

**CWU SUBMISSION ON
REVIEW OF ROYAL MAIL'S PRICING FLEXIBILITY AND THE LEVEL OF
ACCESS HEADROOM: POSTCOMM'S PROPOSALS**

Introduction

1. The Communication Workers' Union (CWU) represents around 250,000 employees in the postal, telecom and related industries. It is the recognised union in the Royal Mail Group for all non-management grades, including those responsible for the collection, sortation and delivery of letters and parcels.
2. On 22 March 2007, following requests from Royal Mail, UK Mail and TNT Post, Postcomm wrote to mail operators and other interested parties to inform them that it had started a review of two key features of Royal Mail's 2006-2010 Price and Service Quality Control. Postcomm sought views on the following:
 - a. the size of the headroom available to those using Royal Mail's downstream access service; and
 - b. Royal Mail's pricing rebalancing flexibility within, and between, its captive and non-captive tariff baskets.
3. Following the initial consultation, Postcomm is seeking views from stakeholders on the following proposals:
 - a. an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year on all products in the 'non-captive' basket B;
 - b. a similar increase in the 'captive' basket A, but subject to the restriction that it can only be applied to product prices currently at least 6% below fully allocated costs. The main change to public stamp prices would be

to enable a maximum second class letter price increase from 24p in 2007/08 to 29p in 2009/10;

- c. no change to the access headroom in April 2008; and
- d. no extension to the scope of headroom regulation to more products as requested by TNT Post and UK Mail.

CWU Response

4. The CWU made clear in its previous submission to Postcomm that we see the requests from Royal Mail, and its competitors TNT and UK Mail, as indicative of a more fundamental problem with the regulation of the UK postal market. Postcomm's last price-control was predicated on a number of false assumptions. Contrary to the regulator's forecasts, mail volumes have declined, downstream access volumes have grown faster than anticipated and end-to-end competition has not developed as expected.
5. While we welcome the opportunity to revisit the issues of access price headroom and price-rebalancing ahead of the next price-control, we do not believe the scope of the review is sufficient and are disappointed that Postcomm has chosen to delay any move on access price headroom until April 2009 at the earliest. We are therefore continuing to call for a full parliamentary review of the impact of liberalisation to date – in line with the Government's manifesto commitment. This review should look at the role of the regulator in defending the USO and give serious consideration to a Universal Service Support Fund to help finance Royal Mail's future universal service obligations.

Access headroom

6. The CWU is disappointed that Postcomm has chosen not to reduce the access headroom level (the controlled margin between the prices Royal Mail can charge for access retail products). Downstream access is now well established and is expected to account for 40% of Royal Mail's bulk mail volumes this year, causing the business to lose revenue at an unprecedented

rate, far in excess of Postcomm's projections. Moreover, and also contrary to Postcomm's forecasts, mail volumes are also now falling and further exacerbating the situation.

7. By rejecting Royal Mail's request and pushing back the earliest opportunity for a change on access price headroom, we believe Postcomm is not acting in the interests of customers, Royal Mail or the wider postal market. Current access prices are not allowing Royal Mail to recover its costs. The business is also unable to increase access prices without similarly increasing retail prices, preventing them from passing on upstream cost savings to retail customers and thus preventing Royal Mail's competitors from enjoying lower prices. It is also allowing Royal Mail's customers to continue to benefit from unsustainable business models based on false cost assumptions that are not in their or the customer's long-term interests. We strongly believe that the margin should be based on the genuine cost difference between retail and wholesale products.
8. The CWU is very disappointed that Royal Mail has failed to provide Postcomm with sufficient robust and up-to-date information to allow the regulator to be confident of current product unit cost for access items. This is unfortunate as it is in nobody's interest for an inappropriate access margin to be maintained. Though Postcomm and Royal Mail disagree on the methodology used for assessing the loss per unit, both agree that access products are loss making, though Postcomm believes there is a significant margin for error. It is essential that Postcomm establishes a fair picture of Royal Mail's access costs and proceeds accordingly. Our concern is that by delaying a decision until 2009 the 2006/07 data upon which Postcomm is now waiting will be as out of date as the 2005/06 data currently is in relation to the proposed April 2008 introduction date.
9. The CWU would like to see the current process speeded up; it is unacceptable and potentially damaging to have to wait until April 2009 to be able to remedy the situation and address Royal Mail's losses. While we are dissatisfied with the pace of this review, we recognise that the responsibility for this delay lies in part with Royal Mail themselves.

10. We welcome Postcomm's decision not to extend the scope of headroom regulation to more products as requested by TNT Post and UK Mail. We do not believe that Postcomm should seek to extend the regulatory burden placed upon Royal Mail in this domain, nor have we seen convincing evidence of margin squeeze occurring between access and retail products not already covered by headroom protection. Like Postcomm, we would like to see Royal Mail negotiate directly with access operators without the need for regulatory intervention.

Costs and efficiencies

11. We agree that Royal Mail needs to do more to innovate and take advantage of growing sectors of the market such as online packet orders and unaddressed mail. We believe this is the key to the future success of the business. We also recognise that Royal Mail needs to modernise and become more efficient through the introduction of new technology to help it compete more effectively. However, we do not accept that Royal Mail should be encouraged to cut costs by short-sighted attacks on its employees' terms and conditions. Given Postcomm's experience of receiving incomplete data from Royal Mail, we are surprised by and strongly object to Postcomm reiterating Royal Mail's unsubstantiated claims to have 40% higher costs and be 25% less efficient than its competitors. Royal Mail has failed to provide evidence to support this claim, but has instead used it to try and undermine their employees' attempts to protect living standards. Given the level of scrutiny Postcomm applies to other Royal Mail claims, we are disappointed that the regulator should see fit to use this one to bolster its own argument.

12. Postcomm agree that Royal Mail's cash flows have been less than anticipated, £198m lower in 2006/07 than forecast at the time of the price control. However, they attribute £120m of this to lower than anticipated cost savings. Rather than allowing Royal Mail to continue to lose revenue, the achievability of Postcomm's anticipated cost savings should be reassessed,

especially in the light of Royal Mail predicting substantially lower than anticipated cost savings going forward.

13. Postcomm must appreciate the reality of implementing the long-term changes the business needs to make. The regulator expresses surprise that Royal Mail should have budgeted for Share in Success payments to employees in forthcoming years, given that efficiency improvements are likely to be lower than anticipated. Yet efficiencies and the process of change are dependent for their success upon the support of employees. Investing in employees should not be seen as a hindrance, but as essential for the success of the business.

Pricing flexibility

14. The CWU opposed the recent introduction of a two-tariff basket price control structure. We believe that a single basket, subject to some price cap limitations, would reduce complexity and allow for a gradual move towards more cost-reflexive pricing. We also recognise the need to protect USO customers and would not like to see a dramatic increase in the proportion of Royal Mail's costs passed on to customers through price increases for stamped mail. It is for this reason that we opposed the dismantling of the traditional system of cross-subsidies that had hitherto successfully financed the USO.

15. To remain financially viable and provide the USO we accept that Royal Mail needs to be able to compete effectively in the current market. To do this it must have some flexibility to rebalance prices within the price controlled tariff baskets. We therefore welcome Poscomm's proposal to increase the sub-cap value from 3% to 8.5% with the restriction that in 'basket' A it can only be applied to those prices currently at least 6% below fully allocated costs. We recognise that the restriction should help limit the extent to which prices can rise above costs for domestic mail users dependent on the USO.

Conclusion

16. The CWU is disappointed that Postcomm has rejected Royal Mail's application to reduce the margin it is required to maintain between its access and retail bulk mail prices. Royal Mail losses on access products and its inability to pass on upstream cost savings to retail customers must be urgently addressed and should not be left until April 2009 at the earliest.
17. We welcome Postcomm's decision not to extend the scope of headroom regulation to more retail products as requested by TNT Post and UK Mail. We also welcome Postcomm's proposal to increase the sub-cap values of Royal Mail's two baskets of regulated products.
18. Postcomm's primary statutory duty is to protect the USO. As competition bites, cross-subsidies are removed and Royal Mail's profitability is undermined and its ability to maintain the USO is threatened. The CWU believe the time has come for Postcomm to consider spreading the financial burden of the USO across all licensed mail operators. This could take the form of a USO support fund or, in the absence of significant end-to-end competition, an uplift of the access price. Competition is now clearly undermining Royal Mail's ability to finance the USO and we believe Postcomm must take action to prevent its erosion.
19. The CWU have argued from the outset that the way Postcomm have chosen to liberalise the market would ultimately hit Royal Mail's revenues and undermine its ability to deliver the USO. Our concern is that Postcomm are elevating the pursuit of competition ahead of their primary duty to protect the USO. We believe the risks to the USO are such that we need a full parliamentary review of the impact of liberalisation to date – in line with the Government's 2005 manifesto commitment.

For further information on the view of the CWU contact:

Billy Hayes
General Secretary
Communication Workers Union
150 The Broadway
London
SW19 1RX

Tel: 020 8971 7251

Fax: 020 8971 7430

Email: bhayes@cwu.org

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