005/6 and 2006/7. However, there remains an unexplained cost decrease in 2006/7 of around £61m. This decrease might reflect either the removal of one-off costs within the 2005/6 cost base, or that Royal Mail has greater cost variability than it claims (i.e. in which case the £189m would be overstated by £61m).

- 3.23. Postcomm's view is that the 4.8% figure is potentially misleading for three reasons. First, in 2006/7 Royal Mail carried 2.6%²⁸ fewer mail items than it did in the previous year. Second, there have been significant shifts in the mix of volume towards less costly items, for example access. Other things being equal, the price control assumed that Royal Mail's costs would be lower as a result of both factors. An example of the volume mix effect is that the success of access means that the combined average cost per unit of bulk mail and access that Royal Mail carried in 2006/7 was around 18.8p as compared with 20.7p in 2005/6. Third, the price control efficiency target of 3% related to productivity improvements, and was stated after the removal of known one-off costs in 2005/6²⁹. Including known one-off costs in the 2005/6 operating cost base, Postcomm's target was around 4.7% (before volume and mix effects). We believe that Royal Mail's 4.8% figure includes one-off costs and volume effects, overstating the level of actual efficiency achieved.
- 3.24. As part of the price control settlement, Royal Mail was set a target to improve its productivity, through a range of efficiency initiatives. The efficiency target was 3% per annum, however in 2006/7 Royal Mail achieved cost savings of £121m less than this target. Consequently, Royal Mail has achieved annual efficiency of around 1.9%, which is below the price control efficiency target of 3% per annum³⁰.
- 3.25. The way in which we have arrived at our view that the level of efficiency actually achieved by Royal Mail in 2006/7 was 1.9% is set out in the table below.

²⁸ The 2006/7 volume fall figure (2.6%) was provided to Postcomm by Royal Mail for our Interim Review analysis in a presentation by Royal Mail Letters' Finance Director in June 2007. Shortly before publication of this document (31 July 2007), Royal Mail finalised its 2006/7 regulatory accounts. We propose completing our analysis on Royal Mail's 2006/7 regulatory accounts as part of the next price control project.

²⁹ The price control assumed that costs would fall with respect to volume declines (i.e. the 3% was stated after volume effects).

³⁰ Additionally, our analysis suggests that the 2005/6 cost base includes one-off costs that do not recur in 2006/7. Postcomm's 3% efficiency target was set before one-off costs and this would suggest that the true level of efficiency in 2006/7 is below 1.9%.

Table 3: Analysis of Royal Mail's Letters business 2006/7 achieved efficiency

| | 2005/6 | 2006/7 | CAGR* |
|---------------------------------------|--------|--------|---------------|
| Nominal costs (£m) | 6,496 | 6,565 | 1.0% |
| Disallowable costs/pension costs (£m) | (556) | (699) | |
| Adjusted Costs (£m) | 5,940 | 5,866 | (1.2%) |
| Inflation | | 3.7% | |
| Real costs (£m 2005/6 prices) | 5,940 | 5,657 | (4.8%) |
| Volume (m) | 24,739 | 24,089 | (2.6%) |
| RUOE (pence)** | 24.0 | 23.5 | (2.2%) |
| Volume and mix effect ³¹ | | | (0.3%) |
| Efficiency | | | (1.9%) |

Source: Royal Mail, LECG and Postcomm.

*CAGR = Compound annual growth rate, which measures the cumulative annual rate of change over time.

**Real unit operating expenditure (RUOE) = total operating accounting costs before depreciation divided by the most relevant unit of output. It is expressed in real terms (i.e. adjusted for the effects of RPI inflation).

Royal Mail's 2006/7 cash flow

3.26. Royal Mail's Letters business 2006/7 actual cash flow was £91m positive³², which represents a £222m improvement on the position set out in Royal Mail's Interim Review business case (which was £131m

³¹ The calculation assumes that Royal Mail has a cost/volume variability of 60% as required by the Price Control. The calculation assumes that Royal Mail achieves these cost reductions first, and that any remaining cost saving can be attributed to real efficiency improvements.

³² Cash flow before interest and tax, i.e. cash from operations less pension deficit payments and exceptional items.

negative). We think it is more important to consider actual cash flows and not the cash flows as set out in Royal Mail's Interim Review business case. The actual position is still £198m below that forecast by Postcomm at the time that the price control was agreed with Royal Mail. A large part of this difference is due to lower cost savings from efficiency initiatives of around £120m when compared to price control forecasts (i.e. achieving only 1.9% efficiency, as against plan of 3%). A contributor to this lower level of savings might be the capital expenditure under spend in the prior year, which was some £158m below that forecast by Postcomm.

- 3.27. Irrespective of Royal Mail's failure to remove costs from the business as mail volume changes, had they met the efficiency target they would have achieved a cash flow position much closer to that forecast by Postcomm as part of the price control project.

Royal Mail's future efficiency

- 3.28. Whilst Royal Mail's 2006/7 achieved efficiency of 1.9% is disappointing compared with the price control target of 3%, what concerns us to a greater extent is what is included in Royal Mail's confidential financial projections to 2009/10. Royal Mail has provided these to Postcomm to support its Interim Review application. These projections, using the methodology described above, incorporate efficiency improvements of just 0.6% per annum over the next three years. The implication of Royal Mail's forecasts is that its cash operating costs would be around 8-9%³³ higher by 2010 than was anticipated at the time of setting the price control.

³³ Postcomm believes that Royal Mail achieved a volume adjusted efficiency (as explained earlier) of 1.9% in 2006/7. Royal Mail now appears to be forecasting a volume adjusted level of efficiency of 0.6% for the last three years of the price control. Compared with the price control target of 3% per annum efficiency, this level of efficiency for the total price control period would leave Royal Mail's costs around 8.8% higher by 2010 than assumed in the price control.

- 3.29. Royal Mail's overall forecast financial position, as set out in its Interim Review business case, is worse than anticipated when it signed up to the new price control. The most significant contributor to this position is lower total cost savings from initiatives of £1,494m³⁴ over the period 2006/7 to 2009/10, probably as a direct result of it now forecasting that it will spend £243m less on capital items over the period 2005/6 to 2009/10. Despite poor projected efficiency improvements, Royal Mail continues to forecast Share in Success bonus payments to its staff in its Interim Review business case. It is also assuming that costs cannot be removed from the business in less than two years when volumes change. These factors contribute to Royal Mail's significantly weaker forecast cash flow position (e.g. a negative cash position of £580m in 2008/9).
- 3.30. The key message arising from this analysis is that in 2006/7, the first year of the current price control, Royal Mail did not achieve the efficiency target it was set by Postcomm in terms of bringing down its high level of operating costs and is not expecting to do so over the rest of the price control period. We appreciate that this task has been made more difficult because of the adverse changes that Royal Mail has experienced in both volume and product mix. However, given the apparent emergence of increased resistance from customers to pay for these increasing costs in higher prices, it is imperative that Royal Mail tackles its efficiency with urgency.

Innovation and responding to changing customer demands

- 3.31. Royal Mail should not be seen as a passive victim of lower market volumes. Although it cannot control how its customers behave, it can influence their choices through greater focus on their needs and product innovation that ensures its mail offering is competitive against the range of alternatives.

³⁴ Of which c.£550m is in 2009/10.

3.32. In 2006/7 some key segments of the market grew significantly, such as packets (for e-fulfilment) and unaddressed mail (leaflets). These are two examples of market segments that face more competition than other parts of the market, are much less regulated³⁵ and have been growing rapidly for some time. However, Royal Mail has not only lost market share in these segments but has also suffered volume declines in these growing parts of the market.

3.33. With the exception of bulk mail, the remainder of the traditional addressed letters market has not yet been significantly impacted by competition. In these parts of the market Royal Mail's attempt to recover its high costs by raising prices appears to have contributed towards the contraction of the total market (Table 4).

³⁵ Royal Mail's Parcelforce and Door-to-Door products are totally unregulated by Postcomm.

Table 4: Comparing Royal Mail's pricing behaviour to changes in its volumes (2005/6 to 2006/7)

| Product Group | Average price change ^A % | Volume change % | Revenue change % |
|-------------------------------|-------------------------------------|-----------------|------------------|
| First Class Standard Tariff | 5.7% | -7.0% | -1.7% |
| Second Class Standard Tariff | 2.8% | -4.9% | -2.3% |
| Presstream | 4.8% | -13.3% | -9.1% |
| Mailsort | -0.2% | -11.4% | -11.6% |
| Downstream Access | 2.0% | 111.1% | 115.3% |
| Bulk Mail ^B | 0.4% | 5.1% | 0.6% |
| Door to Door ^C | 4.0% | -4.3% | -0.4% |
| Standard Parcels ^D | 8.3% | -1.3% | 6.9% |

^A In calculating average price changes for individual product groups, we have assumed a constant volume mix across years.

^B In calculating the average price changes for the category Bulk Mail, because of the huge mix changes between retail and access products, we have used a weighted average of the price changes for each of the constituent product groups. The percentage revenue change for Bulk Mail i.e. 0.6% reflects the fact that there was a large increase in volume for the lower priced access service, whereas volume of the higher priced Mailsort services fell in 2006/7.

^C It is estimated that the 'leaflet market' grew (in volume) by 4% in 2006 following a trend of significant growth (according to Letterbox Consultancy Ltd., August 2007).

^D Parcel and packet volume generated by on-line shopping increased by over 50% in the last 12 months (according to IMRG).

3.34. The key message from this analysis is that Royal Mail can no longer rely upon a growing mail market to deliver efficiency, but must focus on cost reduction.

Conclusions

3.35. Postcomm accepts that Royal Mail has been adversely impacted during 2006/7 by changes in the level and mix of market volumes. The main messages arising from our analysis of Royal Mail's financial context are:

- Although there are significant variances in Royal Mail's current cash flow (and profitability) projections compared to the time of

the price control, these can be accounted for by costs being higher than forecast by Postcomm and the inclusion of some items Postcomm deliberately disallowed at the time of the last price control;

- There is a real urgency in terms of securing a significant improvement in Royal Mail's performance on cost efficiency; and
- Royal Mail should not be seen as a passive victim to lower market volumes. Its lack of innovation in growth market segments and its need to raise prices to recover its high costs in price sensitive segments has contributed significantly to its weakening financial performance.

3.36. We note that in 2006/7 Royal Mail did not use £109m of the pricing flexibility afforded to it by the price control³⁶, which may reflect increased price elasticity constraints, even in captive parts of the market.

3.37. We propose taking forward the analysis of Royal Mail's future efficiency, in more detail, as part of the start of our full review for the post-2010 price control. We shall publish a first consultation document on that price control in the first half of 2008.

³⁶ Royal Mail earned revenue on its price controlled services in 2006/7 that was £109m below the maximum that it was permitted to charge.

4. Royal Mail's request for greater pricing flexibility

Introduction

- 4.1. This section outlines Postcomm's proposals in relation to Royal Mail's request³⁷ to increase its pricing flexibility by increasing the rebalancing threshold from 'plus 3%' per year on any individual product's price to 'plus 8.5%' per year.

Summary of Royal Mail's request

- 4.2. Royal Mail is currently constrained by its price control from raising any individual price controlled price by more than 3% above the average allowed price rise each year. The 3% figure is referred to as the rebalancing 'sub-cap'.
- 4.3. Royal Mail has asked Postcomm to grant it greater pricing flexibility. Specifically, it asked Postcomm to give it more 'rebalancing' freedom, enabling it to raise some individual prices by more than the limits in its price control, whilst offering offsetting price reductions on other products to ensure overall compliance with the price control average maximum allowed price increase. Royal Mail requested that Postcomm issue a direction to increase the rebalancing threshold from 'plus 3%' per year to 'plus 8.5%' per year for the remaining two years of the present price control.
- 4.4. Royal Mail also requested that the structure of the price control be changed to make it easier for it to recover revenue from the adjustment mechanisms for lower delivered volumes and higher pension deficit

³⁷ Under Condition 21(16) of its licence.

costs³⁸. Postcomm confirmed that this was outside the scope of this review and would need to be considered as part of the next periodic price control review or a general price control reopening, should Royal Mail decide to trigger one.

- 4.5. Royal Mail clarified in its Interim Review business case that it no longer wanted Postcomm to consider changing the overall level of the price control (the “X” factor of the RPI-X part of the control) or merge the two tariff baskets into a single tariff basket.

Summary of other stakeholder views

- 4.6. Postcomm received only a few submissions that addressed this issue in response to its consultation letter and industry workshop.
- 4.7. At the Postcomm workshop in April 2007, the Mail Users Association (MUA) raised concerns that scope for large price increases may lead mail customers to make increased use of other media, e.g. e-mail. The MUA was also concerned that some business customers who would face higher prices had no alternative but to use Royal Mail products.
- 4.8. The Mail Competition Forum (MCF) opposed the increase in the sub-cap to 8.5% on a number of grounds including that it would allow some prices to rise unreasonably steeply over a very short period, causing difficulty or hardship to users of those services. Also, it considered that a change in sub-caps creates greater uncertainty about future pricing and will be used by Royal Mail to enable price cuts where there is competition or a threat of competition.

³⁸ Specifically, Royal Mail requested the introduction of a price elasticity factor within the pension and volume adjustments of the sub-cap formula. This would have allowed it further price increases to take account of the fact that in raising some of its prices, some of its customers may make less use of its services, leading to lower revenue than if they had simply borne the higher prices.

- 4.9. The MCF remarked on Royal Mail's request that it be allowed to move to more 'cost reflective' prices. The MCF recognised the commercial sense of such an aim, but had grave concerns that Royal Mail sought to adopt this approach only where it is facing competition and not as a consistent policy.
- 4.10. Postwatch said that further pricing flexibility is not of obvious benefit to customers, and should be refused unless there is an overwhelming need, which it says has yet to be demonstrated. It added that Royal Mail would be deterred from acting commercially to solve its problems if relief were granted, particularly if its problems were caused by weak management or risks that were anticipated and accepted by Royal Mail in agreeing to the price control.

Analysis of the implications for Royal Mail's volumes and revenue

- 4.11. Postcomm asked Royal Mail to provide details of how it intended to use the greater pricing flexibility it requested. Royal Mail provided schedules for planned price changes including those it might increase. Postcomm asked for two schedules: one for a sub-cap of 8.5% and one for a sub-cap of 6%.
- 4.12. Most of the increases would relate to prices in tariff Basket A - the so-called 'captive basket' - that contains the products used by the public (stamps), along with metered and PPI standard tariff products. Only a few price points within Basket B - the so-called 'non-captive' basket - were put forward for price increases utilising the freedom of the higher sub-cap. This may be an indication that the scope for Royal Mail to increase prices in Basket B is already being constrained by customers' willingness to pay. Royal Mail's results for 2006/7 suggest that in spite of last year's price rises, it under-recovered against its price control allowance by £13m for Basket B and £96m for Basket A.
- 4.13. Postcomm and its consultants modelled the effect of these price

changes under the two scenarios of 8.5% and 6% sub-caps. In summary, this work was broadly supportive of Royal Mail's own analysis which showed that increasing the sub-caps would enable Royal Mail to (a) maintain more volume and (b) generate greater revenue (and profit) than would otherwise be the case.

(a) Increasing the sub-caps leads to Royal Mail maintaining more volume

4.14. Royal Mail would use the greater flexibility to raise prices where it did not face strong competitive pressure and reduce prices where it did. Thus a higher level for the sub-caps could be expected to lead to Royal Mail retaining more volume than would otherwise be the case.

4.15. For price changes consistent with a sub-cap level of 6%, Royal Mail forecast that its end-to-end volumes would be, in total, around 520m items higher over the two remaining years of the price control than would otherwise be the case. With a sub-cap level of 8.5% this additional volume rose to 1,278m items. Although it forecast losing volume where prices would be raised (such as stamps) it would retain volume where some prices would be reduced (such as some standard tariff metered/PPI and some bulk mail).

(b) Increasing the sub-caps leads to greater revenue and profit

4.16. Unlike for important initiatives such as Pricing in Proportion and Retail Zonal Pricing, there is no requirement for Postcomm, in changing the sub-caps, to do so in such a way as to ensure revenue neutrality for Royal Mail. Indeed the technical design of the price control does not ensure revenue remains the same if sub-caps are changed³⁹.

³⁹ Allowed revenue (AR) in a particular year of Royal Mail's price control is determined by multiplying actual mail volumes by notional maximum allowed prices (product by product). The use of actual volumes means that AR is not a fixed level, nor is it determined *ex ante* - it can only be calculated at the conclusion of the period in question when actual volumes are known. Actual volumes are also used in

Therefore, Royal Mail could benefit if such price changes afforded by a higher sub-cap were to lead to (positive) changes in customer behaviour and patterns of spending. However, in considering whether to grant Royal Mail's request for higher sub-caps, Postcomm considers that it should have regard to the revenue increases that might potentially result.

- 4.17. For price changes consistent with a sub-cap level of 6%, Royal Mail forecast that its revenue would be, in total, £38m higher over the two remaining years of the price control than would otherwise be the case. With a sub-cap level of 8.5% this additional revenue increases to £75m.

Analysis of Royal Mail's cost reflectivity

- 4.18. In the Final Proposals consultation for the price control, Postcomm recognised the merit in Royal Mail's argument that if Postcomm supports cost reflective pricing it should set a threshold that allows Royal Mail to set prices in line with fully allocated costs for its major products (such as the public tariff first class letter stamp price) by the end of the price control period⁴⁰. Postcomm also ensured that overall both Basket A and Basket B were cost reflective. Postcomm concluded then on a sub-cap of 'plus 3%'.
- 4.19. Following receipt of Royal Mail's 'plus 8.5%' application Postcomm requested Royal Mail to provide product cost data in support of its aims to increase prices in Basket A⁴¹. Despite Postcomm's earlier support

calculating the earned revenue (ER), i.e. actual revenue achieved by Royal Mail. ER is calculated by multiplying actual volumes by actual prices charged (product by product). Any difference between ER and AR is added to or deducted from AR in the following year of the control. In other words, Royal Mail's price control does not set an absolute *ex ante* Allowed Revenue in any particular year – rather it allows Royal Mail to recover an amount of revenue in any particular year that is determined by both the level and mix of mail volume achieved in that year.

⁴⁰ Price control December 2005, Final Proposals, paragraph 6.37.

⁴¹ This data was provided in contrast to the 2006/7 detailed access cost data that Postcomm requested.

for Royal Mail's major initiatives such as Pricing in Proportion, this data (summarised in Table 5) indicates that there are still many instances of Royal Mail's prices being considerably out of line with its fully allocated costs.

- 4.20. Assuming that Royal Mail's unit costs and prices move in line with RPI-X as set in its price control, the only scope for aligning prices more closely with fully allocated costs is provided by the rebalancing sub-cap, currently 'plus 3%'. Therefore, the maximum extent to which Royal Mail could address the gap between prices and costs by the end of the price control without any regulatory changes would be plus 6% in total (i.e. 3% per year for two years). Table 5 shows that this would leave Royal Mail with 26 price points for which prices would remain below cost in Basket A by April 2010, including some with significant volume such as second class standard tariff stamped letters, second class standard tariff meter letter and first class standard tariff Large Letter 0-100g. Table 6 shows those price points where Royal Mail would be able to either realign prices with costs without need for higher sub-caps, or for which prices are already in excess of costs. We propose that the price points shown in Table 6 would not qualify for higher sub-caps.

Table 5: Basket A products that qualify for higher rebalancing sub-cap of 8.5% (data from 2006/7)

| Product | Volume m | Tariff 2006/7 p | Profit Margin % | |
|----------|-------------|--------------------|--------------------|------|
| 2C Stamp | LL501-750 | 1.0 | 109.0 | -55% |
| 2C Stamp | LL251-500 | 5.9 | 75.0 | -55% |
| 2C Meter | LL501-750 | 2.8 | 98.0 | -49% |
| 1C Stamp | LL251-500 | 10.5 | 90.0 | -48% |
| 1C Stamp | LL501-750 | 1.5 | 131.0 | -44% |
| 1C Stamp | LL101-250 | 52.7 | 65.0 | -39% |
| 2C PPI | LL251-500 | 14.5 | 68.0 | -31% |
| 2C PPI | LL501-750 | 2.8 | 98.0 | -29% |
| 1C PPI | LL501-750 | 3.0 | 124.0 | -29% |
| 2C Stamp | P501-750 | 8.8 | 177.0 | -27% |
| 2C Stamp | P751-1000 | 2.8 | 212.0 | -25% |
| 1C Meter | LL251-500 | 24.9 | 85.0 | -24% |
| 2C PPI | P251-500 | 5.0 | 131.0 | -24% |
| 1C Meter | LL501-750 | 4.2 | 124.0 | -21% |
| 2C Stamp | LL101-250 | 33.6 | 55.0 | -21% |
| 2C Stamp | P251-500 | 15.8 | 139.0 | -16% |
| 1C PPI | LL251-500 | 11.6 | 85.0 | -16% |
| 2C Meter | P501-750 | 4.4 | 163.0 | -15% |
| 2C Meter | P751-1000 | 1.2 | 195.0 | -14% |
| 1C Stamp | LL 1-100 | 144.0 | 44.0 | -13% |
| 2C Meter | LL251-500 | 17.8 | 68.0 | -10% |
| 2C Stamp | L | 1,070.1 | 23.0 | -9% |
| 2C PPI | P751-1000 | 0.1 | 195.0 | -7% |
| 2C PPI | P101-250 | 4.0 | 102.0 | -6% |
| 2C Meter | L | 1,120.9 | 21.0 | -6% |
| 1C Stamp | P501-750 | 14.5 | 220.0 | -6% |

Source: Royal Mail

Table 6: Basket A products that would not qualify for higher rebalancing sub-cap of 8.5% (data from 2006/7)

| Product | Volume | Tariff 2006/7 | Margin |
|--------------------|---------|---------------|--------|
| | m | p | % cont |
| 2C PPI L | 1,054.0 | 21.0 | -4% |
| 2C Meter P251-500 | 8.2 | 131.0 | -2% |
| 1C Stamp P751-1000 | 9.3 | 270.0 | -2% |
| 1C Stamp P251-500 | 28.3 | 170.0 | -1% |
| 2C PPI P1-100 | 1.9 | 79.0 | 3% |
| 1C PPI P1-100 | 4.9 | 94.0 | 4% |
| 2C Meter P1-100 | 7.8 | 79.0 | 4% |
| 1C Stamp L | 1,232.4 | 32.0 | 4% |
| 2C Stamp P101-250 | 14.2 | 109.0 | 6% |
| 2C Meter P101-250 | 9.5 | 102.0 | 6% |
| 1C Stamp P101-250 | 25.1 | 127.0 | 6% |
| 2C PPI LL 1-100 | 190.1 | 33.0 | 10% |
| 2C Stamp LL 1-100 | 120.0 | 37.0 | 11% |
| 1C PPI P251-500 | 4.8 | 160.0 | 16% |
| 2C Meter LL 1-100 | 172.0 | 33.0 | 17% |
| 2C PPI P501-750 | 1.6 | 163.0 | 18% |
| 1C PPI P501-750 | 3.1 | 207.0 | 18% |
| 1C Meter L | 1,008.2 | 30.0 | 19% |
| 1C PPI LL 1-100 | 122.6 | 41.0 | 22% |
| 1C PPI L | 647.9 | 30.0 | 22% |
| 1C Meter LL 1-100 | 216.6 | 41.0 | 22% |
| 1C PPI P751-1000 | 1.4 | 255.0 | 23% |
| 1C Meter P1-100 | 6.8 | 94.0 | 23% |
| 1C PPI P101-250 | 3.6 | 120.0 | 24% |
| 2C PPI LL101-250 | 58.9 | 49.0 | 24% |
| 1C Stamp P1-100 | 11.4 | 100.0 | 24% |
| 2C Stamp P1-100 | 6.4 | 84.0 | 27% |
| 1C PPI LL101-250 | 41.7 | 61.0 | 27% |
| 1C Meter P101-250 | 11.6 | 120.0 | 28% |
| 1C Meter P501-750 | 7.2 | 207.0 | 31% |
| 1C Meter P251-500 | 12.2 | 160.0 | 31% |
| 1C Meter LL101-250 | 89.8 | 61.0 | 32% |
| 2C Meter LL101-250 | 64.8 | 49.0 | 33% |
| 1C Meter P751-1000 | 5.4 | 255.0 | 38% |

Source: Royal Mail

4.21. If a higher sub-cap level of 'plus 8.5%' were allowed, Royal Mail could fully address, within the remaining two years, those price points that are currently up to 17% below fully allocated cost and make progress toward addressing the losses of those price points that are even further below fully allocated costs (and could address those price points that

are currently up to 12% below fully allocated costs for the 'plus 6%' scenario).

Discussion

- 4.22. The sub-caps effectively govern the speed at which Royal Mail can bring prices into line with its costs. Because of its weak financial position (see Section 3) the sub-caps also inadvertently govern the speed at which Royal Mail can cut prices – because Royal Mail would wish to offset any revenue dilution from price cuts with revenue gains from price increases where it can.
- 4.23. Postcomm's approach to cost reflectivity (as summarised in Section 2) depends on the degree of competition that Royal Mail faces. Broadly speaking, Postcomm is more concerned about price changes where customers have little choice than price changes in parts of the market where competition may be possible. Accordingly, Postcomm considers there are merits in framing its response to Royal Mail's application slightly differently for products in Basket B compared to products in Basket A.
- 4.24. A number of factors limit the risk of Royal Mail using greater pricing flexibility on products in Basket B in ways other than improving its cost reflectivity. Firstly, this is the area where Royal Mail is facing some competition, albeit most of it through access arrangements rather than through rival delivery networks. Secondly, the price elasticity of customers in Basket B is such that Royal Mail has under-recovered against its price control allowance and it has suggested only a limited number of price increases if granted the increased flexibility. Thirdly, for some products, Royal Mail will need to reduce access prices by an amount corresponding to the retail price reduction in order to maintain the required access headroom. Fourthly, the anti-competitive provisions of Condition 11 continue to apply in the case of price reductions. Overall, therefore, Postcomm judges that granting Royal

Mail's request would be best calculated to meet its statutory duties and would be consistent with the principles of better regulation (which include only regulating to the minimum degree necessary to meet a defined objective).

- 4.25. For products in Basket A, different conditions prevail. There is limited competition. Access headroom regulation does not apply because there are no equivalent access products. It also contains universal service products whose prices must continue to be affordable. However, revenues were also significantly under recovered in Basket A in 2006/7 (by £96m).
- 4.26. Some of the indicative price rises suggested by Royal Mail for Basket A were on products whose prices are already greater than Royal Mail's fully allocated costs. Thus Royal Mail could use the increased flexibility not just to move prices into line with costs but also to increase margins on those customers who cannot avoid the price increase by using rival offers.
- 4.27. Taking all these factors into account, Postcomm considers that greater pricing flexibility is still merited for Basket A products and will further its statutory duty in relation to furthering the interests of users by promoting effective competition between postal operators. Greater pricing flexibility is also consistent with Postcomm's universal service and finance duties.
- 4.28. However, Postcomm also thinks that the furtherance of its consumer duty also requires that a protection ought to be in place to prevent captive customers facing price rises to levels unduly in excess of costs. Postcomm is keen to achieve this balance in a way that involves the least regulatory intervention and does not require ongoing periodic review and monitoring throughout the remainder of the present price control period. Postcomm considered a number of options, including whether to allow greater price rebalancing for all products where costs

are currently greater than prices, and concluded that a pragmatic way to achieve such a balance would be to limit the application of the 'plus 8.5%' rebalancing cap to those prices that are currently at least 6% below fully allocated cost as indicated by Royal Mail's 2006/7 cost data presented in Table 5 above (i.e. those products for which Royal Mail would not otherwise be able to align prices with costs by the end of the price control period).

4.29. The impact of 8.5% rebalancing, assuming the price point passes the cost reflectivity threshold outlined above, would allow Royal Mail to increase prices on second class stamped letters by RPI-X+8.5% each year, i.e. a maximum increase of around 24% by 2010. This would represent an increase from 24p in 2007/8 to a maximum of 29p by 2009/10⁴². First class stamped letters would not meet the cost reflectivity threshold, and so the current 3% sub-cap would continue to apply (see Table 7).

Table 7: Maximum First Class and Second Class Stamped Letter prices

| Prices in pence* | Current plus 3% sub-cap | | | Proposed plus 8.5% sub-cap | |
|------------------------------|-------------------------|--------|---------|----------------------------|-----------|
| | 2007/8 | 2008/9 | 2009/10 | 2008/9 | 2009/10 |
| First class Stamped Letters | 34.0 | 35.0 | 37.0 | No change | No change |
| Second class Stamped Letters | 24.0 | 25.0 | 26.0 | 26.0 | 29.0 |

Source: Postcomm

Note: This depends on actual inflation over the period and other technical factors, such as the adjustment within the price control for changes in mail volume levels - the 'G' factor.

⁴² This depends on actual inflation over the period and other technical factors, such as the adjustment within the price control for changes in mail volume levels - the 'G' factor.

4.30. In assessing whether this possible increase in second class public stamp prices over and above the price control settlement is reasonable, Postcomm has taken into account the results of its market research on postal users' demands in 2006 (published in its Review of Collection and Delivery Times, June 2007). This showed that all classes of public postal user, including vulnerable groups, believed the current level of postage was affordable. With the average household spending less than 50p per week on postage, Postcomm does not believe the maximum increases to second class standard tariff letter prices suggested in Table 7 by 2010 would alter this conclusion.

Postcomm's proposals

4.31. Following its review of the evidence and stakeholder views, Postcomm proposes, subject to considering responses to this consultation, to issue a direction under Royal Mail's licence containing the following key provisions:

- An increase in the price rebalancing sub-cap from 3% per year to 8.5% per year on all products in Basket B – the 'non-captive' basket as per Royal Mail's request; and
- An increase in the price rebalancing sub-cap from 3% per year to 8.5% per year on all products in Basket A – the 'captive' basket as per Royal Mail's request but subject to the following restriction: that it can only be applied to prices that are currently at least 6% below fully allocated costs as indicated by Royal Mail's 2006/7 cost data presented in Table 5. Under this proposal the main possible change to the public stamp prices will be to enable the maximum second class letter price to increase to 29p by 2010 (this depends on actual inflation over the period and other technical factors, such as the adjustment within the price control for changes in mail volume levels - the 'G' factor).

5. Royal Mail's, TNT Post's and UK Mail's requests to review the level of access headroom

Introduction

5.1. This section outlines Postcomm's proposals in relation to the requests by Royal Mail, TNT Post and UK Mail to review the level of access headroom, the minimum margin between prices for Royal Mail's access and analogous retail services. It also sets out Postcomm's proposals in relation to the additional request by TNT Post and UK Mail to extend the scope of headroom regulation to a broader set of Royal Mail products.

Summary of the requests from Royal Mail, TNT Post and UK Mail

5.2. In its application, Royal Mail argued that the average level of headroom was too high and should be reduced. It argued it was making a loss on access items it handled and the (high) level of headroom made it too easy for competitors to undercut its bulk mail retail prices. It also claimed that the current price control access mechanism distorts the market to the detriment of customers, by restricting Royal Mail from passing on savings it makes on its upstream activities to its retail customers, without also passing on those savings to competitors through lower access prices. Subsequently, Royal Mail clarified that it wanted additional scope to narrow headroom for the largest retail volume mailings (more than 250,000 items per mailing). Royal Mail proposed that headroom should be reduced from between 0.2p and 2.9p per item for the letter⁴³ format (ranging from between 7% and 57% of the current access headroom levels) depending on the particular access product.

⁴³ The letter format accounted for 91% of access mail in 2005/6.

- 5.3. TNT Post and UK Mail argued the opposite. They claimed that headroom levels needed to be increased as the current level of access headroom offered insufficient scope to enable long-term investments by access operators and was thus inadequate to promote effective competition in the longer term. They argued that any reductions in headroom would have a substantial negative impact on their businesses and may make them unsustainable. Both argued that Royal Mail has failed to control its costs and in particular had failed to make downstream efficiencies.
- 5.4. In addition both TNT Post and UK Mail asked that the regulatory safeguard of headroom (or margin) regulation be extended across a broader range of access products than those used by Postcomm in setting Royal Mail's price control in early 2006. Both argued that headroom regulation should be extended to cover the other Royal Mail products against which they are competing (or that they may reasonably wish to compete against). Both maintained that *ex-post* anti-competitive investigations would take too long and that they might have to exit the market before conclusions were reached.

Summary of other stakeholder views

- 5.5. Two large customers expressed the view that access headroom should either remain the same or be increased to help ensure competition in the market and thereby maintain the pressure on Royal Mail to deliver cost efficiencies.
- 5.6. At the Postcomm workshop in April 2007, The National Trust and The Mail Users Association (MUA) expressed the view that it would be better for Royal Mail and the other operators to work together to help expand the mail market rather than fight over a shrinking market.
- 5.7. Postwatch noted customers' concerns on this issue; i.e. on the one hand, it is in customers' interests for upstream competition to flourish

because it is acting as a spur to efficiency and innovation and providing improved quality and customer choice. On the other hand, it is vital to safeguard the 'final mile' delivery business which underpins the USO.

- 5.8. The CWU supported Royal Mail's position. It argued that Royal Mail is losing money on access and the application of headroom regulation meant that Royal Mail could not respond to market developments. This could place the financing of the universal service at risk. The CWU says that whilst it believes Postcomm is right to revisit access headroom and price rebalancing, it did not believe this review would suffice and so it would be calling for a full parliamentary review of the impact of liberalisation.

Analysis of access volumes

- 5.9. So far, access is the principal form of competition to Royal Mail in the letters market. Volumes of access have grown significantly since the first commercial access deal was signed between Royal Mail and UK Mail in 2004. Access has grown faster to date than was anticipated at the time of the last price control (see Table 8). Effectively, Royal Mail is currently losing retail volumes to access one year ahead of Postcomm's forecasts made in 2005. It is important to bear in mind, however, that around 50% of access volumes are with bulk mailers who remain Royal Mail customers, via Customer Direct Access (CDA) arrangements⁴⁴. If Royal Mail's latest forecast for access volumes for 2007/8 proves accurate, it will mean that about 20% of total letter volume will be handled via access arrangements this year. Most commentators expect access volumes to eventually plateau at around 5-6bn items per annum as the size of the addressable market is limited⁴⁵.

⁴⁴ CDA is where the customer has signed a direct access agreement with Royal Mail, allowing the customer to outsource its upstream activities (collection, sortation and trunking), using Royal Mail's network for final delivery.

⁴⁵ Second class bulk mail.

Table 8: Downstream access volumes (actuals and projections)

| Downstream access volume (million items) | 2004/5 | 2005/6 | 2006/7 | 2007/8 | 2008/9 | 2009/10 |
|--|--------|--------|--------|--------|--------|---------|
| Actuals | 87 | 1,157 | 2,442 | N/A | N/A | N/A |
| Postcomm's price control forecast | 87 | 1,117 | 1,872 | 2,556 | 3,515 | 4,454 |
| Royal Mail's price control forecast | 87 | 1,238 | 3,259 | 3,617 | 4,536 | 4,960 |
| Interim Review forecast from Royal Mail | 87 | 1,157 | 2,442 | 4,000 | 4,800 | 5,200 |

Source: Royal Mail and Postcomm

Analysis of the implications of Royal Mail's proposal on access volumes

5.10. Postcomm asked Royal Mail to estimate the impact on access volumes if we were to approve its application to reduce the (average) available headroom. Royal Mail projects that the effect of its proposal would be to reduce the level of access in the last two years of the price control by about 1.4 billion items (Table 9). This would effectively stop the growth of access, which would remain at around the estimated 2007/8 level.

Table 9: Impact of Royal Mail's proposal on access volumes

| <i>Billion items</i> | 2008/9 | 2009/10 | Total (over last two years of the price control) |
|--|--------|---------|--|
| Royal Mail's forecast (no change to access headroom) | 4.8 | 5.2 | 10.0 |
| Royal Mail's forecast (if its proposal is approved) | 3.4 | 3.8 | 7.2 |
| Difference (reduction in access volumes from Royal Mail's proposal) | 1.4 | 1.4 | 2.8 |

Source: Royal Mail

Analysis of the implications of Royal Mail's proposal for its profitability

5.11. Royal Mail states that in 2006/7 it made a loss on access of £43m after a full allocation of its costs. However, Postcomm estimates that access made a £200m contribution to its fixed costs in 2006/7 on Royal Mail figures. In Royal Mail's 2006/7 regulatory accounts, access is shown to have made an average loss of 1.8p per item on a fully allocated cost basis on average (Table 10). However, these accounts also show that Royal Mail made a loss on its retail bulk mail products of 0.9p per item on average. The loss on access is significantly lower than the average 2.6p loss it showed in its half year 2006/7 results. These numbers are summarised below, and are all based on Royal Mail's costing system.

Table 10: Royal Mail's estimate for profitability of access

| Pence (nominal) | 2004/5 | 2005/6 | HY 2006/7 | FY 2006/7 (regulatory accounts) | 2006/7 increase/ (decrease) versus 2004/5 |
|--|--------|--------|-----------|---------------------------------|---|
| Fully Allocated Cost (FAC) per item (p) | 13.8 | 14.3 | 15.9 | 15.2 | 10% |
| Revenue per item (p) | 13.8 | 13.1 | 13.3 | 13.4 | (3%) |
| Profit/(loss) per item (p) (Regulatory accounts) | - | (1.2) | (2.6) | (1.8) | - |

Source: Royal Mail

5.12. Royal Mail estimates that if its proposals were accepted by Postcomm, it would eliminate its losses on access, and would enable it to generate an additional £104m in net cash flow over the last two years of the price control (£44m in 2008/9 and £60m in 2009/10).

Implications from Postcomm's adjustments to Royal Mail's cost data

- 5.13. Postcomm, with assistance from its consultant, has reviewed the data made available by Royal Mail to support its application. As well as frequent meetings and discussions with Royal Mail, Postcomm made seven further information requests in an attempt to secure an improved quality of information from Royal Mail.
- 5.14. The most recent detailed costs provided by Royal Mail were for 2005/6 (Royal Mail was not able to provide 2006/7 product unit costs for access items) and these have been rolled forward to both 2006/7 and 2007/8 to try and reflect current costs. This analytical work has identified a number of issues upon which Postcomm disagrees with the way in which Royal Mail's costing system allocates costs to access products. Some of these issues relate to errors and inconsistencies and some relate to a difference of view as to the appropriate method for allocating costs such as central overheads. As a result, Postcomm estimates that Royal Mail is making a loss of around 0.5p per item on access in 2007/8 (and 0.5p loss in 2006/7) – albeit that this estimate is itself based on Royal Mail's data, which has a high degree of uncertainty.
- 5.15. Postcomm's adjusted estimate of Royal Mail's 2006/7 costs suggests that the total loss on access in 2006/7 was £12m, compared with Royal Mail's figure of £43m. However, although access might show a loss in relation to fully allocated costs, it still makes a significant contribution per item towards Royal Mail's fixed costs. Based on Royal Mail's current estimate of variable costs of about 40%⁴⁶ of its total costs, we estimate that access items on average make a contribution towards Royal Mail's fixed costs per item of about 8p.

⁴⁶ Postcomm used a figure of 60% cost/volume variability for the price control and has not been provided with compelling evidence from Royal Mail to suggest that 40% is an appropriate figure.

- 5.16. Postcomm's 0.5p loss per item of access mail estimate (in 2006/7 and 2007/8) is highly sensitive to the quality of the underlying data and has an associated margin of error of 1p (as estimated by Postcomm's consultant).
- 5.17. An example of Postcomm's adjustments to Royal Mail's access costs is for revenue protection of access mail. Royal Mail's 2005/6 costing system indicates a revenue protection cost per item of access mail of 0.37p compared with around 0.02p per item of retail mail. We have reduced the cost per item of access mail by some 0.3p in order to give a more realistic long run level of revenue protection cost.
- 5.18. In addition to the cost adjustments that Postcomm considers appropriate, we note that Royal Mail imposes additional operational requirements on access operators such as forecasting of access volumes. However, Royal Mail claims that there is no offsetting cost saving from imposing on access operators these extra requirements. Given that access operators find such provisions onerous and they argue that they are imposed to frustrate the development of access competition, we propose that Royal Mail either justify the cost/benefit of such requirements or discontinue them.

Assessment of the reliability of Royal Mail's cost data

- 5.19. Postcomm believes that the underlying data provided by Royal Mail for access costs and headroom calculations cannot be relied upon as being sufficiently robust. This is because of the scale and nature of the adjustments that have had to be made (discussed above); other concerns are about the data being outdated and about its variability and margin of error.
- 5.20. Postcomm's concern about the data being outdated arises because Royal Mail was not able to provide 2006/7 product unit costs for access

items (it was, however, able to do this for the products affected by its rebalancing proposal – see Section 4).

- 5.21. Although Postcomm anticipates receiving from Royal Mail all the 2006/7 data for access products before the end of the calendar year, this will require significant review. It will not be possible to complete this review within the timetable for our Interim Review on which a firm decision has to be reached in November 2007. Postcomm has, therefore, had to base its judgements on the best data and analysis that it had available at the time of issuing this document. Postcomm's analysis of access headroom has, therefore, needed to rely on information provided by Royal Mail for the year ending March 2006.
- 5.22. In addition to Royal Mail's product level data being out of date, Postcomm has also been concerned about the quality and reliability of the data that has been provided. Postcomm understands that access, being a relatively new product, will take time to settle down in terms of the reporting of stable and accurate costs. However, the degree of variance has been a cause for significant concern. For example, Royal Mail's access costs in aggregate fell by 0.8p per item between the publication of its half year accounts (16.0p) and its full year regulatory accounts (15.2p). This compares with a 13.8p cost of access that Royal Mail published in its 2004/5 regulatory accounts (i.e. access costs are purported to have increased by 16% from 2004/5 to 2006/7).
- 5.23. Even relatively small variations in access costs can make a significant difference, especially in the consideration of access margins where analysis is required to fractions of a penny. Postcomm's consultant has acquired a very detailed insight into Royal Mail's costing systems and believes that the margin of error could be as high as plus or minus 1.0p per item on access costs and plus or minus 0.5p per item on retail costs. Combining these figures, this amounts to a margin of error on access headroom of plus or minus 1.5p per item. This is very significant (c.30%) when the average access headroom is about 4.5p

per item⁴⁷.

Assessment of the TNT Post and UK Mail requests

- 5.24. Postcomm has sought to understand the claims of TNT Post and UK Mail that the present access headroom is insufficient by undertaking an economic analysis called a 'margin squeeze' test⁴⁸. We have used the benchmark of the 'as efficient' test. This test assumes that market entrants are as efficient as the incumbent operator. Failure of the 'as efficient' margin squeeze test could constitute a breach of UK competition law.
- 5.25. If access headroom on individual products is insufficient to cover Royal Mail's upstream costs and provide a return then this would indicate margin squeeze, i.e. an entrant would not be able to trade profitably even if its costs were as efficient as Royal Mail's costs.
- 5.26. The profit margins available to Royal Mail's competitors - as provided to Postcomm by TNT Post and UK Mail - appear to be tight. The implication is that reducing the headroom as per Royal Mail's request would have dramatic consequences for these new entrants' business models, potentially rendering them unsustainable, and possibly creating instances of margin squeeze.
- 5.27. Royal Mail's own cost data and the applications received from TNT Post and UK Mail highlight the variability in headroom across different bulk mail products. The two products with substantially higher headroom than other access products (Access 120 and Access 1400), are the original ones negotiated by Royal Mail at a time when such agreements were under close regulatory scrutiny. This was shortly after Postcomm had published its provisional assessment of likely

⁴⁷ 4.3p in 2006/7, 4.5p in 2007/8

⁴⁸ Margin squeeze may occur if Royal Mail were to set its prices for access and retail such that the difference between these two prices (i.e. the margin available to competitors) is reduced below the level which allows them to trade profitably.

access prices ('Notice of a proposed Direction to Royal Mail on downstream access', May 2003), and was on the point of publishing its final assessment. Since then, UK Mail and TNT Post argue that they have had to negotiate with a super-dominant monopolist, which has been able to impose tough commercial terms, against a background where both new market entrants were keen to avoid a potentially lengthy determination request from Postcomm⁴⁹.

5.28. There are, however, several factors which suggest that access operators are able to trade successfully within the current levels of access headroom. Firstly, the growth of access volumes has been faster than predicted, suggesting that operators see a future in the access market. Secondly, one of the operators, UK Mail, reported a margin of 7.1%⁵⁰ on its mails business in its latest published accounts. Postcomm recognises, however, that this is partly due to UK Mail's letters business sharing costs with its established parcels business. Thirdly, data provided by TNT Post and UK Mail has indicated that their upstream operations are more efficient than Royal Mail's. Fourthly, at present both operators are able to offer customers a price incentive to switch their business in the form of a discount to Royal Mail's retail bulk mail prices. This is currently required to overcome customer inertia and the perceived risks of switching. To the extent that a more mature market lessens these latter two factors, higher prices and hence higher margins might be possible for the other operators in the future.

5.29. There are, however, several challenges that these operators face, which point in the opposite direction and were considered in our analysis, but for the purpose of our margin squeeze calculations have been excluded. First and most important is the unequal application of

⁴⁹ Postcomm expressed its concerns that the margin for the more recently introduced access products is significantly smaller than those negotiated originally (Postcomm Initial Proposals, June 2005).

⁵⁰ This figure includes substantial CDA mail where the percentage margin is greater than on standard access mail because the Royal Mail access charge is not included in revenue or operating costs.

the VAT regime⁵¹. Although the recently negotiated 'agency agreement'⁵² helps level the playing field for upstream operators, the regime still creates a significant distortion especially for those seeking to develop rival delivery networks in the future. Second, other operators have said that Royal Mail's QMP incentive⁵³ given to mailing houses (but not access operators) acts, in effect, as a further price discount that they need to compete with when seeking work from mailing houses and thus in practice reduces headroom.

Discussion

- 5.30. Postcomm's analysis on Royal Mail's 2005/6 cost data projected forward to 2006/7 and 2007/8 indicates that the profit margin on upstream operations is variable across access products. This may imply that headroom should be increased for some products and reduced for others. There are certain products where Royal Mail is making losses on access and the equivalent retail product, implying that it could raise both sets of prices, alleviate the losses on both and still maintain access headroom.
- 5.31. There are also two access services that Royal Mail prices lower than the maximum allowed in its licence.
- 5.32. It could be argued that Royal Mail should increase the prices of all its retail equivalent products that are priced below cost⁵⁴ and price all access prices as high as they are allowed under its licence before

⁵¹ The European Commission has recently published its Reasoned Opinion against the UK, Germany and Sweden (see EC press notice at <http://www.europa.eu>).

⁵² Royal Mail agreed an 'agency access' agreement with UK Mail and TNT Post which allows them to raise a single bill with their customers for the whole delivery of their mail, while only charging them VAT on their upstream prices.

⁵³ Royal Mail's QMP scheme ended on 30 April 2007, though Royal Mail continued to pay commission to mailing houses until 30 June 2007. The new scheme began on 1 July 2007 and currently offers commission payments of 1.5% for volumes of mail sent via Royal Mail. The origin of these payments was as a quality reward to mailing houses.

⁵⁴ Assuming Royal Mail increases its retail (Mailsort) prices so as to make 0.5p profit per item, equating to c.3 to 4% profit margin.

seeking regulatory remedies to its access loss problem - subject to the price control rebalancing sub-cap limits⁵⁵.

- 5.33. However, as Royal Mail made clear in its own application, and our own analysis has shown, the scope for Royal Mail to increase prices may be limited by customers' willingness to pay higher prices. Those findings imply that Royal Mail needs to focus its attention even more on cutting costs instead of adjusting prices in order to restore profitability.
- 5.34. According to our figures, Royal Mail will make a loss of around £20m on access in 2007/8 after an appropriate allocation of fixed costs. We would contend that Royal Mail could, however, reduce these losses by around 80% (see Table 11) through its own actions by (a) raising access prices to the maximum allowed, and (b) raising both retail and access prices whilst still maintaining headroom levels. Both changes would allow Royal Mail to raise access prices, which would help to further cover its fully allocated costs⁵⁶. Given the variability in Royal Mail's cost data and the margin of error associated with its costs, Postcomm does not consider it would be justified in adjusting access prices.
- 5.35. Table 11, below, illustrates how Royal Mail might be able to reduce its 2007/8 access losses by its own actions as described above. The final column of the table indicates Postcomm's view of the extent to which Royal Mail can reduce its access losses by raising access prices to the maximum allowed (without creating a margin squeeze) and/or raising both its retail and access prices.

⁵⁵ Separately, as part of the Interim Review, we are proposing increasing the sub-cap limit for Basket B products (including Mailsort products) to 8.5%.

⁵⁶ On Postcomm's figures, by making these changes, Royal Mail could ensure that all of its access services at least break even, apart from Access 1400, Access 120 and Access 120 OCR.

Table 11: Percentage reduction in access losses that Royal Mail can itself address by changing retail and access prices (and preserve the current headroom levels) – 2007/8 forecast

| | | Access products (Letters) | 2007/8 revenues (m) | % difference from fully allocated costs | % reduction in total FAC ¹ loss on access after changes Royal Mail can make itself |
|--------------|--|-------------------------------|---------------------|---|---|
| 1 | Where Royal Mail is already making a satisfactory access margin | None | - | - | - |
| 2 | Where Royal Mail is not making a satisfactory access margin but where to do so would impose margin squeeze on the access operators | Access 700 CBC | 234.9 | 0.8% | 39% |
| 3 | Where Royal Mail needs to raise both the end-to-end retail price and the access price to make a satisfactory profit | Access 120 CBC | 52.0 | -4.6% | 12% |
| | | Access 120 OCR | 67.2 | -8.3% | 24% |
| 4 | Where Royal Mail has the ability to utilise the access headroom available to it to improve the margin | Walksort | 5.6 | 5.5% | 2% |
| 5 | Where an increase in the access price would require a reduction in headroom | Access 1400 | 82.1 | -11.2% | 0% |
| | | Access 120 (MS 1400 residues) | 95.8 | -5.8% | 6% |
| Total | | | 538 | | 83% |

Source: Postcomm

Note: Assuming Royal Mail's revised forecast of 4bn access items in 2007/8, at the same access product mix as in 2005/6.

¹FAC = Fully allocated costs.

5.36. Even if Royal Mail made all these changes, our margin squeeze analysis (albeit also on Royal Mail data) seems to indicate that some access prices could still be too low i.e. affording high upstream margins. On the other hand, our analysis agrees with TNT Post and UK Mail who believe that some access prices are too high i.e. with

insufficient upstream margin. The picture is, therefore, one of significant variation in the profitability across access products.

- 5.37. This variability in headroom indicates that there may be scope for commercial negotiation between Royal Mail and the other operators to adjust access prices and it should not be necessary to rely on regulatory intervention. We urge Royal Mail and the access operators to work together to agree increases to access prices that are too low with corresponding reductions to access prices that are too high⁵⁷.
- 5.38. Therefore, in summary, there are a number of actions that Royal Mail itself can, and should, take to reduce its access losses.
- 5.39. However, there is also a judgement that must be made about how far Royal Mail's underlying cost data can be relied upon for a regulatory determination on the level of access headroom.
- 5.40. In light of all the factors mentioned earlier, Postcomm does not believe it is appropriate to make a decision either to reduce or increase the level of access headroom at this stage. The consequences of such an action could be very profound for the market. Postcomm has little confidence that the underlying access cost data currently provided to it by the three applicants can be used to provide the degree of assurance that is needed for such a major decision.
- 5.41. In essence Postcomm cannot be satisfied that, in approving Royal Mail's application, it would be furthering its universal service, consumer, competition and finance duties. Furthermore, approving Royal Mail's application may risk acting contrary to its statutory duties. It is notable that the revenue gains Royal Mail has estimated would accrue from approving its application are relatively small (and that an even bigger effect on profit could be obtained by Royal Mail achieving

⁵⁷ This may require a licence modification if Royal Mail and other operators wish to change access headroom levels that are currently fixed in Royal Mail's licence, as part of mutually changed headroom rebalancing.

the efficiency targets set in the price control) and that the adverse effects on competition could be substantial.

- 5.42. Postcomm does not, however, think it is appropriate to rule out any changes to access prices - if these cannot be freely negotiated between the parties - before the present price control arrangements are due to be replaced in April 2010. However, we would only review access headroom ahead of April 2010 in light of substantially better quality 2006/7 cost data from Royal Mail. Only then would we consider a further application by Royal Mail or another operator to review the levels of access headroom. The 2006/7 data would require substantial analysis followed by a public consultation period that means any potential changes would not take effect before April 2009 (i.e. for the last year of the present price control).

TNT Post and UK Mail's request to extend the scope of headroom regulation

- 5.43. Postcomm decided, as part of the price control, that the most appropriate way to regulate access was by freezing the headroom for a number of access benchmark products. Postcomm indicated that this approach would signal to the market what it broadly considered to be the appropriate margin for other access products, taking account of differences in operational characteristics between products.
- 5.44. TNT Post and UK Mail argue that Royal Mail is super-dominant and that they need the benefits of *ex ante* headroom protection for products currently outside the scope of access regulation. Such a change would require a modification to Royal Mail's licence, which Royal Mail could reject, forcing Postcomm to refer the matter to the Competition Commission for investigation. This would create a period of regulatory uncertainty which could be damaging for competition.
- 5.45. Although TNT Post and UK Mail have requested Postcomm to expand the scope of regulated access products, at this stage the case is not

made. Moreover, there is already scope within Royal Mail's licence for operators to seek an access price determination for a new product (Condition 9) and to call for the investigation of any undue discrimination or preference that may be apparent (Conditions 10 and 11). Postcomm therefore proposes not to expand the regulation of access headroom at this stage. It is our hope that Royal Mail and the access operators can achieve a satisfactory outcome without regulatory intervention.

Royal Mail's desire to introduce volume related discounts

5.46. At Postcomm's industry workshop held after Royal Mail had submitted its application, Royal Mail clarified one of the specific actions that it was seeking from Postcomm. Royal Mail said it should be able to offer additional, larger, discounts for very large retail bulk mailings due to upstream scale economies that it enjoyed from such mailings. These discounts should not, it claimed, be passed into access prices because they relate to upstream cost savings.

5.47. Although Postcomm does not reject the principle behind Royal Mail's request, Postcomm has not been provided by Royal Mail with compelling evidence to demonstrate how such discounts could be provided on an objective cost basis. Postcomm expects to take this issue forward with Royal Mail as part of its continuing review of new data to ensure that it is able to process any future applications to change access headroom levels. Postcomm does not anticipate, however, making any such changes prior to April 2009.

Postcomm's proposals

5.48. Postcomm therefore proposes that for the following reasons it should not make any changes in access headroom to be implemented from April 2008:

- Postcomm's adjustments to Royal Mail's allocation of costs indicates that losses claimed by Royal Mail on access are overstated;
- There are a number of actions that Royal Mail can undertake itself to decrease access losses, for example by raising bulk mail prices and access prices where it can and by further efforts to improve its cost efficiency;
- Royal Mail's access cost data cannot be relied upon and involve a significant margin of error. The risk arising to competition of reducing the level of access headroom could be profound but the benefit to Royal Mail in terms of additional net contribution to profits is relatively small compared with its c.£6bn of annual costs. The four year price control for access headroom was set on the basis that it would remain unless there was compelling, good quality evidence that suggested change was necessary; this has not been provided by any of the applicants; and
- In commenting on Royal Mail's access profitability, it is important to remember that Postcomm's margin squeeze analysis (albeit also on Royal Mail data) seems to indicate that some access prices would still be too low i.e. affording high upstream margins. On the other hand, our analysis agrees with TNT Post and UK Mail who believe that some headroom levels are too low i.e. with insufficient upstream margin.

5.49. Postcomm does not, however, think that it is appropriate to rule out any changes to access headroom before the price control arrangements are due to be replaced in April 2010. This will be facilitated by the provision of volume and access cost per product data for 2006/7 from Royal Mail later this year. We would expect this data to be of substantially better quality for us to consider a further application by

Royal Mail or another operator to review the levels of access headroom. This data would require substantial analysis by Postcomm that means any potential changes would not take effect before April 2009.

- 5.50. Royal Mail's profitability and the available headroom vary significantly across the access product set. However, variability in headroom margins seems to imply that there is scope for Royal Mail and the other operators to negotiate changes in access prices per product.
- 5.51. Postcomm also expects to consider any information Royal Mail can provide to justify its claim that discounts should be offered on retail bulk mail but not be reflected in access prices owing to cost savings made upstream.
- 5.52. Postcomm proposes not to extend the scope of headroom regulation to more products as per the requests by TNT Post and UK Mail. Postcomm believes that the provisions of the current licence are adequate for this purpose for now.
- 5.53. Royal Mail imposes on access operators extra requirements such as forecasting of access volumes, yet claims it derives no offsetting cost savings from this. Postcomm proposes that Royal Mail either justify the cost/benefit of such requirements or discontinue them.