



**ROYAL MAIL'S RESPONSE
TO POSTCOMM'S
"REVIEW OF ROYAL MAIL'S PRICING
FLEXIBILITY AND THE LEVEL OF
ACCESS HEADROOM (THE 'INTERIM
REVIEW' OF THE PRICE CONTROL)
POSTCOMM'S PROPOSALS"**

9 October 2007

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FOREWORD

Royal Mail's applications for change

In March 2007 Royal Mail submitted a business case and made applications for changes to the regulatory framework under its Licence. This followed completion of a financing package with its shareholder and lender, the Government, that would facilitate Royal Mail's transformation programme.

The applications were made recognising that the UK mail market is changing in ways that are having serious adverse effects on Royal Mail's finances – effects much greater than those predicted at the time the last price control was set. This is evidenced by the recent audited regulated accounts for 2006/07 where the price controlled area made a loss of £12 million compared to a profit of £779 million¹ predicted at the time of the last price control review – despite Royal Mail meeting the efficiency targets on which the price control is predicated.

Given the rapidly deteriorating financial position, Royal Mail's requests were framed to facilitate an efficient process that would not require licence modifications. These were:

1. Early removal of financial penalties under the licence for the consequence of industrial action.
2. Implementation of retail zonal prices for non-USO bulk mail products.
3. An increase in sub-caps from 3% to 8.5%, the level it proposed during the price control review and consistent with regulatory precedent elsewhere.
4. A reduction of the access headroom on existing products to a level equalling Royal Mail's upstream costs – in light of the successful introduction of downstream access competition.

Postcomm has responded to the first request through a separate published statement which we have welcomed, and it has responded to the second through a separate consultation.

Postcomm's Interim Review consultation focuses on requests 3 and 4 above, and on the financial context of Royal Mail's applications. This document is Royal Mail's response to that consultation. In it, we seek to explain why we believe Postcomm should act urgently on Royal Mail's requests to mitigate some of the risks to the finances of the universal service. We also highlight that Royal Mail delivered its efficiency targets and we hope Postcomm's suggestions to the contrary in its consultation document will not lead other respondents to draw the wrong conclusions when framing their own responses.

¹ "Royal Mail Price and Service Quality Review: Final Proposals for consultation", Table 10.1, Postcomm, December 2005.

Royal Mail's financial position

The deterioration in Royal Mail's financial results for 2006/07 - relative to those predicted - were not due to Royal Mail failing its efficiency targets. Royal Mail believes that the difference between actual results and what was expected when the price control was set is due to both market decline - which has materially reduced actual revenues compared to those assumed when setting the control - and allowed costs being set at levels significantly below true costs.

In its consultation document, Postcomm presents a partial reconciliation of the costs it allowed in setting the control to the actual outturn figures in 2006/07. This suggests significant gaps between actual costs and allowed costs, and ultimately to an efficiency estimate of 1.9% in 2006/07 compared to a regulatory target of 3%.

Royal Mail has undertaken its own reconciliation of the costs allowed by Postcomm in setting the control to the outturn for 2006/07. This shows the allowed costs to have been materially understated. We have also used Postcomm's own methodology to demonstrate that Royal Mail achieved the 3% efficiency target set by Postcomm - failure to meet targets is not an explanation for the gap in our financial results. Finally, we have found that, on a comparable basis, revenues were almost £300 million below those predicted for 2006/07 by Postcomm under the price control.

As a result, cash flows for Controlled Services are materially weaker than predicted at the time of the last price control, with consequential effects on the finances of Royal Mail Group Limited as licence holder and provider of the universal service in the United Kingdom.

Postcomm's specific proposals

Postcomm proposes to modify price rebalancing in Basket A by defining a specific set of price points for relaxation of the sub-caps. While we broadly welcome these proposals for greater price rebalancing for Basket A we do propose refinements to Postcomm's framework to take into account some of the wider commercial considerations. This has the effect of increasing the number of price points with an 8.5% sub-cap for Basket A, while retaining the same average price control. Postcomm has adopted a different approach to the sub-caps for Basket B and Royal Mail believes that this approach is appropriate,

On the contrary, Postcomm's proposals for access headroom continue market distortions that have led access volumes to exceed those forecast by Postcomm when setting the control - for 2007/08 access volumes are forecast to be 4 billion, 60% higher than the prediction of 2.5 billion. Postcomm's proposals will prevent Royal Mail's prices from becoming more cost reflective - particularly Royal Mail's prices to very large customers, most of whom are now using access products. A proportionate regulatory response would be to use an ex post margin squeeze test

to police any apparent anti-competitive behaviour by Royal Mail, removing the current artificial and arbitrary headroom constraint altogether. Alternatively Postcomm should justify the need for an ex-ante headroom constraint and justify why the current level of headroom is correct.

Conclusion

The price control set by Postcomm 18 months ago was based on assumptions that are very different to the reality in 2006/07, as highlighted in the regulatory accounts. In 2006/07 Royal Mail met its efficiency target, actively sought to innovate and has made important innovations. Additionally, through the Interim Review applications, it has sought to offset adverse and unforeseen financial effects arising from the changing market observed in the second half of 2005/06 and through 2006/07 – and which are continuing in 2007/08.

Postcomm does recognise in its document that Royal Mail's financial position is weaker than either it or Royal Mail had envisaged and has proposed some changes in the Interim Review in respect of price rebalancing and financial compensation arrangements. We welcome these proposals.

However – they do not go far enough. We believe that the rapidly deteriorating financial position puts at risk Royal Mail's ability to finance the universal service, and would urge Postcomm to consider again carefully our initial requests.

Alex Smith
Director of Strategy

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EXECUTIVE SUMMARY

There are some important messages in Postcomm's document² which are frequently stated and with which Royal Mail agrees. Postcomm recognises the need to secure the universal service, for Royal Mail to modernise and innovate, for prices to become more cost reflective and for regulation to be removed as the market develops.

There are also some important developments in Postcomm's document which Royal Mail welcomes:

- It acknowledges that the financial position of Royal Mail is not as strong as Postcomm predicted in setting the price control.
- It recognises that customers are changing their behaviour and making choices over mail postings in ways that were not anticipated at the time of setting the current price control. It acknowledges that Royal Mail is competing with other communications media; customers are looking to reduce costs through the alternative services offered by Royal Mail, other providers and other media; and that access volumes in 2006/07 were higher than were expected.
- It acknowledges that, even after Pricing in Proportion, Royal Mail's prices still need to change to better reflect its costs.
- It recognises that competition law can act as a safeguard against anti-competitive behaviour by Royal Mail to reduce the need for ex-ante regulation.
- It recognises the limited scope in practice to increase the prices in Basket B and the potential scope to deregulate in the "business mail market"³. It has started therefore to consider competition in terms of market segments rather than just in terms of Royal Mail's services.
- It recognises the need to take account of costs in assessing margin squeeze and setting the level of access headroom.

Postcomm's document has been produced specifically in response to Royal Mail's two applications for changes to increase pricing flexibility under Condition 21(16) and changes to the level of access headroom required under Condition 21(5). In making these applications, Royal Mail submitted evidence to Postcomm of its financial and market context to demonstrate the need for change to the regulatory

² "Review of Royal Mail's pricing flexibility and the level of access headroom (the 'interim review' of the price control"

³ Postcomm's Interim Review document, paragraph 7.

environment. Postcomm has a duty under the Postal Services Act to have regard to the ability of licence holders to finance the activities authorised or required by the licence. This obligation is even more important in relation to the finances of the universal service provider. The applications need to be considered against this background, but each request needs to be considered against an appropriate “test” for that respective request.

Financial compensation arrangements: Royal Mail welcomes Postcomm’s confirmation that there has been sufficient evidence of change to firstly alter the potential financial penalties on Royal Mail arising from industrial action and secondly increase the rebalancing threshold for some retail prices. As Postcomm states: “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, where industrial action has taken place and quality of service figures have dropped”⁴.

However, by inference, Postcomm confirms there has not been sufficient evidence of change to warrant all of the changes requested by Royal Mail in its applications. This, at least in part, appears to derive from some confusion and partial understanding on Postcomm’s part of Royal Mail’s finances in 2006/07.

Royal Mail’s financial position: In 2006/07 the price controlled area made a loss of £12 million compared to a profit of £779 million⁵ predicted at the time of the last price control review – despite Royal Mail meeting the efficiency targets on which the price control is predicated.

Postcomm presents a partial and confused reconciliation of the costs it allowed in setting the control to the actual outturn figures in 2006/07. This suggests there are significant gaps between actual costs and allowed costs, and an efficiency estimate of 1.9% in 2006/07 compared to a regulatory target of 3%.

Royal Mail has undertaken its own reconciliation of the costs allowed by Postcomm in setting the control and the outturn for 2006/07, the results of which show very limited unexplained differences. We have also used Postcomm’s own methodology to demonstrate that Royal Mail achieved the 3% efficiency target set by Postcomm.

In fact, in 2006/07, Royal Mail observed a revenue reduction of nearly £300m relative to Postcomm’s allowed revenue, on a comparable basis. Postcomm’s document confirmed that, in setting the price control, underlying Royal Mail Letters’ costs were understated by over £100m in 2006/07 and further understated by about £70m if cost shocks and compensation for operational vehicle and employee

⁴ Postcomm’s Interim Review document, paragraph 4.

⁵ “Royal Mail Price and Service Quality Review: Final Proposals for consultation”, Table 10.1, Postcomm, December 2005.

accidents are taken into consideration. While some other factors offset some of this in part, the fact is that after just one year of the four-year price control, the cash outflow position assumed by Postcomm in setting the control, is significantly weakened for the regulated services, with consequential effects on the finances of Royal Mail Group Limited as licence holder and provider of the universal service in the United Kingdom.

Innovation: Postcomm's document unfortunately presents an incomplete picture on Royal Mail's innovation and the comments on Royal Mail's position in the fulfilment market are based on a mis-understanding.

While Postcomm's document appears to portray a passive Royal Mail in respect of innovation since March 2006, Royal Mail has been very active in this area. Products introduced by Royal Mail include Business Mail Secure, Cleanmail Plus, Cleanmail Advance, Automated Standard Tariff Large Letters, Royal Mail Tracked and Royal Mail Heavyweight. Royal Mail has also successfully changed its pricing structure to reflect size as well as weight for many of its inland services. Royal Mail has changed some non-price terms to facilitate on-line billing and purchasing (Smartstamp and Online Postage) and streamline its operations (such as minimum order value).

This has all been achieved in the presence of regulatory constraints and uncertainties. Royal Mail has sought to change its charging for non-universal services to better reflect costs. It has sought to introduce longer-term contracts and looked into the potential for offering discounts when costs are avoided upstream. It has sought clarity from the regulator on Postcomm's approach to determining whether new services are inside or outside of the price control, which can materially affect the business cases for those services. It has to apply to remove products from a requirement to publish changes to prices 3 months ahead of their implementation and has sought several such exemptions⁶. In each of these areas regulatory actions affect Royal Mail's ability to innovate quickly in competitive segments of the market.

Royal Mail's presence and growth in the fulfilment market is also much greater than Postcomm's document suggests. (Postcomm appears to have based its figures on Royal Mail's Standard Parcel product alone while a wider range of Royal Mail's products serve fulfilment.

Rebalancing: While Royal Mail broadly welcomes Postcomm's proposals for greater price rebalancing for Basket A, Royal Mail proposes refinements to Postcomm's framework that take into account some of the wider commercial considerations that a commercial business like Royal Mail has to take into account when setting prices. This has the effect of increasing Postcomm's proposed 26

⁶ Given the requirements for such applications and their subsequent regulatory review and consultation, to-date Royal Mail has applied for Condition 7 exemptions for Sameday, Branch Direct, Postal Voting and International Bulk Mail.

price points with an 8.5% sub-cap to all price points within five of the 13 Controlled Services of Basket A (that is, about 50 price ranges), while retaining the same average price control (such that as some prices are increased, other prices are reduced to offset).

Postcomm's approach and review of the sub-caps for Basket B is broader and takes account of the market environment faced by Royal Mail for such services. As such Royal Mail is pleased that Postcomm has accepted its proposals for all Basket B products to have sub-caps of 8.5% and agrees with Postcomm that this suite of products services competitive markets.

Access headroom: Postcomm's document indicates that it has carried out a margin squeeze test for assessing the level of access headroom (the extent to which regulated access prices have to be set below their retail counterpart) that is necessary in order to allow entrants to be able to trade profitably. The document is lacking any detail on the application of this test.

The document does not confirm whether the current level of headroom (according to this test) is sufficient to allow an 'as efficient' or 'reasonably efficient' access operator to compete with Royal Mail retail and, if it is more than sufficient, to what level the headroom should be reduced.

Postcomm's document portrays Royal Mail's costs for access in 2005/06 as inaccurate whereas, in fact, both Postcomm and Royal Mail identified adjustments that could and have been made to those costs, but Postcomm has not taken the opportunity in its consultation document to clarify what adjustments, in its view, should be made for the purpose of its application of a margin squeeze test. Further, Postcomm has not set out how these costs of Royal Mail, should, in its view, be adjusted (if at all) to reflect those of an as efficient or reasonably efficient access operator.

Postcomm's proposals for access headroom continue market distortions that have lead access volumes to exceed those forecast by Postcomm when setting the control. They will prevent Royal Mail's prices from becoming more cost reflective - particularly in Royal Mail's prices to very large customers, most of whom are now using access products. A proportionate regulatory response would be to use an ex post margin squeeze test and remove the current artificial headroom constraint altogether. Alternatively Postcomm should justify the need for an ex ante headroom constraint and justify why the current level of the headroom is correct.

Conclusion: The price control set by Postcomm 18 months ago was based on assumptions that are very different to the reality in 2006/07, as highlighted in the regulatory accounts. In 2006/07 Royal Mail met its efficiency target, has actively sought to innovate and has made important innovations. Additionally, through the Interim Review applications, it has sought to offset adverse and unforeseen

financial effects arising from the changing market observed in the second half of 2005/06 and through 2006/07 – and which are continuing in 2007/08.

Royal Mail's financial position is weaker than either it or Royal Mail had envisaged and has proposed some changes in the Interim Review in respect of price rebalancing and financial compensation arrangements. Royal Mail welcomes these proposals

Postcomm has a duty under the Postal Services Act to have regard to the ability of licence holders to finance the activities authorised or required by the licence. This obligation is even more important in relation to the finances of the universal service provider as it is Postcomm's primary duty to ensure the provision of the universal service. The cash flow position of Royal Mail's regulated activities will have a material impact upon Royal Mail Group's finances, and hence on the Group's ability to invest in services relating to the future provision of the universal service. We believe that the rapidly deteriorating financial position puts at risk Royal Mail's ability to finance the universal service, and would urge Postcomm to consider again carefully our initial requests.

1. PROPOSED PRICE REBALANCING

1.1 Overview

- 1.1.1 Royal Mail's application for price rebalancing sought to amend the sub-cap for all prices in Baskets A and B from 3% to 8.5%, as originally requested in the last price control review. This in the context of the average basket prices still moving by the overall controls of RPI-0.14 for Basket A and RPI-1.96 for Basket B such that the increase in prices within any basket from the higher sub-cap will be offset by greater price reductions elsewhere within the same basket.
- 1.1.2 Postcomm's document does propose to amend the sub-cap for 26 price points in Basket A and all price points in Basket B. It proposes to review the inclusion of the price elasticity in the volume and pension adjustments in the forthcoming price control.
- 1.1.3 Postcomm presents a restrictive accounting rule to assess what price restrictions should apply for Basket A, which does not take account of standard considerations that a commercial business, like Royal Mail, would need to factor in when setting its prices. While Royal Mail broadly welcomes Postcomm's proposals for greater price rebalancing for Basket A, Royal Mail proposes refinements to Postcomm's framework that take into account some of the wider commercial considerations. This has the effect of increasing Postcomm's proposed 26 price points with an 8.5% sub-cap to all price points within five of the 13 Controlled Services of Basket A (ie. about 50 price ranges).
- 1.1.4 There are several factors that need to be taken into account when setting prices - and these factors do not fit with narrow and overly prescriptive rules for setting prices and the sub-caps for those prices. Firstly, Royal Mail does not simply apply fully allocated costs per item as a means of setting its prices, as Postcomm implies within its document, but takes account of several factors. Royal Mail regards Postcomm's approach as narrow in focusing on fully allocated costs rather than broader aspects of commercial price setting. Secondly, Postcomm applies its approach in a prescriptive manner that narrowly looks at each individual price point. Royal Mail retains the view that the same sub-cap should apply to all price points within a basket as a means of facilitating the deployment of coherent commercial prices, reducing the reliance of specific cost allocation accounting rules, and recognising that the competitive market affects the prices of all services. Consequently, Royal Mail has also sought to develop from Postcomm's proposal to explain the influence of bringing a broader range of factors into Postcomm's proposed accounting approach which has the effect of increasing the number of price points to which 8.5% would apply back towards the full set of prices in the Basket A.
- 1.1.5 Postcomm's approach and review of the sub-caps for Basket B is broader and takes account of the market environment faced by Royal Mail for such services. As such

Royal Mail is pleased that Postcomm has accepted its proposals for all Basket B products to have sub-caps of 8.5% and agrees with Postcomm that this suite of products services competitive markets.

- 1.1.6 In addition to the application for a Direction to change the sub-cap under Condition 21(16), Royal Mail also sought to amend the calculation of the sub-cap through the inclusion of a price elasticity for the volume and pension adjustments. On this point, Postcomm's document proposes no change on the basis that this will be addressed during the forthcoming price control. Royal Mail sees no reason why this could not be addressed now through a Direction under Condition 21(16).

1.2 Legal context

- 1.2.1 As Postcomm explains in its consultation document, the price control limits overall the average price increases on Royal Mail's price controlled products, as well as limiting the increase in prices of individual products. The overall price cap means that, even if Royal Mail is permitted to increase the sub-caps (ie the prices of individual products) beyond the 3% currently specified in the licence, the overall limit on average price increases will still apply. So any resulting price increases will need to be compensated by price reductions elsewhere.
- 1.2.2 Postcomm accepts the irrefutable principle that "the sub-cap threshold should be set to allow Royal Mail to achieve cost reflective pricing", although it suggests that this is only for "major services". It would be inconsistent with the approach of the Postal Services Directive for a regulator to create a regulatory structure which prevents such cost-reflective pricing for universal services as Article 12 of the Directive requires, inter alia, that tariffs for universal services are "geared to costs".
- 1.2.3 Postcomm comments that its approach to cost reflectivity has to be seen in the context of its statutory duties and vision for the development of the mail market⁷. This is inconsistent with Article 12 of the Directive in so far as it means that Royal Mail is prevented from pricing universal services cost-reflectively.
- 1.2.4 Postcomm suggests in two places in its document that there are different approaches to cost reflectivity and that it may change its approach to the regulation of cost reflective pricing over time as competition develops. We would expect Postcomm's approach to cost reflectivity to be transparent and consistently applied. Whilst Postcomm may form a view as to whether Royal Mail's costing system accurately reflects costs, the principle of cost reflectivity is clear: if prices are not in line with costs Royal Mail should be allowed to correct those prices to bring them in line with costs. The only distinction to be made is as to whether costs should cover fully allocated costs or long run marginal costs.

⁷ See paragraph 2.15 of its consultation document

1.2.5 Futhermore, Postcomm’s suggestions imply that it is Postcomm’s objective to “promote effective competition, wherever it can”⁸. This disregards the fact that Postcomm’s primary duty is to ensure the provision of the universal service⁹. Subject to this duty, Postcomm is to exercise its functions in the manner best calculated to further the interests of users of postal services – and only where appropriate by promoting effective competition. In its original application and in this document Royal Mail demonstrates that the need to make the changes to the rebalancing sub-caps (and to the headroom) are directly related to the financing of Royal Mail and therefore of the provision of the universal service.

1.3 Basket A subcaps

1.3.1 Postcomm has applied a strict accounting rule to six controlled services using 2006/07 data to identify 26 price points in Basket A to propose that the sub-cap changes from 3% to 8.5% in these instances. The accounting rule identifies these points as having profit margins against fully allocated costs (as measured by Royal Mail’s current accounting system in 2006/07) as being -6% or worse. The points selected by Postcomm are shown in light shade (yellow) in Table 1.1.

Table 1.1: Postcomm’s proposed price points with sub-caps of 8.5%

		1C Stamp	1C Meter	1C PPI	2C Stamp	2C Meter	2C PPI
Letter	0-100						
Large Letter	0-100						
	101-250						
	251-500						
	501-750						
Packet	0-100						
	101-250						
	251-500						
	501-750						
	751-1000						

1.3.2 Royal Mail has four main observations on Postcomm’s selection of 26 price points within Basket A. Royal Mail believes that the rule for selecting the points needs to take account of the need to:

- (a) maintain price relationships;
- (b) consider the perspective at the end of the current price control;
- (c) consider other directly related prices; and
- (d) focus on Controlled Services.

These are discussed further below.

Maintaining price relationships

1.3.3 The accounting rule has been applied without having regard to commercial pricing and customer value considerations, such as in the relationship of prices between

⁸ See paragraphs 2.15 and 2.16 of its consultation document
⁹ S3(1) Postal Services Act 2000

meter, PPI and stamped items. Currently Royal Mail applies the same price to meter and PPI items; further the prices for meter and PPI do not exceed the stamped price. To maintain this commercial position at price points where Postcomm proposes that the sub-cap of one or other of the PPI or meter increases to 8.5%, the sub-cap of 8.5% needs to apply to the equivalent meter, PPI and stamped prices. This would lead to the addition of 5 price points: Letters 0-100g 2C PPI, Packets 101-250g 2C stamp, Packets 101-250g 2C meter, Packets 251-500g 2C meter, Packets 501-750g 2C PPI. These are highlighted in dark shade (green) shown in Table 1.2, in addition to Postcomm's proposed price points which are highlighted in light shade (yellow).

Table 1.2: Postcomm's proposed price points with sub-caps of 8.5% amended to take account of the need to maintain some pricing relationships.

		1C Stamp	1C Meter	1C PPI	2C Stamp	2C Meter	2C PPI
Letter	0-100						
Large Letter	0-100						
	101-250						
	251-500						
	501-750						
Packet	0-100						
	101-250						
	251-500						
	501-750						
	751-1000						

Note: Postcomm's original proposed pricing points are marked in light shade (yellow) and the additions are marked in dark shade (green)

End of the price control perspective

- 1.3.4 The accounting rule has been applied on the assumption that the sub-caps will lead to each of the price points in 2009/10 recovering its fully allocated cost. However, the fully allocated cost used in the rule is that of 2006/07 rather than 2009/10. Royal Mail expects the decline in mail volumes and down-trading to continue to over the period of the control. In such circumstances, the fully allocated cost per item could rise in 2009/10 relative to the position in 2006/07.
- 1.3.5 This effect is partially offset by efficiency gains and the volume adjustment mechanism - which provides an additional revenue allowance as volume falls to facilitate a partial recovery of the fixed costs. However, it is important to recognise that this mechanism has been set to facilitate the recovery of only part of the fixed costs. This is shown in Section 3.6. The reasons why it is only part and not full are outlined below:
- (a) the mechanism only changes the allowance on revenue and sub-caps when delivered volumes are over 2% adrift from Postcomm's projection as stated in Royal Mail's Licence.
 - (b) the mechanism values the fixed cost element only by reference to the price of downstream access services rather than end-to-end services.

- (c) the mechanism assumes 40% of costs are fixed, which is a long-run measure in the presence of volume growth, rather than a shorter term measure in the presence of volume decline.
- (d) the volume adjustment is lagged by a year such that the scope to recover the additional revenue allowance occurs a year after the fully allocated costs have moved.
- (e) the mechanism allocates the allowance into Baskets A and B, and the products in those baskets face different market conditions regarding price and the ability to recover that allowance.
- (f) the sub-cap adjustment of 'g' takes no account of price elasticity.

1.3.6 In addition to the above, Royal Mail has also made known its intention to develop its costing system to better reflect the commercial environment. Royal Mail expects this to be in place before 2009/10 and it is likely to lead to a greater allocation of fixed costs to these services.

1.3.7 In the light of these comments and, in particular, with a view to a more commercially orientated final proposal, Royal Mail believes it would be prudent for Postcomm to amend its approach to apply to price points in 2006/07 having a small positive margin of, say, 6% or less (rather than Postcomm's proposed -6% or worse). Royal Mail would expect this could still leave some of the price points within the six Controlled Services below the fully allocated costs in 2009/10, but should reduce the degree to which this occurs. The inclusion of these price points (combined with the commercial considerations above) are highlighted in dark shade (in green) in Table 1.3.

Table 1.3: Postcomm's proposed price points with sub-caps of 8.5% amended to take account of the need to maintain some pricing relationships and accounting for some of the changes to fully allocated costs in 2009/10.

		1C Stamp	1C Meter	1C PPI	2C Stamp	2C Meter	2C PPI
Letter	0-100						
Large Letter	0-100						
	101-250						
	251-500						
	501-750						
Packet	0-100						
	101-250						
	251-500						
	501-750						
	751-1000						

Note: Postcomm's original proposed pricing points are marked in light shade (yellow) and the additions are marked in dark shade (green)

Other directly related prices

1.3.8 The accounting rule has been applied to only six of the Controlled Services in Basket A. There are in fact thirteen Controlled Services in Basket A, two of which are Response Services 1C and 2C. The prices for Response Services take the prices

set for the 1st class and 2nd class PPI services and add an additional charge for the Response Service. The delivery service that customers receive is 1st or 2nd class. To maintain this commercial alignment sub-caps for Response Services should be the same as those for the 1st class and 2nd class PPI services. The inclusion of the Response Service price points is shown in Table 1.4.

Table 1.4: Postcomm’s proposed price points with sub-caps of 8.5% amended to take account of the need to maintain some pricing relationships, accounting for some of the changes to fully allocated costs in 2009/10 and including response services

		1C Stamp	1C Meter	1C PPI	2C Stamp	2C Meter	2C PPI	1C Response	2C Response
Letter	0-100								
Large Letter	0-100								
	101-250								
	251-500								
	501-750								
Packet	0-100								
	101-250								
	251-500								
	501-750								
	750-1000								

Note: Postcomm’s original proposed pricing points are marked in light shade (yellow) and the additions are marked in dark shade (green)

Controlled Services focus

1.3.9 When setting prices it is important that prices can be changed on a consistent basis to one another within a product’s price line, between weight steps and the formats at the same weight steps. As far as customers are concerned, there are a small number of services (1st, 2nd class and Response Services) with a number of different price points. Stamp, meter and PPI simply represent payment channels. It is also important to avoid over dependency on specific detailed information from a single year that may or may not recur. This leads to a helicopter - rather than excessively detailed - perspective with the scope to simplify the rule over the sets of price points to have a 8.5% sub-cap. Using this approach, Royal Mail proposes that the 8.5% sub-cap be applied to *all* price points within the following Controlled Services: First Class Stamp, Second Class Stamp, Second Class Meter, Second Class PPI and Second Class Response Service. This is shown in Table 1.5.

Table 1.5: Royal Mail’s price points with sub-caps of 8.5% for inland services proposed in response to Postcomm’s proposals following a focus on full sets of prices within Controlled Services

		1C Stamp	1C Meter	1C PPI	2C Stamp	2C Meter	2C PPI	1C Response	2C Response
Letter	0-100								
Large Letter	0-100								
	101-250								
	251-500								
	501-750								
Packet	0-100								
	101-250								
	251-500								
	501-750								
	750-1000								
	Over 1kg								

Note: Postcomm’s original proposed pricing points are marked in light shade (yellow) – with and the additions are marked in dark shade (green)

1.4 Basket B subcaps

1.4.1 Postcomm’s document proposes that the sub-cap for all Basket B prices is 8.5%. It sets out four arguments to support this position:

- (a) there is increased competition, mainly through access, for services in Basket B;
- (b) Royal Mail has under-recovered its allowed revenue in Basket B;
- (c) Royal Mail could reduce some retail prices in Basket B without reducing Access prices;
- (d) Condition 11 ensures Royal Mail has regard to whether any price reductions are anti-competitive.

1.4.2 Royal Mail agrees with these statements and welcomes the proposal to change the sub-cap for Basket B services from 3% to 8.5%. Royal Mail believes a sub-cap move from 3% to 8.5% for Basket B provides a measured regulatory change and welcomes it as a positive and first step towards further deregulation for this basket. Royal Mail offers some further points of clarification on the subject.

Competition

1.4.3 Basket B services relate to the end-to-end postal services for large, bulk mailers. These mailers have several options other than communicating through the use of mail. Increasingly these customers are using other forms of communication such as the internet. In addition, they have the option to undertake upstream activities and access Royal Mail’s network either directly (customer direct access) or via other upstream operators.

1.4.4 Since the ‘headroom’ is based on a percentage discount any increase in retail price will increase the absolute minimum difference between Royal Mail’s retail and Wholesale services and thereby enhance either the profit made by other operators

or the potential for customers to obtain lower prices. Further, any increase in retail prices that was accompanied by an increase in access prices could encourage competition for downstream activities.

Recovering allowed revenue

- 1.4.5 Mail volumes are declining and are expected to decline in ways that will cause the volume adjustment mechanism within the Licence to allocate more allowed revenue into Baskets A and B. While Royal Mail would hope to recover most of the additional allowance in Basket A, Royal Mail currently does not expect to be able to recover the allowance in Basket B (as customers are not prepared to bear price increases and have a viable option of switching to access) and this will mean that the under-recovery position in Basket B is likely to be sustained and grow through the remaining price control period. This is a direct consequence of the limited scope to increase prices discussed above.

2. PROPOSED LEVEL OF ACCESS HEADROOM

2.1 Overview

- 2.2.1 Postcomm's document indicates that it has carried out a margin squeeze test for assessing the level of access headroom (the extent to which regulated access prices have to be set below their retail counterpart) that is necessary in order to allow entrants to be able to trade profitably. The document is lacking any detail on the application of this test. The document does not confirm whether the current level of headroom is sufficient to allow an "as efficient" or "reasonably efficient" access operator¹⁰ to compete with Royal Mail retail and, if it is, to what level the headroom should be reduced.
- 2.2.2 Postcomm's document proposes no change to the level of access headroom from April 2008, and invites applications to review for April 2009. Postcomm's document recognises the need to take account of costs in assessing margin squeeze and setting the level of access headroom. However, Postcomm's proposal to delay to April 2009 is based on Postcomm's claims that:
- (a) Royal Mail has not achieved efficiency targets in 2006/07;
 - (b) Royal Mail has scope to increase retail and access prices;
 - (c) there remain several potential obstacles to entrants such as VAT, Royal Mail's QMP scheme and the forecasting requirements for access;
 - (d) the scale of the adjustments Postcomm considered it necessary to make to the cost data acceptable was excessive
- 2.2.3 Royal Mail questions in this section whether these are sufficient grounds for a delay to reducing the level of headroom until April 2009. The relevant question is whether the headroom is sufficient to allow an as efficient or reasonably efficient access operator to compete with Royal Mail retail and, if it is, to what level the headroom should be reduced. Given Postcomm's apparent use of an ex post margin squeeze test, Royal Mail questions whether the ex ante access headroom is required at all.
- 2.2.4 The application of a margin squeeze test requires an analysis of Royal Mail's costs. Postcomm's document portrays Royal Mail's costs for access in 2005/06 as inaccurate whereas, in reality, both Postcomm and Royal Mail identified adjustments that could and have been made to the reported costs (taken from Royal Mail's costing system), but Postcomm has not taken the opportunity in its consultation document to clarify what adjustments, in its view, should be made for the purpose of its application of a margin squeeze test. Further, Postcomm has not set out how these costs of Royal Mail, should, in its view, be adjusted (if at all) to reflect those of an as efficient or reasonably efficient access operator.

¹⁰ These are two alternative standards proposed for a margin squeeze test by case law.

2.2.5 In Royal Mail's March 2007 application for review of the headroom margins we made clear our belief that the existing level of access headroom margins:

- distort competition;
- disadvantage mail users;
- unwarrantedly go beyond competition law tests for margin squeeze;
- are inconsistent with the principles of good regulation; and
- encourage inefficient entry beyond appropriate levels.

2.2.6 Nothing in Postcomm's document dissuades us from continuing to believe that these issues remain. In fact, there is much in Postcomm's proposals documents that confirms our beliefs.

2.2.7 Postcomm's proposals for access headroom continue the market distortions that have lead access volumes to exceed those forecast by Postcomm when setting the control. They prevent Royal Mail's prices from becoming more cost reflective - particularly in Royal Mail's prices to very large customers, most of whom are now using access products. A proportionate regulatory response would be to use an ex post margin squeeze test and remove the current artificial headroom constraint altogether.

2.2 Efficiency

2.2.1 Royal Mail has achieved the 3% efficiency in 2006/07 assumed by Postcomm in setting the control. This is discussed more fully in Section 3. As such Royal Mail does not regard this as a reason to continue with the current level of headroom. Further, a margin squeeze test would consider the "as efficient" and "reasonably efficient" access operator.

2.3 Price Changes

2.3.1 Postcomm's document at paragraph 5.33 confirms that Royal Mail has limited scope to increase retail and access prices. Postcomm's document at paragraph 5.34 then refers to the scope for Royal Mail to increase access prices to recover Wholesale's fully allocated costs.

2.3.2 Royal Mail confirms that the scope for it to increase prices for access services and their equivalent retail services is limited. Royal Mail finds that the scope for Wholesale to increase its prices unilaterally is not material, because access prices are currently at or close to the level of the maximum allowed access prices (a constraint imposed by the headroom requirement). Further, an increase in the prices of retail services and their equivalent access service will lead to an increase in the absolute price difference. This would allow other operators to offer the same prices and increase mail volume or increase their prices to increase their profit, or some combination of the two. It would not resolve the distortions created by the current headroom.

2.3.3 Postcomm's primary duty is to ensure the provision of the universal service. Royal Mail would expect this to lead Postcomm to focus on the finances of Royal Mail Retail and Wholesale services combined, (along with the regulated services, the universal services and Royal Mail Group Limited) as it did in setting the current control, rather than the finances of any other part of its business.

2.4 Barriers to entry

2.4.1 Postcomm's document confirms that access volumes have been greater than it forecast at the time of setting the control. As Postcomm note this is prima facie evidence that the current headroom is at least sufficient for entry. Since access volumes have exceeded Postcomm's expectations, Royal Mail concludes that the current headroom levels are in fact more than sufficient and, in fact, excessive.

2.4.2 Postcomm's document refers to potential barriers to entry in respect of VAT, Royal Mail's QMP scheme and practices regarding forecast access volumes. However, Postcomm presents no evidence that these are material. Indeed, the fact that access volumes have exceeded Postcomm's expectations is evidence that, even if they exist, these are not material barriers to entry (if indeed they are real barriers).

2.4.3 In respect of VAT, the exemption derives from UK law which, in Royal Mail and HM Treasury's opinion, is consistent with the Sixth VAT Directive, in that Royal Mail is the body authorised to supply exempted services and Article 13A(1)(a) of the Directive mandates the exemption from VAT of all postal services supplied by Royal Mail. This issue is being considered by the European Court of Justice.

2.4.4 Postcomm incorrectly describes the forecasting requirements in the access contracts as "**additional**" when, as Postcomm is aware, they are in fact similar to those which exist in Mailsort contracts¹¹. The Mailing House (QMP) scheme is only

¹¹ For the avoidance of doubt, in terms of forecasting arrangements for retail customers, the Mailsort User Guide states:

"If you are posting continuously (daily) or regularly (at least once a week), you do not need to notify us of individual mailings. However, you should provide your local Accepting Office with a rolling forecast of the daily, weekly or monthly postings as appropriate.

Regular planning meetings should be scheduled to allow both parties to identify the resources required for the week or month ahead.

If you're a less regular user of our range of services, you must provide at least two working days' notice of intention to post. This will enable our Accepting Office to provide the appropriate resources."

Basic forecasting information is essential if Royal Mail is to avoid staffing up for levels of traffic which fail to materialise or find that there are insufficient resources to process unexpectedly high volumes of mail. Access contracts require two forecasts, namely (a) a weekly forecast and (b) a 24 hour forecast. There is no contractual sanction for an inaccurate weekly forecast although we expect all customers to provide a weekly forecast in good faith, thus any suggestion that this is in any way a barrier to entry is misconceived. The 24 hour forecast is important as this information is used by Mail Centres to plan their resource deployment. The contract is flexible in that the 24 hour forecast has to be accurate within 15%, leaving it open to Royal Mail to decline to process mail in excess of 115% of the forecast if sufficient resources are not available. While we always try to process mail received under access contracts wherever possible, there have been rare instances

relevant at a retail level and does not entail discounts. Postcomm has carried out a preliminary investigation into the scheme (which raised the question around whether it created a distortion between Wholesale and Retail) and found insufficient reason to conduct a full investigation.

- 2.4.5 Further, while Postcomm recognises that the change to the level of access headroom would, within Royal Mail's modelling results, suggest a levelling off of access volumes for the remainder of the current price control, the same modelling results would suggest an increase in bypass. Consequently, entrant volumes would continue to grow¹².
- 2.4.6 Finally, Postcomm's document recognises that there is some variability in the level of cost difference between the various access products and the nearest end-to-end equivalent product. This suggests that there is some distortion in the market caused by the current level of access headroom, and that these distortions are likely to remain while the level of headroom remains unaltered.
- 2.4.7 Hence, in following a detailed and intricate costing process, Postcomm appears to have missed the opportunity to standardise the headroom across products and to reset these to more appropriate levels for April 2008. It has not acknowledged that continuing to set a headroom retains market distortions, which affects innovation and cost reflective pricing, particularly to its very large customers, most of which are now using access products.

2.5 Data evidence

- 2.5.1 Postcomm's document raises concerns over the data quality of Royal Mail's access costs. Royal Mail has concerns over the reporting of the facts in this case and the absence from Postcomm of a clear statement of the adjustments to Royal Mail's access and retail costs that Postcomm views as necessary to undertake a margin squeeze test.
- 2.5.2 The Licence refers to the possibility of a review of the level of access headroom for April 2008. This encouraged Royal Mail, TNT and UK Mail to make applications for a change to the level of headroom during 2006/07 when only audited information for the full year 2005/06 was available. Hence applications were made on this basis and with the expectation of being able to update to 2006/07 as and when that information became available.

where specific Mail Centres have had to decline to process large volumes of access mail that they were not expecting at all. This problem is further exacerbated where mail was forecast to be machineable but in fact turned out to be non-machineable.

In terms of very large, infrequent volumes ("Key National Postings") both RM Wholesale and RM Retail liaise with our respective sending customers well in advance, typically two or three months prior to the posting date.

¹² By excluding the impact of bypass in Table 9 of their document, despite having the data, the presentation of the impacts of Royal Mail's proposals by Postcomm is materially misleading.

- 2.5.3 During 2006 and prior to any application to change the level of headroom, Postcomm asked its consultant (Brockley Consulting) to undertake a detailed review of the 2005/06 costing system. As part of that review a comparison was made between each access product and its nearest retail equivalent. During the discussions at that time it was accepted by both Royal Mail and Postcomm's consultant that irregularities might well be expected in any such assessment, due to both the granularity of Royal Mail's costing methodology and the relatively new concept of access in the operation.
- 2.5.4 After Royal Mail submitted its application for a change to the level of headroom, Postcomm advised Royal Mail of its consultant's preliminary review and conclusions of the changes that needed to be made to the 2005/06 costs. This identified several adjustments that, when applied, would lead to a reduction in the cost differential claimed by Royal Mail.
- 2.5.5 At Royal Mail's request a meeting was held between Postcomm's consultant and Royal Mail at which the consultant explained his findings. At that meeting Royal Mail emphasised the need for Postcomm to take account of 2006/07 data and costs, but at the time Postcomm wished to focus on 2005/06 costs. Following that meeting, Royal Mail informed Postcomm that while its consultant had identified some adjustments that would reduce the difference in costs, there were further adjustments that it had not identified but which were necessary, and that when these were applied the difference in cost returned close to the levels originally claimed by Royal Mail.
- 2.5.6 The adjustments identified by Postcomm's consultant and those identified by Royal Mail were found after Royal Mail's unaudited half year 2006/07 results were submitted to Postcomm. Hence the half-year 2006/07 figures reflected unadjusted costs. The adjustments were known and applied to the full year 2006/07 data at a high level. More detailed cost allocations by access product required detailed revenue derived volumes to be formed for 2006/07,
- 2.5.7 Royal Mail does not find the scale of the adjustments being made and the differences between the half-year and full year 2006/07 costs to be reasons to delay changing the level of access headroom. Postcomm itself initiated the need to apply adjustments to Royal Mail's costing system. Postcomm was also aware of the fact that the unaudited half year 2006/07 data was unadjusted, the full-year 2006/07 data was adjusted and the revenue derived volumes were not available at the time of Postcomm's request for this information.
- 2.5.8 Further, in arriving at its conclusions, Postcomm appears to have simply projected forward its adjusted 2005/06 fully allocated unit costs of Access products to an estimated 2006/07 level using an approach that does not fully allow for the actual changes to costs and volumes that occurred between the two years. The effect of this is just as significant (if not more so) than any issues related to the 'high degree

of uncertainty' in Royal Mail's data¹³. As a result, conclusions using Postcomm's estimated 2006/07 figures must be treated with a great deal of caution and arguably should not be relied upon.

- 2.5.9 Royal Mail has already advised both Postcomm and the public that it is revising its costing system to reflect better the commercial environment Royal Mail now faces. This may affect the allocation of costs between access and retail services and needs to be taken into account in any change to the level of headroom whether in April 2008 or April 2009. While Royal Mail looks to prepare this information to the standards required by Postcomm, Royal Mail requests that Postcomm inform Royal Mail of the final set of adjustments for access services it believes to be necessary to apply to Royal Mail's costing system for application, in Postcomm's view, in a margin squeeze test. This can then inform discussion and avoid delay at a later stage.

2.6 Retail offers

- 2.6.1 Postcomm's document does not include an explanation of how the Licence potentially limits Royal Mail's ability to introduce a new product variant with a reduction in the price of an existing service based on greater avoided upstream costs. If that new product or variant is or is deemed to be substantially similar to the existing product, the reduced price would also cause the access price to reduce, via the headroom constraint. For example, if a new product involved reduced upstream costs (eg, in collection only), Royal Mail would be forced to pass on such upstream cost savings to its downstream prices even through the (collection) activity forms no part whatsoever of the downstream product. Royal Mail believes that a requirement to pass on upstream savings into downstream prices as required under Condition 21(5b) is irrational, prevents cost reflective pricing and prevents Royal Mail retail from legitimately competing in the market.

- 2.6.2 Royal Mail has sought clarity on Postcomm's approach to determining whether services are inside or outside of the control, as this can materially affect the business cases for such proposals. Royal Mail believes that there should be scope for Royal Mail to introduce new products that are based on avoided upstream costs on the basis that they are then treated as being outside of the price control and thereby avoid any consequential change to the level of access prices.

2.7 Competition law

- 2.7.1 Postcomm's document refers to Postcomm using the margin squeeze test to assess the appropriate level of access headroom to apply under Royal Mail's Licence. It has therefore applied an ex-post regulatory test to review and potentially determine the ex ante regulatory requirement of the access headroom within Royal Mail's Licence. Since the ex post test of margin squeeze applies under competition law irrespective of an ex ante regulation, it does raise the question of whether Licence

¹³ Paragraph 5.14 of Postcomm's document.

Condition 21(5b) is surplus to regulatory requirements and not in accordance with the Principles of Good Regulation adopted by the Better Regulation Commission. Postal services regulation should intervene no more than is proportionate to safeguard the provision of the universal service – Postcomm’s primary duty. On this basis, Postcomm should justify the need for an ex ante headroom constraint and justify why the current level of the headroom is correct.

- 2.7.2 Indeed, if a competitor felt that the existing headroom was too low and really infringed competition law, as other applications may imply, then as an alternative to its application to change the level of headroom with Postcomm the competitor could also pursue its case under competition law. It is then interesting to note that no such case has been raised to-date.
- 2.7.3 Further, the calculation being considered by Postcomm looks at the level of headroom as a fully allocated cost of upstream costs. The European Postal Services Directive¹⁴ requires prices to take account of “avoided costs” which can legitimately be read as marginal costs. Indeed, Royal Mail’s use of fully allocated costs for upstream cost within its original application of March 2007 may be viewed as conservative.
- 2.7.4 Royal Mail, as the universal service provider, should be allowed flexibility to respond to competition to safeguard its ability to provide the universal service and to safeguard its own competitive position. This is consistent with competition law and the Postal Services Directive – the provisions of Condition 21(5b) severely restrict Royal Mail’s ability to do so.

¹⁴ 97/67/EC – Article 12.

3. ROYAL MAIL'S FINANCIAL CONTEXT

3.1 Overview

- 3.1.1 Postcomm presents a partial and confused reconciliation of the costs it allowed in setting the control to the actual outturn figures in 2006/07. This suggests there are significant gaps between actual costs and allowed costs, and an efficiency estimate of 1.9% in 2006/07 compared to a regulatory target of 3%.
- 3.1.2 Royal Mail has undertaken its own reconciliation of the costs allowed by Postcomm in setting the control and the outturn for 2006/07, the results of which show very limited unexplained differences. We have also used Postcomm's own methodology to demonstrate that Royal Mail achieved the 3% efficiency target set by Postcomm.
- 3.1.3 In fact, in 2006/07, Royal Mail observed a revenue reduction of nearly £300m relative to Postcomm's allowed revenue, on a comparable basis. Postcomm's document confirmed that, in setting the price control, underlying Royal Mail Letters' costs were understated by over £100m in 2006/07 and further understated by about £70m if cost shocks and compensation for operational vehicle and employee accidents are taken into consideration. While some other factors offset some of this in part, the fact is that after just one year of the four-year price control, the cash outflow position assumed by Postcomm in setting the control, is significantly weakened for the regulated services, with consequential effects on the finances of Royal Mail Group Limited as licence holder and provider of the universal service in the United Kingdom.

3.2 Updating Postcomm's allowed costs

- 3.2.1 Royal Mail reviewed Postcomm's summary of the financial context and its reconciliation between the allowance for costs and actual costs as presented in Table 1 of its consultation document. The table presents a confused picture of both costs allowed for in the control and the reconciliation of those costs to actuals. Part of this may have arisen from the categorisation used in Table 1, and so we undertook the reconciliation using categorisations more familiar to those within Royal Mail's business.
- 3.2.2 In January 2006 Postcomm published LECG's report stating a 'base line' cost of £5908m 2005/06 (in 2004/05 prices)¹⁵. In the same document Postcomm published a base-line cost of £5877m for 2006/07 (in 2004/05 prices) and Postcomm's original nominal figure was £6198m¹⁶. However, Postcomm also assumed an efficiency of 3% per annum during the price control. Hence the £6198m figure would be adjusted to £6023m, after efficiency is applied to the non-

¹⁵ LECG's document "Base Year and Baseline Final Conclusions" January 2006 in Table 18.

¹⁶ Postcomm assumed 2.5% and 2.89% inflation rates for 2005/06 and 2006/07 respectively.

pension element of costs for 2006/07. Consequently, the figure of £5905m in Postcomm's Table 3.1 of its Interim Review document is understated by £118m – or £119m in actual 2006/07 prices.

3.2.3 Royal Mail would also contend that these figures are understated further because they exclude some costs that should have been allowed. For example, all 'compensation' costs were disallowed as if these were payments made by Royal Mail to postal customers, whereas in fact part (approximately £35m in 2005/06) of the 'compensation' costs reflect payments made arising from uninsured claims (eg. vehicle and employee accidents) incurred in undertaking the day-to-day operations of the business. However, these issues are put to one side here for the purpose of reconciling figures and estimating efficiency.

Table 3.1 Updated calculation of Postcomm's expected costs (£million) for Royal Mail Letters when setting the control (£million)

Royal Mail Letters business	2005/06	2006/07
For costs in 2004/05 prices		
LECG's base line costs	5908	5877
Volume adjustment ¹⁷	44	-40
Pension costs (excluding pension deficit)	-293	-332
Sub-total before efficiency	5658	5505
Assumed efficiency adjustment of 3%	0	-165
Sub-total excluding all pension costs (2004/05 prices)	5658	5339
Pension costs (excluding pension deficit)	293	332
Pension deficit costs	122	308
Sub-total including all pension costs (2004/05 prices)	6074	5980
Inflation adjustment	157	389
Sub-total including all pension costs (nominal prices)	6234	6367

3.2.4 In Table 3.1 the starting costs for 2005/06 and 2006/07 from LECG's report are adjusted for the volume outturns. This volume adjustment uses the approach adopted by Postcomm applying its long run marginal cost (LRMC) per item factors to account for cost changes. The on-going pension costs are then excluded and the efficiency target of 3% is then applied and the assumed saving deducted. This forms an allowed cost for Royal Mail, excluding pension costs, of £5339m in 2006/07 (in 2004/05 prices). When the full pension costs (including pension deficit) are added back and adjusted to nominal prices, the allowed cost is £6367m.

¹⁷ The long run marginal costs used by LECG and Postcomm in setting the control originally gave an LRMC estimates of £3766m for 2005/06 on their forecast volumes for which the figure is £3811m on outturn volumes (both in LECG's original 2005/06 prices). For 2006/07 the corresponding figures are £3717m and £3676m (both in LECG's original 2005/06 prices).

3.3 Comparison of outturn costs to the costs expected for Royal Mail Letters by Postcomm (£million)

3.3.1 Table 3.2 shows a reconciliation of the figures from Royal Mail's operating costs in its Regulated Accounts to the costs forecast by Postcomm updated for outturn volumes (as shown in Table 3.1).

Table 3.2 Actual costs reconciled to Postcomm's calculation of allowed costs (£million)

	2005/06	2006/07
Royal Mail actual costs per Regulated Accounts	6622	6769
Less		
P&L pension costs	465	629
Cash pension costs (Postcomm's allowance including pension deficit ¹⁸)	-426	-682
Interbusiness cost (equivalent to interbusiness income)	112	106
Regulated Account depreciation	123	142
Additional inter-business depreciation	28	28
One off costs	25	62
Compensation	63	42
Additional labour cost	12	12
Other (cost shocks) ¹⁹		34
Net actual cash costs	6220	6396
Difference	14	-29
Net allowed cash costs (from Table 1.1)	6234	6367

3.3.2 For 2005/06 the figure of £6220m in Table 1.2 corresponds with the updated Postcomm allowance apart from £14m. For 2006/07 the figure of £6396m in Table 3.2 exceeds the updated Postcomm allowance by some £29m. This is a significantly closer reconciliation than shown by Postcomm in its Interim Review document and supports Royal Mail's understanding of allowed costs.

3.4 Efficiency

3.4.1 There are several ways in which an efficiency estimate could be calculated. For 2006/07 Royal Mail estimates the efficiency to be around 3% when applying long run (rather than short turn) marginal cost factors to take account of the volume change. Table 3.3 shows a calculation of efficiency from the actual costs in 2005/06 and 2006/07. This calculation yields an efficiency estimate of 2.6% using Postcomm's long run marginal cost factors. Separately, using actual long run marginal cost factors from 2005/06 and actual volumes and Postcomm's methodology adopted in its consultation document, Royal Mail calculates the

¹⁸ Postcomm's allowed figures are used in this table for comparison with Table 1.1.

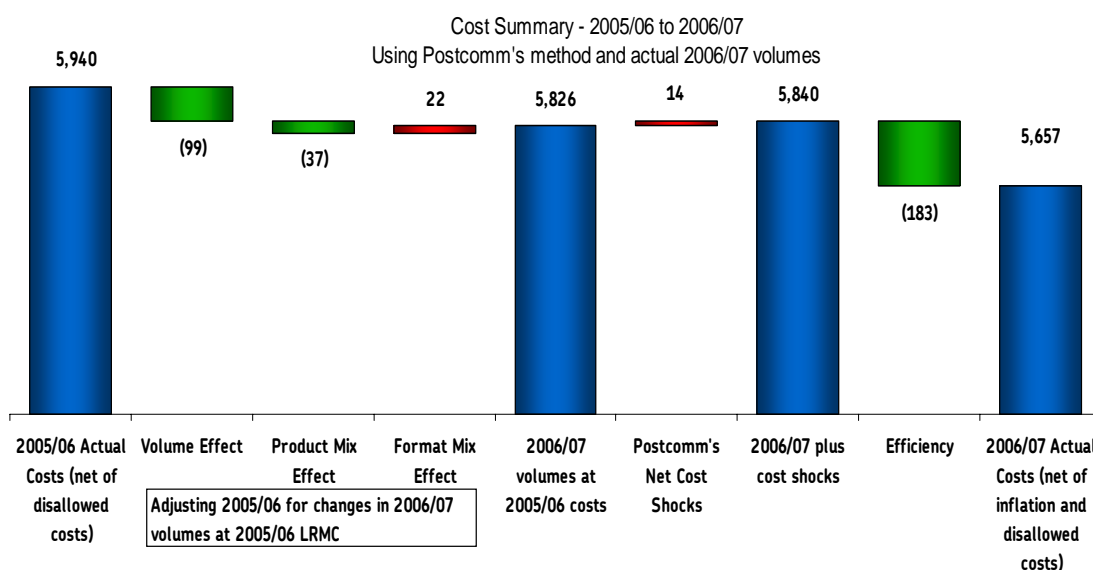
¹⁹ This includes both a step change in fuel costs (£14m) and terminal dues (£20m) for 2006/07. It excludes any cost shocks in 2005/06 that, if present, could also carry through into 2006/07 when compared to Postcomm's allowed costs.

efficiency to be 3.1% as shown in Figure 3.1. Hence, when applying Postcomm's assumptions of the long-run marginal cost adjustments for volume, Royal Mail estimates the efficiency in 2006/07 to be 3%, and significantly above the 1.9% estimated by Postcomm.

Table 3.3 A calculation of efficiency 2006/07 from cash costs using Postcomm's long run marginal cost factors

	Actual 2005/06	Actual 2006/07
Cash costs with pensions (nominal) - £m	6220	6396
Less pension cash costs (nominal) - £m	426	682
Cash costs less pensions (nominal) - £m	5794	5714
Inflation factor		1.0373
Plus volume/mix adjustment ²⁰ (nominal) - £m		135
Adjusted cash costs less pensions (real) -£m	5794	5644
Efficiency		2.6%

Figure 3.1 Cost summary for 2005/06 to 2006/07 updating for Postcomm's method and actual 2006/07 volumes



3.4.2 Royal Mail notes that this calculation assumes that the volume adjustment should take account of the long-run marginal cost impact on costs of different volume levels and mixes. Footnote 31 in Postcomm's document states:

"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".

²⁰ See footnote 17.

- 3.4.3 The Licence makes no requirement for Royal Mail or Postcomm to calculate the efficiency under this assumption. The 60% factor was used by Postcomm in its calculations for setting the allowed revenue and its value formed part of the volume adjustment mechanism. It was not accepted by Royal Mail as a means of calculating the allowed revenue or efficiency in the presence of volume decline. Indeed,
- (a) Postcomm's forecast did not assume a volume decline in its main calculation of allowed revenue;
 - (b) It takes time to identify real volume movements in the volatile markets we operate in. Importantly, the volume decline accelerated during the year of 2006/07, as Postcomm has now recognised.
 - (c) Royal Mail would expect any adjustment to apply a short-run marginal cost type adjustment within a year, rather than a long-run marginal cost factor that clearly, and by definition, applies only in the long run. In volume decline the cost of extracting costs (through for example voluntary redundancy) becomes significant;
 - (d) The impact of the market change has accelerated over the year. This reduces the scope to respond further.
- 3.4.4 During the last price control review Royal Mail assumed no change would happen in one year, with the long run marginal cost factor applied 50:50 over the subsequent two years. This is supported by papers from Royal Mail and external experts presented to Postcomm in February 2005. Royal Mail would expect the efficiency estimate to exceed 3% if this approach were taken.

3.5 Innovation

- 3.5.1 Since March 2006, Royal Mail has issued twenty-four Condition 7 notifications of new product launches and product changes. These include seven new products - including Postal Voting, Automated Standard Tariff Large Letters, Business Mail Secure and Cleanmail Advance. The needs of the fulfilment market and online packet order market have been specifically addressed through Royal Mail Heavyweight, and Royal Mail Tracked. In addition Early Collect, Early Extraction and Pre-Sorted Delivery have been converted to full product status. Royal Mail has changed its pricing structure to reflect size as well as weight for many of its inland services. Royal Mail has changed some non-price terms to facilitate on-line billing and purchasing (Smartstamp and Online Postage) and streamline its operations (eg. Minimum order value).
- 3.5.2 Online Postage was launched in June 2006 in response to customer demand for subscription-free, easy access to postage. This offering was a runner-up in the Revolution awards in the Business to Consumer Innovation category. In March of

this year Online Postage was integrated into E-bay so that the needs of this growing segment of the fulfilment market have easy access to both Royal Mail and Parcelforce Worldwide products. Special Delivery's recently introduced Saturday Guarantee accounts for 10% of Post Office Limited's Friday retail sales. Redeliveries can now be arranged online. Safeplace and an alternative delivery option have been introduced to improve first time delivery. These many examples demonstrate that Royal Mail has far from been lacking in innovation.

- 3.5.3 Royal Mail's ability to deliver innovation and to legitimately respond to competition in the mails sector and wider communications or fulfilment markets is however constrained by its licence and regulatory action. Royal Mail has sought to change its charging for non-universal services to better reflect costs. It has sought to introduce longer-term contracts and looked into the potential for offering discounts when costs are avoided upstream. It has sought clarity from the regulator on Postcomm's approach to determining whether new services are inside or outside of the price control, which can materially affect the business cases for such new services. It has to publish changes to prices 3 months ahead of their implementation – even for products in competitive markets²¹. In each of these areas Postcomm has recently hindered, or continues to adversely affect, Royal Mail's innovation in segments of the market where the changes sought would not have a material effect on competition.
- 3.5.4 Postcomm makes specific reference to fulfilment and unaddressed mail markets as areas where Royal Mail has lacked innovation and where – it suggests – Royal Mail's market share has reduced. In practice, Royal Mail has introduced new services to address these markets and continues to develop services to bring to market, subject to the regulatory constraints and uncertainties it faces.
- 3.5.5 In respect of the fulfilment market, Royal Mail grew its market share in the highly competitive UK domestic parcels market over 2006/07. Postcomm's document is based on figures for Royal Mail's Standard Parcel Service. Postcomm is mistaken in its view that the Standard Parcels Service is Royal Mail's offering to the fulfilment market which is primarily a market for business to consumer packets. Overall Royal Mail Letters has seen a growth in packet postal items in 2006/07. Parcelforce Worldwide has also grown its market share in the highly competitive UK domestic parcels market over 2006/07. Parcelforce Worldwide parcel volumes grew by 10% (comparing 2005/06 and 2006/07 financial years) and they are currently showing a 17% year on year increase. This is reflected in the figures produced by the Parcels Market Analysis programme, an independently run benchmarking programme²²,

²¹ Royal Mail can seek exemption from this requirement. To-date Royal Mail has applied for exemptions under Condition 7 for Sameday, Branch Direct, Postal Voting and International Bulk Mail.

²² These constitute the key carriers that PFW competes with on a daily basis. Data received from carriers is then aggregated, and from this it is possible to form an accurate picture of how relative market shares have changed, judged against this universe of carriers. Carriers involved in the Programme are: DHL, TNT, Parcelforce Worldwide, Royal Mail Special Delivery, Lynx, UPS, Parceline, Interlink, City Link, Target, ANC, Amtrak, Business Post.

which relies on revenue and volume data submitted in confidence by 13 major UK carriers, including all of the top 10. This programme indicates that the Parcelforce Worldwide market share by volume has grown by over 6% from 7.8% to 8.3% overall relative to these other carriers over the last financial year.

- 3.5.6 Only in unaddressed/leaflet mail has Royal Mail failed to keep up with market growth – and Royal Mail intends to seek to reverse that position by removing the capacity constraint imposed by current union agreements.
- 3.5.7 Alleged lack of innovation is not an explanation for Royal Mail's declining financial performance. We continue to play a leading role in making mail (including parcels) a successful medium in communications and fulfilment – despite the many restrictions in the licence.

3.6 Royal Mail's financial position

- 3.6.1 In 2006/07 the price controlled area made a loss of £12 million compared to a profit of £779 million²³ predicted at the time of the last price control review – despite Royal Mail meeting the efficiency targets on which the price control is predicated.
- 3.6.2 In 2006/07 Royal Mail has experienced a revenue reduction of £280m relative to Postcomm's allowed revenue, on a comparable basis. Even when under-recovery (£114m), the volume adjustment allowance (£27m) and Postcomm's adjustment to costs (£43m) are applied, this still means an adverse, underlying cashflow impact of £96m.
- 3.6.3 Further, and as discussed in earlier in this section. Postcomm understated the allowed by £119m in 2006/07, based on underlying costs, and this is further understated by about £70m when cost shocks and compensation for operational accidents are taken into consideration.
- 3.6.4 It is noted that these effects are all before any consequences of industrial action on quality of service. Such action may cause a further deterioration in the cashflow position over the period of the price control.
- 3.6.5 These factors combined result in an underlying adverse cashflow position of about £285m per annum through the control period to 2010 relative to Postcomm's projection in setting the price control. This appears to have been offset by about £215m of additional non-Controlled Service revenue over that assumed by Postcomm in 2006/07, which may or may not continue to 2010. This would yield a net adverse cashflow impact on Royal Mail of about £70m per annum through the control, on the assumption that the non-regulated revenue continues in future

²³ "Royal Mail Price and Service Quality Review: Final Proposals for consultation", Table 10.1, Postcomm, December 2005.

years. Given that Postcomm projected a Royal Mail Letters' cashflow of £953m over the four years to 2010, its update, other things being equal, would yield a cashflow of about £670m over the period of the price control.

- 3.6.6 Further, the cashflow position for the services regulated by Postcomm is significantly more adverse than that for Royal Mail Letters as a whole. The regulated accounts show the price controlled area to have a c.£200m adverse operating profit before exceptionals relative to Royal Mail Letters²⁴. Compared to the positive cash inflow of £907m²⁵ for regulated activities projected by Postcomm for the four years to 2010, its update, other things being equal, would yield a significantly lower cash outflow - and potentially a negative cash outflow over the period of the price control.
- 3.6.7 As such Royal Mail's regulated activities would have a significantly lower cashflow position than that projected by Postcomm when setting the control. And overall the adverse cashflow impact on Royal Mail would mean that it is unlikely to get close to an investment grade credit rating by the end of the period - which was one of Postcomm's key objectives in setting the last price control. Postcomm has a duty under the Postal Services Act (Section 5(a)) to have regard to the ability of licence holders to finance the activities authorised or required by the licence. This obligation is even more important in relation to the finances of the universal service provider as an inability to fund the provision of the universal service (in the short or long term) will impact on Royal Mail's ability to provide the universal service. The cashflow position of Royal Mail's regulated activities will have a material impact upon the Royal Mail Group's finances, and hence on the Group's ability to invest in services relating to the future provision of the universal service. As it is Postcomm's primary duty to ensure the provision of the universal service, Postcomm must pay full regard to this in exercising its functions.
- 3.6.8 The price control set by Postcomm 18 months ago was set on assumptions that are very different to the market reality confirmed in 2006/07 and which continues to-date. Royal Mail has met the efficiency targets, has actively sought innovations and sought, through the Interim Review applications, to offset the adverse effects of the changing market. Postcomm has proposed some changes in the Interim Review in respect of price rebalancing and financial compensation arrangements and Royal Mail welcomes these changes.
- 3.6.9 However, Postcomm's document appears to have an incomplete understanding of Royal Mail's financial position and, the impact this has on the provision of the universal service. In making its final decisions in respect of Royal Mail's applications, Postcomm needs to have greater regard to these aspects as it seeks to fulfil its primary duty of ensuring the provision of the universal service and its obligation to have regard to the need to ensure that Royal Mail can finance its activities.

²⁴ The USO area has a £167m adverse operating profit before exceptionals relative to Royal Mail Letters.

²⁵ Table 10.1 of Postcomm's final proposals document, December 2005