MAIL COMPETITION FORUM

Mail Competition Forum response to Postcomm's proposals of 9 August 2007
Review of Royal Mail's pricing flexibility and the level of access headroom
(the 'Interim Review' of the price control)

1. The Mail Competition Forum welcomes the opportunity to comment on Postcomm's consultation document dated 9 August 2007 "Review of Royal Mail's pricing flexibility and the level of access headroom"

2. We acknowledge the considerable level of analysis of Royal Mail's financial context, presented in Section 3 of the proposal document. The analysis clearly demonstrates the weaknesses of Royal Mail's costing and accounting systems and the misleading conclusions that Royal Mail draws from them. Furthermore, the analysis demonstrates the failure of Royal Mail management to achieve the reasonable efficiency targets agreed in the 2006 price control. This is evidence of the fact that Royal Mail is, even now, after several years of market liberalisation, failing to act as a commercial enterprise. Instead, the management believe that, rather than putting their own house in order, they can traipse the well-worn path to government (now the regulator) and ask for a bail-out to cover their inadequacies. It really is not acceptable that, only one year after agreeing a price control that provided customers and other stakeholders with a reasonable framework within which they could plan for coming years, Royal Mail should now want to throw the market into turmoil. Only a super-dominant operator with scant regard for its customers could attempt to do this. Faced with such a risk, it is fully understandable that two of our members sought to counter Royal Mail's damaging request to reduce access margins.

3. We are very surprised that Postcomm, having largely conceded to Royal Mail's request for additional pricing flexibility whilst simultaneously pointing out Royal Mail's failure to improve its efficiency, has itself not stated clearly that the responsibility for the company's current malaise lies squarely in the hands of its management and that Postcomm will not tolerate any further approaches for similar relief unless Royal Mail can demonstrate both an absolutely urgent need and that it has taken every possible step to avoid recourse to the regulator.

4. We do not feel that Royal Mail has demonstrated an absolutely urgent need for change on this occasion and we believe that Postcomm should reject all aspects of Royal Mail's application (including the pricing flexibility) while it is still able.

5. There is one over-arching fundamental which we wish to highlight. Postcomm has frequently drawn attention to the lack of competition to Royal Mail – other than the limited competition represented by downstream access – that has emerged since market opening. Postcomm has correctly acknowledged a number of the barriers to entry that exist, such as the disparity in VAT treatment between Royal Mail and its competitors.

There are, however, two barriers which are entirely within Postcomm's own control, and which are amongst the most significant inhibitors of business decisions to enter the UK postal market or to expand incrementally within it. We refer to: (a) the lack of regulatory certainty and stability over a number of years; and (b) an "allowed revenue" price control which artificially reduces prices in a non-commercial manner.

6. It becomes at best problematic, and at worst impossible, to justify a business case for the investment necessary to set up or substantially expand an end-to-end delivery network when the regulatory regime provides little or no certainty on the dominant incumbent's ability to make dramatic changes to its pricing structure for more than a year or two ahead. No business can expect immunity from normal business risks, but the UK postal sector does not at present (and will not for many years yet) benefit from the operation of a properly functioning competitive market. Royal Mail is uniquely (super)dominant, and the combination of Government ownership and its universal service obligation means that it cannot be allowed to fail – almost without regard to how uncommercially it may choose to operate. A 4-year price control should offer competitors, both actual and potential, a realistic degree of certainty, but even without the interim review provision the current price control appears to have allowed Royal Mail far too much flexibility on an ongoing basis to achieve this objective. The interim review provision, allowing Royal Mail to request flexibilities sufficient to enable material changes to the pricing of individual products, effectively signals to competitors that any assumptions about the future pricing of their major (super-dominant) competitor may have no more that a few months validity and can be substantially undermined thereafter. Businesses cannot and will not take decisions of critical importance to their futures on such a basis.

7. We note that the preceding point is not only of relevance to Royal Mail's competitors. We are absolutely convinced that their customers are also frustrated by the lack of regulatory certainty in the market. When end-to-end competition, particularly in the bulk mail sector, is underdeveloped and access competition is dependent upon Royal Mail tariffs customers can barely avoid being affected by Royal Mail's price changes. There are many sectors which currently have a strategic reliance upon the mail system. For instance, investment cases for publications can have five year timeframes and, being as mailing costs can make up a substantial proportion of the total cost of a publication, the risk associated with unpredictable pricing of mail services can make many investments unviable.

8. In the face of such regulatory and resultant commercial uncertainty, and little prospect of adequate returns to compensate for the risk, investors will place their money in safer places. In the case of mail operators this will be somewhere other than the UK mail market and in the case of mailers probably in the form of the electronic distribution systems even where in other circumstances mail would remain the preferred medium. (As Postcomm points out, it is possible for mail to compete with electronic media; it is a pity that Postcomm has not realised that the increased uncertainty in postal pricing that it is proposing to allow will actually have a contrary effect, and will encourage major customers to focus on more electronic substitution.)

9. There is a second point of principle which we also regard as important and on which we feel we must put on record our dissatisfaction. It is unreasonable to expect us

to be able to comment in a balanced way on that part of the request which relates to additional flexibility within the baskets when we have only part of one side of the picture. Royal Mail has based its need for additional re-balancing flexibility on its stated desire to increase the prices of the second class service to bring them more closely into line with claimed costs. However, what is of at least as much concern to us is how they wish to implement the necessary offsetting reductions: made necessary, of course, because of the artificial constraints imposed by an "allowed revenue" price control. Thus, for example, the metered mail and standard tariff PPI mail sectors are of considerable interest both to end-to-end operators and to downstream access operators. If Royal Mail's intentions are – as data supplied in support of the request seems to imply – to use the additional flexibility sought in Basket A to substantially reduce the prices of these products, (which, incidentally, are not protected by access headroom) we would see this as a deliberate ploy to target and to price out competition in these areas, and would wish to object in the strongest possible terms.

10. Furthermore, and consistent with our previous observation about the needs of customers, we would have welcomed considerably greater transparency of the Basket B costs than is provided in Postcomm's document. The ability of stakeholders to comment on Postcomm's proposals in a useful way is almost wholly frustrated when they do not know what effect these proposals might have on them. Even the information provided about the Basket A prices and margins does not enable stakeholders to determine the impact of greater flexibility on them[1]. For instance, will Royal Mail preferentially counter any price reductions in 1C metered packets (highest profits) with increases in 1C and 2C stamped large letters (highest losses)? Or will they preferentially balance reductions in the price of 1C metered letters with increases in the price of 2C stamped letters? Although we might have our suspicions it is not possible for us (or other stakeholders) to predict these moves and it is even less possible (virtually impossible) for us to do so for Basket B.

11. Having decided that it would be reasonable to allow Royal Mail the very substantial additional pricing flexibility it sought, we believe that Postcomm should in return have obliged Royal Mail to publish its proposals for the actual prices it wishes to impose on the market. Customers are not interested in "rebalancing sub-caps"; what they want to know are prices. Postcomm's insistence on the publication of the proposed prices would have facilitated a better informed discussion about this interim price control and simultaneously reduced market uncertainty. We believe that there is still value in doing this as soon as possible. If Royal Mail is unable to comply then it indicates that the business has no idea of what it wants to do with the increased flexibility and that its application is just time wasting or deliberate "water muddying" to maximise market uncertainty. Given the considerable importance of this proposal to the market, it is wholly desirable that Postcomm publishes the proposed prices and gives stakeholders sufficient opportunity to provide feedback before making the final decision.

12. We are not certain that Postcomm's proposed rebalancing process for Basket A leads to improved cost reflectivity. A service that currently has a margin of -6% can

[1] We note that Basket A contains several services such as international mail and response mail that are not included in Table 5 of Postcomm's proposal.

benefit from two 8.5% increases, taking it to a margin of +11%. This means that it would be less cost reflective than at its starting point. Postcomm should only allow Royal Mail one 8.5% increase for services losing less than about 10%. At the same time we suggest that Postcomm needs to insist that Royal Mail prioritises rebalancing of the services that currently have the largest loss margins.

13. We note that Postcomm has repeatedly stated that it has no power to prevent Royal Mail reducing its prices other than the protection against anti-competitive pricing (e.g. not to price in a predatory manner or to prevent "as efficient" operators from trading profitably in upstream services). Postcomm does, however, have the power through the various price control mechanisms to effectively force Royal Mail to reduce the prices of some of its products. We also note that Royal Mail, in common with any other business, should be limited in the extent to which it can reduce prices by the desire to maximise its profits. In the absence of a price control which forces Royal Mail to reduce some prices in order to increase prices elsewhere the business would increase prices where it was able and reduce prices only where it made sense to do so. The rigour of the price control, even in its current state, is such that Royal Mail might be forced to make compensatory price reductions that harm the market. If there are indeed services on which Royal Mail makes disproportionate losses then Postcomm should allow Royal Mail to increase the prices of these services without forcing it to cut prices elsewhere. Underlying this, of course, is a pressing need for Royal Mail to improve its efficiency.

14. We note that Postcomm is minded to decline Royal Mail's request to reduce the headroom between its retail and wholesale tariffs, justifying its decision on the basis that the cost data supplied by Royal Mail was unreliable. Our immediate reaction to this decision, on being informed of it at our meeting with Postcomm on 8th August 2007, was one of considerable scepticism because we fail to understand why Royal Mail's costs would be any more reliable for the basket argument than for the headroom case. One of our members has provided you with an analysis of the price and margin data presented in your consultation paper. This analysis identifies 19 inconsistencies within the data and we feel that Postcomm should have identified and drawn attention to these in its own analysis. (Several of these inconsistencies relate to 2C metered and PPI packets, the costs of which are virtually all above those of the 1C equivalents, raising the suspicion of systematic predatory pricing.) We further note that your consultation paper reveals that you employed external consultants to review Royal Mail's data for the access headroom argument but there is no indication of you allocating similar resources to a study of the reliability of the basket data.

15. There are many reasons why the reliability of the cost data is of crucial importance to your decision and we present some of the most important ones below:

> (i) Most of Royal Mail's pricing moves are predicated on a desire to move to more cost reflective pricing. It is impossible to judge whether progress is being made towards this goal if the cost data is unreliable;
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> (ii) There is an argument that if the cost data for the highest volume services is accurate then the accuracy of the data for lower volume services is of secondary importance. Our counter argument is that some mailers who use

lower volume services might be considerably disadvantaged by this approach, either paying more than they should pay for services to which Royal Mail incorrectly allocates too much cost or facing considerable price rises when Royal Mail finally realises that its costing system really is deficient. We urge Postcomm to determine the true structure of Royal Mail's costs before giving Royal Mail increased flexibility to adjust its prices.

(iii) In any case, Royal Mail has demonstrated that it is unable to determine its own costs in a consistent manner. Despite Postcomm's reluctance to involve itself in the management of Royal Mail's business (which is, of course, correct) this is one area where direct regulatory intervention is called for.

16. Another argument that we have heard is that Royal Mail's universal service obligation justifies cross-subsidies between services. We believe that this is a novel and incorrect assessment of the purpose of cross-subsidies within postal services. Within the context of the universal service obligation cross-subsidies between low cost and high cost geographical areas are allowed in order to ensure a uniform geographical price or to minimise any price differences. We are not aware of any legislation or interpretation of legislation that allows one service to be subsidised by another, in contravention of the EU Postal Directive's requirement for prices to be geared to costs, simply because either or both services fall within the universal service obligation.

17. We also wish to place on the record our disappointment at Postcomm's treatment of our response to your industry letter of 22 March 2007 in which you asked stakeholders to comment on this interim review. In our response we raised the following four explicit comments about Royal Mail's request to increase the sub-caps:

(i) A sub-cap of 8.5% would allow some prices to rise unreasonably steeply over a very short period causing difficulty or hardship to users of those services;
(ii) Royal Mail has given no indication of which services would face price increases and which would benefit from lower prices;
(iii) There is at present no basis for assessing whether the claimed cost reflectivity justification in each case would stand up to rigorous (and preferably independent) scrutiny;
(iv) Without such scrutiny there is a risk that increases will simply fall on products for which Royal Mail faces least competition in order to finance lower prices where competition exists or is more likely to emerge.

Although, in your proposal document, you have mentioned our concerns it does not appear that you have considered them with the seriousness that we believe they deserve. There is little or no discussion of our concerns in your proposal document. We hope that you will give them the attention they deserve in your current deliberations.

18. We turn now to the specifics of the access headroom requests.

(i) Pro-competition request:
Two of our members, TNT Post UK Limited and UK Mail Limited, submitted applications (the “pro-competition request”) for a decrease in access prices and for an extension of the current ex ante margin squeeze protections to all relevant Royal Mail services.

(ii) Royal Mail request:
Royal Mail Group Limited, on the other hand, requested a very material increase in access prices which would have had a profoundly damaging impact on competition.

19. We believe that the Postcomm decision to reject the Royal Mail application was correct but we share a number of significant concerns about the rejection of the “pro-competition request”. Our reasons for these concerns are as follows.

Pro-competition request data robust – highlighting low margins:

(i) While the data provided by Royal Mail was deemed to be insufficient, the same allegation cannot be made in the direction of the pro-competition request. Postcomm concluded that “data provided by TNT Post and UK Mail has indicated that their upstream operations are more efficient than Royal Mail’s” and yet that “the profit margins available to Royal Mail’s competitors – as provided to Postcomm by TNT Post and UK Mail – appear to be tight.” Postcomm also states, wrongly in our view, that “whilst access margins may be tight, we do not have clear evidence at this stage to suggest that they are too tight – especially against a backdrop of rapidly increasing access volumes.” We cannot agree that Postcomm should accept a situation in which, notwithstanding that these are more efficient operators than Royal Mail, these competitors are faced with extremely limited margins which may well be too tight.

(ii) It is also important to consider in the appropriate context the 7.1% margin reported by UK Mail. As Postcomm accepts, this figure includes a high proportion of customer direct access (“CDA”) traffic, where only the upstream revenues are taken into account and, thus, average margins are increased. The principal reason for the high level of CDA traffic is Royal Mail’s unique VAT exemption. The (mostly VAT-exempt customers) who use CDA services do so in order to avoid VAT on the Royal Mail downstream services. It is quite unacceptable that Postcomm should acknowledge this in a footnote but, still, use this market distortion as a reason for citing this 7.1% figure in support of its decision to reject the pro-competition request.

(iii) Unlike Royal Mail, who apparently failed to provide reliable information (notwithstanding repeated requests from Postcomm), the reliability and validity of the TNT Post and UK Mail data was not called into question. For that reason, our members who submitted the pro-competition request totally refute Postcomm’s statement that it has “little confidence that the underlying access cost data currently provided to it [by them] can be used to provide the degree of assurance that is needed for such major decision."

(iv) Having reached the conclusion that TNT Post and UK Mail are more efficient than Royal Mail, it follows that Postcomm is then in a position to carry out a margin squeeze analysis by relying on the (lower) costs of these two more efficient operators – notwithstanding the absence of reliable Royal Mail data. In other words, it is not necessary to carry out a detailed review of Royal Mail's costs because a more efficient operator than Royal Mail who cannot trade profitably is, by definition, subject to margin squeeze because the "as efficient" operator test requires an even greater level of headroom.

20 Discounts will remain essential to enable switching:

Postcomm states that "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 services. This is currently required to overcome customer inertia and perceived risks of switching. To the extent that a more mature market lessens these latter two factors [i.e. high unit costs due to relatively low volumes and high price of switching discount incentives] higher prices and hence higher margins might be possible for the other operators in the future."[2] This purported, and admittedly speculative, justification for rejecting the pro-competition request does not stand up to scrutiny. It is beyond doubt that a material discount to overcome customer inertia against switching from Royal Mail will remain a commercial necessity, given the strength of the Royal Mail brand, the generally low priority given to mailing costs within most businesses and the relatively complex processes involved in downstream access services (e.g. forecasting). We see no reasonable prospect for any material reduction in the level of discount which customers will demand, nor for any opportunity to increase prices in a "more mature market" (when the opposite is more likely because of the fierce competition in upstream services among operators who are seeking to recover their investments).

21. Future volume increases may not reduce need for headroom:

(i) It is also wrong to assume that growing volumes necessarily reduce upstream unit costs. Where an operator is efficient, an increase in volumes requires greater investment and higher direct and indirect costs. While upstream unit costs may decrease with increased volumes, there is certainly not a linear reduction. Following each investment, e.g. in costly sortation equipment, there is an immediate increase in average unit costs until such time as the new asset is being sufficiently used to reduce the unit costs.

(ii) TNT Post and UK Mail contend that, while they have maintained or improved their high levels of upstream efficiency, Royal Mail have not achieved the downstream efficiency improvement that should be expected from the price control regime. Royal Mail efficiency gains have very largely been upstream (were it faces competition) while it has sought only to increase its access (downstream) prices (where it retains over 99% of the market). TNT Post and

[2] At paragraph 5.28

UK Mail, as customers or Royal Mail's downstream services have not befitted from any Royal Mail downstream efficiency to which they are reasonably entitled through the Royal Mail price control.

22. Volume growth does not imply profitable future:

(i) Despite Postcomm's very clear acknowledgement of the financial position of Royal Mail's competitors, and contrary to what was specifically stated in the pro-competition request i.e. that, to create sustainable upstream competition, it is essential to increase the differential between retail and wholesale prices, Postcomm stated that "the growth of access volumes has been faster than predicted, suggesting that operators see a future in the access market.[3]"

(ii) This statement fails to take into account a fundamental business reality. If there is no scope for future, profitable trading, a business will not persist in its activity no matter what the level of historical growth. In other words, there is no business sense in being a "busy fool".

(iii) We note that Postcomm reports "most commentators expect access volumes to eventually plateau at around 5-6 billion items as the size of the addressable market is limited" (at 5.9). Although the footnote says this relates to "second class bulk mail", we consider this remains misleading. While it may be true that the size of the addressable market into which TNT Post and UK Mail initially entered (second class bulk, presorted mail) may eventually plateau at that level, both TNT Post and UK Mail have invested in capability and extended their service offering in order to enter other markets (e.g. second class unsorted mail and first class mail). It would be wrong to imply that there is a 5-6bn item limit to the overall, potential market for TNT Post and UK Mail.

23. Volume growth essential in spite of reducing margins:

The statement also overlooks one hugely significant point: since the initial access price was set, on the back of which very significant investment has been made, there has been a very material reduction in available headroom. Faced with a choice of (a) continuing to trade or (b) stopping trading, making staff redundant and writing off these investments, competitors have grown their volumes as part of the continual process of making unit costs as low as reasonably possible and have sought to generate an acceptable level of profitability: but as Postcomm concludes, margins are "tight". It is, therefore, a gross over-simplification to state that historical volume growth in some way suggests a profitable future.

24. Proposed rejection of the pro-competition request could be extremely damaging:

Postcomm's intervention to correct historical margin squeeze and to prevent future margin squeeze is essential and it is extremely disappointing that Postcomm has not yet adequately addressed the concerns in the pro-competition request. We urge Postcomm

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[3] At paragraph 5.28

to re-consider its position and require Royal Mail to increase headroom to a level where an operator "as efficient" as Royal Mail is able to trade profitably, taking into account the market reality that a discount must be offered to win business and the VAT distortion.

25. If Royal Mail's prices are below cost they must increase – it is not an option:

We are, frankly, puzzled by the suggestion that Royal Mail somehow has an option not to "increase the prices of all its retail equivalent products that are priced below cost"[4] because "the scope for Royal Mail to increase prices may be limited by customers' willingness to pay higher prices".[5] We simply fail to see how this apparent endorsement of continued below-cost pricing (indeed, potentially predatory pricing, if the prices are below fully allocated cost[6]) is consistent with competition law or Postcomm's statutory duties. Such a stance is wholly unacceptable. While we absolutely support Postcomm's desire for Royal Mail to become more efficient – that is, after all, good for the postal market as a whole – if the prices of a super-dominant operator are below costs, they must rise. It is unacceptable to allow them to remain below costs thereby causing prolonged periods of damage to the competitive market in the hope that at some indeterminate point in the future efficiency gains may enable those costs to fall. A closely related point is the need for Postcomm to continue to press Royal Mail for both improved costing information and for greater transparency so that future pricing submissions, whether concerning processes or actual pricing levels, are not undermined by uncertainties and speculation.

26. Not realistic to secure "smoother" headroom levels by negotiation:

Postcomm suggests 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."[7] Realistically, there is not. What incentive would Royal Mail possibly have to increase the level of headroom? Should they not agree to any change, operators would need to request a determination under condition 9 of the Royal Mail licence. To avoid this protracted process, and to recognise the insufficient level of headroom, two of our members have asked Postcomm to review the levels of headroom as part of the interim review. Royal Mail could easily have agreed to increase the headroom on a number of services as part of the interim review. They have not done so. To suggest that the solution now lies in asking Royal Mail to agree a commercial rate of headroom will, frankly, do nothing more than prolong the period during which a non-commercial headroom remains in place. Again, we find this proposed rejection extremely disappointing and urge Postcomm to re-consider its position and require Royal Mail to adopt more acceptable headroom levels, through a decrease in access prices and/or an increase in retail prices.

27. Extending the scope of headroom protection does not mean uncertainty:

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[4] At paragraph 5.32 and
[5] At paragraph 5.33
[6] At paragraph 4.4 and footnote 6 of Postcomm's Final Report on Business Mail Secure (August 2007)
[7] At paragraph 5.37

(i) We do not accept that the need for a licence change is proper justification for proposing to refuse to extend the margin squeeze protection measures to other services. Postcomm has apparently misunderstood the request. Our members currently compete against a number of retail services by using the current next day access service. These services include 1st and 2nd Class stamps, meters, PPI and Cleanmail services; Mailsort Lite; Mailsort 3 and Presstream services. There is, therefore, no question of a "new product" being requested or a determination being appropriate. It is for that reason that the interim review has been used as the appropriate opportunity to review the scope of the margin squeeze protection rules.

(ii) We do not accept that a reference to the Competition Commission would lead to "a period of regulatory uncertainty which could be damaging for competition". The current levels of headroom, insufficient though they are, would remain in place against Mailsort 2 services and all that would remain to be assessed would be the mandatory level of headroom protection for the other services. We fail to see how achieving greater ex ante margin squeeze protection against a clearly identified range of services can be considered to be damaging to competition. As competitors, we feel that we are in a very good position to make this assessment.

(iii) With current margin levels "tight" or "too tight" when selling to Mailsort 2 customers, there is a clear need to win volumes from customers using retail services other than Mailsort 2. This can be done by offering them discounts hitherto unavailable to them and where there is some prospect for charging a higher price. This has been made possible by our members setting up collection networks for customers with relatively small volumes and making significant investments in state of the art sorting machinery. It is critical for a sustainable, profitable business that our members can compete for these volumes and, therefore, that there is certainty over the prices Royal Mail can charge for them. The "signal" about an acceptable level of headroom on these other services is far from clear. We therefore request Postcomm to review its proposed decision not to widen the scope of the margin squeeze protection and create much needed regulatory certainty as to "what it broadly considered to be the appropriate margin for other access products". Postcomm has stated[8] that margin squeeze occurs where the headroom "is reduced below the level which allows [competitors] to trade profitably." Upstream competition is still in its relative infancy and Postcomm needs to have the regulatory courage to set out very clearly the parameters within which Royal Mail must operate to avoid the elimination of upstream competition.

28. Future regulation:

(i) The clear statement that the reduction in headroom would prevent a further growth of 1.4 billion items of access mail demonstrates beyond any doubt the true motive behind the Royal Mail request. Postcomm must consider this when regulating access prices and headroom, going forward.

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[8] At paragraph 2.6 and footnote 16

(ii) Postcomm has identified a number of measures which Royal Mail can take under the existing price control (without any need to change it). Before any change should be made to allow Royal Mail to increase access price (and thereby decrease headroom), all other means of recovering revenues should be exercised. This should include, not only, increasing retail and access prices by the levels already permitted but also increasing efficiency in their downstream and upstream operations and removing cost-generating activities for downstream access customers.

(iii) Rolling forward historical data from 2005/06 to set prices for 2008/09 could lead to extremely unreliable analysis. If Royal Mail is to have a request taken seriously, it must produce accurate, reliable, relevant and up to date data (as was the case for TNT Post and UK Mail).

(iv) We will respond to the Strategy Review, Emerging Themes consultation and appreciate that headroom protection beyond 2010 will be a very important ongoing protection. In the meantime, however, it is very important that Postcomm acts more robustly and gives much greater certainty about the extent to which this wider range of retail services must be priced to avoid margin squeeze.

Mail Competition Forum
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