

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

A Decision and Direction by the Postal Services Commission

January 2008

Summary

- S.1. This document explains Postcomm's decision on the requests received in March 2007 from Royal Mail, TNT Post and UK Mail, for Postcomm to amend certain aspects of Royal Mail's price control¹ (the 'Interim Review'), taking into consideration the responses from stakeholders to our August consultation document².
- S.2. Postcomm has decided to make the following changes in relation to the rebalancing sub-cap in Royal Mail's price control:
- For products in Basket A, the 'captive' basket, whose prices are currently at least 6% below fully allocated costs, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year. As an amendment to the proposals made in August, this 8.5% sub-cap will now also apply to Royal Mail's related Response Services³. For the remaining products in Basket A, the sub-cap will stay at 3% per year for the remainder of the price control; and
 - For products in Basket B, the 'non-captive' basket, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year.
- S.3. Annexed to this document is a Direction allowing Royal Mail this greater pricing flexibility (see **Annex A**). This Direction will come into effect for implementation of Royal Mail's new prices on 1 April 2008.
- S.4. In addition, this document explains that Postcomm has decided to reject the requests from Royal Mail, TNT Post and UK Mail to make changes to the level of access headroom, and the requests from TNT Post and UK Mail to extend the scope of headroom regulation to more products from April 2008.

¹ The requests can be found on Postcomm's website at <http://www.psc.gov.uk/policy-and-consultations/consultations/price-control.html>.

² Review of Royal Mail's pricing flexibility and the level of access headroom (the 'Interim Review' of the price control), Postcomm's proposals, August 2007.

³ Pre-printed reply envelopes, cards or labels.

Contents

Postcomm's approach and decision	1
Royal Mail's finances	9
Royal Mail's request for greater pricing flexibility	13
Royal Mail's, TNT Post's and UK Mail's requests to review the level of access headroom	25
Annex A - Direction allowing Royal Mail greater pricing flexibility	39
Annex B - A list of the organisations that provided non-confidential responses to the consultation	44
Annex C - Basket A Price Ranges that qualify for the rebalancing sub-cap of 8.5%	45

1. Postcomm's approach and decision

Purpose of this document

1.1. The purpose of this document is to explain Postcomm's decision on the requests received in March 2007 from Royal Mail, TNT Post and UK Mail, to amend certain aspects of Royal Mail's price control with effect from 1 April 2008 (the 'Interim Review'), taking into consideration the responses from stakeholders to our August 2007 consultation document, in which we proposed:

- that there should be a change to Royal Mail's rebalancing sub-cap:
 - for products in Basket A, the 'captive' basket, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year, as per Royal Mail's request but subject to the following restriction: that it can only be applied to prices that are currently at least 6% below fully allocated costs; and
 - for products in Basket B, the 'non-captive' basket, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year, as per Royal Mail's request; and
- that there should be no change to the levels of minimum access headroom from 2008/09, and that the scope of headroom regulation should not be extended to more products.

1.2. This document summarises the responses received to our August consultation document, sets out Postcomm's analysis of those responses, and reports the final decision made by Postcomm in relation to the requests.

Context

Statutory duties

- 1.3. Postcomm is required to exercise its functions in the manner which it considers is best calculated to –
- ensure the provision of a universal postal service,
 - further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators (having regard to the interests of vulnerable users and those in rural areas), and
 - promote efficiency and economy on the part of postal operators.
- 1.4. Additionally, in exercising any of its functions in relation to licence holders, under the Postal Services Act 2000, Postcomm must have regard to the need to ensure that they are able to finance the activities authorised or required by their licences.

Royal Mail's financial performance

- 1.5. The Interim Review was conducted against a background of declining total market volumes, changes in volume mix, and an increase in access volumes for operators other than Royal Mail:
- Royal Mail's financial performance for the year ending 25 March 2007 was weaker than in the previous year with operating profits (before exceptional items) for Royal Mail Letters' business falling from £344m to £194m. Higher pension costs of £296m account for much of this decline in profitability. For the regulated area, Royal Mail recorded operating losses of £29m in 2006/07 compared with profits of £168m in 2005/06.
 - The universal service remained profitable overall though less so than in the previous year (operating profit was £27m compared with £54m in 2005/06).

- The use of access products has grown quickly, with access volumes of 2.4 billion items in 2006/07 compared with around 1.2 billion items in 2005/06, and is set to grow to around 4 billion in 2007/08.

1.6. Postcomm's analysis showed that one of the causes of the decline in Royal Mail's financial position was its inability to reduce its costs as quickly and effectively as was assumed when the price control was set. There are two aspects to this. First, Royal Mail has been unable to extract costs sufficiently in the face of declining volumes. Second, Postcomm has identified that Royal Mail has delivered efficiency savings of around 2% for 2006/07 against a target of 3%. It could however be argued that achieving 2% efficiency in 2006/07, even though Royal Mail's investment programme had not started, is a reasonable performance. By contrast, Royal Mail appears to be forecasting efficiencies of only 0.6% per annum for the remaining period of the price control, which would leave it with operating costs around 8-9% higher by April 2010 than anticipated when setting the price control.

Price flexibility within Royal Mail's licence

- 1.7. The 2006/2010 price control set an overall limit on average price increases $(RPI - X)^4$, called a 'price cap'. In addition, the price control also constrained Royal Mail from raising any individual price by more than 3% above the price cap. The 3% figure is called the price rebalancing 'sub-cap'.
- 1.8. This means that an individual price point can rise by $RPI - X + 3\%$ per year on a two-year rolling basis, but will need to be balanced by reductions elsewhere, such that the overall average price increase is

⁴ Where RPI is the 'all items' retail price index and X is an efficiency factor with a value of 0.14% for Basket A and 1.96% for Basket B.

no more than RPI - X.⁵ Other technical adjustments also potentially affect the maximum individual price rise allowed, such as volume and pension adjustment factors.

- 1.9. In the Final Proposals for the 2006/10 Price Control⁶, Postcomm acknowledged Royal Mail's argument that the sub-cap threshold should be set to allow Royal Mail to achieve cost reflective pricing for its major products, such as the public tariff first class stamp. Postcomm concluded on this basis that it would allow a 3% sub-cap over the 4 years of the control.
- 1.10. Thus in accordance with Condition 21(16) of its licence, Royal Mail is required to adhere to a price rebalancing sub-cap of 3% except "*as Postcomm on the application of the Licensee may by direction in writing approve otherwise*". The sub-cap determines the annual level, and so the speed, at which Royal Mail can adjust individual prices. Hence Royal Mail may apply to Postcomm for greater pricing flexibility for any individual price controlled product or group of products. It is within this context that Royal Mail made its application in March 2007.
- 1.11. It is worth noting that Royal Mail is not constrained by its licence from making price reductions (subject to Conditions 10, 11 and 21 of its licence and general competition law). If Royal Mail had performed in line with the assumptions set out in the price control, it would have been sufficiently profitable to be able to afford to reduce prices on products facing competition. Given Royal Mail's current financial situation, however, Royal Mail can only afford to reduce prices for some products by first raising additional net contribution from other products.

⁵ Within its licence, Royal Mail is allowed to rebalance individual prices in successive years, which means that it can roll forward any underutilised sub-cap from one year to the next.

⁶ Royal Mail Price and Service Quality Review, Final Proposals for consultation, December 2005.

The access regime

- 1.12. Access headroom is the difference between Royal Mail's retail price and its respective access price for delivery by Royal Mail, which is set by the price control. As part of the price control introduced in 2006, the levels of headroom between access prices and the prices of a benchmark set of analogous Royal Mail retail products are regulated to ensure that Royal Mail cannot reduce headroom below the minimum set for the duration of the price control⁷. The aim of this provision is to prevent margin squeeze by Royal Mail on access operators.
- 1.13. In 2004, Royal Mail and UK Mail negotiated the first access agreement. Since this agreement, Royal Mail has agreed to a further six types of access agreement, either with other operators or large mail users (National Condition 9 Access (for both operators and large mail users), Zonal Condition 9 Access (for both operators and large mail users), National Condition 9 Access Agency (for operators only), Zonal Condition 9 Access Agency (for operators only), Condition 9 Access Premium Agency (for operators only).
- 1.14. In order to protect the development of access competition in the face of a potential reduction in margins for access operators, the access headroom levels that had been negotiated between Royal Mail and other operators were required by Postcomm to be maintained by Royal Mail as part of the price control condition included in its licence from 1 April 2006. The purpose of this *ex ante* control on access headroom was to provide some certainty in the margin for new operators, and protect them against the risk of margin squeeze by Royal Mail.
- 1.15. At the time that the price control was agreed, Postcomm stated that it had limited confidence in Royal Mail's costing system regarding

⁷ It is the percentage difference rather than the absolute difference that is fixed.

upstream and downstream costs⁸ and therefore proposed an option for Royal Mail, other licensed operators, and/or customers to ask Postcomm to determine a different margin after two years if there had been material changes in relative upstream and downstream costs. It is under this provision that Royal Mail, UK Mail and TNT Post made their applications to Postcomm. Royal Mail argued that the level of access headroom for a number of products was too high, while UK Mail and TNT Post claimed that headroom levels in relation to some access products were too low.

- 1.16. The acceleration of access volumes since 2004/05, compared with Postcomm's forecast at the time of setting the price control, has been significant, increasing from 87 million items to 2.4 billion items between 2004/05 and 2006/07. It is important to bear in mind, however, that around 50% of access volumes⁹ are with bulk mailers who remain Royal Mail customers, via Customer Direct Access arrangements.¹⁰

The Interim Review to date

- 1.17. In March 2007 Postcomm received three applications, forming the basis of the Interim Review. Upon receiving the three applications, Postcomm issued a consultation letter to all interested stakeholders on 22 March 2007 inviting views on the key issues. Postcomm also asked all three applicants to provide a business case to support their requests by 31 March 2007; these were then reviewed by Postcomm with assistance from consultants.

⁸ Royal Mail Price and Service Quality Review, Final Proposals for consultation, December 2005, page 47.

⁹ For 2006/07.

¹⁰ In addition, we note that end to end actual volumes for 2006/07 were only 35m compared with Postcomm's forecast at the time of setting the price control of 278m.

1.18. In addition, Postcomm hosted a workshop on 24 April 2007 at which all three operators presented their case for change and took questions from those present.¹¹

1.19. On 9 August 2007, Postcomm set out its proposals in relation to the requests received from the three operators. Postcomm received 29 written responses to this consultation. A list of the organisations that provided non-confidential responses to the consultation can be found at **Annex B** to this paper. All the responses have been reviewed and fully considered. All non-confidential responses are available on our website.

Postcomm's decision

1.20. Postcomm has decided to make the following changes in relation to the rebalancing sub-cap in Royal Mail's price control:

- For products in Basket A, the 'captive' basket, whose prices are currently at least 6% below fully allocated costs, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year. As an amendment to the proposals made in August, this 8.5% sub-cap will now also apply to related Response Services. For the remaining products in Basket A, the sub-cap will stay at 3% per year for the remainder of the current price control to April 2010. **Annex C** lists the Basket A products that qualify for the higher rebalancing sub-cap of 8.5%; and
- For products in Basket B, the 'non-captive' basket, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year.

1.21. In addition, Postcomm has decided to reject the requests from Royal Mail, TNT Post and UK Mail to make changes to the level of access headroom and, the requests from TNT Post and UK Mail, to extend the

¹¹ The presentations made at the April workshop are available at <http://www.psc.gov.uk/policy-and-consultations/consultations/price-control.html>

scope of headroom regulation (to more products) to be implemented from April 2008.

2. Royal Mail's finances

Introduction

- 2.1. Royal Mail's financial performance provides important context to Postcomm's decision on the Interim Review. Taking Royal Mail's business case and its regulatory accounts, Postcomm's staff (with help from its consultants) looked at Royal Mail's performance in 2005/06 (the base year for the price control), its performance in 2006/07 and its projected performance for the remainder of the price control period to April 2010. In Royal Mail's Interim Review application, it argued that there were problems with Postcomm's current price control financial forecasts for Royal Mail's business.
- 2.2. In particular, for Postcomm's August 2007 proposals, we looked at Royal Mail's outturn for 2005/06 and 2006/07 and found:
- that the cost adjustments Postcomm made to Royal Mail's baseline in setting the price control appeared to be appropriate;
 - Royal Mail had achieved an efficiency saving of 1.9%¹² against its target of 3% for 2006/07; and
 - Royal Mail had only forecast efficiency savings of 0.6% per annum for the remaining three years of the price control period. This would cause Royal Mail's annual costs by 2009/10 to be around £500m higher than assumed when setting the price control.
- 2.3. In its response, based on its own calculations, Royal Mail argued that Postcomm had excluded around £120m in its forecast of Royal Mail's costs for 2006/07. It also argued that its efficiency for 2006/07 is 2.6%, using Postcomm's methodology and a Long Run Marginal Cost (LRMC)¹³ of around 60% (the figure used when setting the price control). Separately, Royal Mail has recalculated its efficiency saving for 2006/07 using outturn volume data for 2006/07 and an updated

¹² Based on Period 7 (October 2006) forecasts.

¹³ The long-run marginal cost ('LRMC') factor is a measure of the change in variable costs to a change in volumes.

LPMC factor to reflect 2005/06 data. On this basis, Royal Mail says it made an efficiency improvement of 3.1% for 2006/07.

Royal Mail claims that 2006/07 costs are understated by around £120m

- 2.4. We cannot support Royal Mail's analysis that allowable costs in 2006/07 are understated by around £120m. In performing its analysis, Royal Mail restated its baseline costs (2004/05) for actual volumes and applied a 3% efficiency saving only in 2006/07. Therefore, this analysis incorrectly excluded Royal Mail's efficiency savings in 2005/06.
- 2.5. By excluding its cost efficiencies in 2005/06, Royal Mail overstated its costs in both 2005/06 and 2006/07. At the time of setting the current price control, Royal Mail forecast cost savings for 2005/06 of £104m (in 2004/05 prices). These savings are consistent with Royal Mail's actual 2005/06 savings of £110m (2004/05 prices). Hence, Royal Mail's statement that costs are understated by around £120m can be explained fully by the exclusion of savings actually achieved in 2005/06 (after taking into account adjustments for inflation).

Royal Mail's claim that its efficiency improvement is at least 2.6%

- 2.6. In calculating its revised efficiency saving figure for 2006/07, Royal Mail used outturn volumes for the full year 2006/07 whereas Postcomm had to rely on Period 7 forecasts, which was the data Royal Mail provided to Postcomm for the Interim Review.
- 2.7. Royal Mail has now provided Postcomm with full year volumes for 2006/07. Using this latest data, our consultants have re-estimated Royal Mail's efficiency improvement to be 2%.
- 2.8. Royal Mail has included what it calls 'cost shocks' in calculating its efficiency figure, i.e. it has made adjustments for increases in costs

which are higher than overall inflation (e.g. for fuel price increases). This is not consistent with the price control where the efficiency target recognises that some costs will increase faster than inflation while others will increase below inflation, or might even decline. It would be inappropriate to dissect Royal Mail's individual costs on a line-by-line basis.

- 2.9. However, there could be a case for adjusting for an element of these cost shocks that relate to accounting policy changes. Royal Mail has raised such an accounting adjustment whereby £12m of costs relating to transactions for Jersey, Guernsey and the Isle of Man are now recognised in its accounts as costs, whereas previously they had been netted off against revenues from services provided to these islands. However, we do not believe that Royal Mail has provided sufficient evidence to support the case for adjustment. We would have expected some formal written support for such accounting changes. Taking account of this adjustment, Royal Mail would record an efficiency improvement of 2.2%.

Conclusion

- 2.10. Our analysis indicates that Royal Mail has delivered efficiency improvements for 2006/07 of around 2.0%. Given the delays in the implementation of Royal Mail's investment plans this could be considered as a reasonable performance.**
- 2.11. However, the most recent Royal Mail financial forecasts provided to Postcomm project future efficiency improvements to be just 0.6% per annum, which would lead to Royal Mail's operating costs being around 8-9% greater by April 2010 than assumed for the purpose of the price control (equivalent to costs being around £500m greater than anticipated).**

Long Run Marginal Cost (LRMC) and phasing of cost savings

2.12. Royal Mail contends that the actual LRMC it is experiencing at the moment because of declining volumes is nearer 40% than the 60% used in setting the price control. Royal Mail says that its 60% estimation was based on past empirical evidence in an expanding market, whereas now Royal Mail is facing falling volumes. Its finance team has since advised us that it is conducting further work to investigate, and better understand, the variability of its costs to changes in volumes. This work will include consideration of the phasing for cost reductions. Royal Mail also says that there is a lag of two years between a reduction in volumes and its being able to reduce its variable costs.

Conclusion

2.13. **In setting the price control, Postcomm used Royal Mail's data as the basis for an LRMC of around 60%. On phasing, Postcomm assumed Royal Mail could achieve cost savings in response to declining volume within the same year. Royal Mail has not provided any new supporting evidence that these assumptions were inappropriate, though we will revisit this issue as part of the next price control.**

3. Royal Mail's request for greater pricing flexibility

Introduction

- 3.1. Postcomm's August 2007 proposals recommended that there should be a change to the rebalancing 'sub cap', but subject to certain limitations:
- For products in Basket A, the 'captive' basket, Postcomm proposed an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year, as per Royal Mail's request but subject to the following restriction: that it can only be applied to prices that are currently at least 6% below fully allocated costs; and
 - For products in Basket B, the 'non-captive' basket, Postcomm proposed an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year, as per Royal Mail's request.
- 3.2. This section sets out our assessment of the issues raised by Royal Mail and other stakeholders in response to the August consultation document.
- 3.3. Having taken these responses into consideration, Postcomm considers that its August proposals should remain unchanged except that the additional flexibility for products in Basket A should extend to coverage of the related Response Services. Postcomm will issue a Direction to Royal Mail's licence as attached at **Annex A**.

Summary of Royal Mail's request

- 3.4. Royal Mail submitted its business case in March 2007 requesting greater pricing flexibility to enable it to raise individual prices by more than the sub-cap allowed under the current price control. It requested an increase in the sub-cap from 'plus 3%' to 'plus 8.5%' per year for the remaining two years of the price control. It made this request to address its "*significant pricing cross subsidies*", e.g. first class Meter letters made

£49m profit (16% margin) for Royal Mail in 2006/07 while first class stamped Large Letters (101-250g) lost £22m (65% negative margin).

Responses from stakeholders to Postcomm's proposal

The overall response to the proposal

- 3.5. Royal Mail welcomed the proposal to increase the price rebalancing sub-cap to 8.5% for Basket B products as a positive move by Postcomm that recognises the increased competition for products in this basket. However, it also argued that the proposed extra flexibility for Basket A products is too restrictive, and does not recognise Royal Mail's commercial pricing policy and the price differentials it seeks to maintain between products, formats and weight steps.
- 3.6. Other respondents were concerned that the case for assisting Royal Mail was not justified, because it had brought many of its cash flow problems upon itself. It had failed to deliver efficiency improvements, to make the most of existing price flexibility, to make the most of market opportunities or to innovate.
- 3.7. The MCF and other operators were concerned that additional pricing flexibility might allow Royal Mail to "*fund price reductions*" where it faces competition. In particular they were concerned about the impact on meter/PPI prices, which they would see "*as a deliberate ploy to target and to price out competition in these areas*" and to which they "*would wish to object in the strongest possible terms*".
- 3.8. Postwatch and mail users were concerned that price rises will dissuade both existing and potential new customers from using mail communications. Publishing companies meanwhile were concerned about the potential rise in prices for Presstream over the next two years and what they consider to be insufficient notice for such large price

changes, were Royal Mail to make full use of the additional pricing flexibility.

3.9. This section sets out the main issues raised by respondents in relation to pricing flexibility and Postcomm's conclusions on these matters. The main consultation responses concerned:

- *Data issues;*
- *Price stability;*
- *Presstream price increases;*
- *Customers should not have to pay for Royal Mail's management failures;*
- *Additional pricing flexibility will allow Royal Mail to fund price reductions where they face competition and affect the development of end-to-end competition;*
- *The extent of rebalancing that is appropriate; and*
- *Directly related prices – Response Services.*

Data issues

3.10. The MCF and other operators questioned the quality of Royal Mail's data in two ways:

- (a) if the data is of insufficient quality for an access headroom determination, how can it be adequate to support a change in pricing sub-caps; and
- (b) one respondent highlighted a number of apparent cost discrepancies between different price points in Royal Mail's data.

3.11. On point (a), as discussed in our August consultation document, the effect of even a small degree of uncertainty over Royal Mail's costs makes a substantive difference to available access headroom. We stated that Royal Mail's upstream costs were around 4.5p plus or minus 1p. However, for price rebalancing, relatively large discrepancies in the

data would not undermine the case for greater price rebalancing as in many instances prices are significantly out of line with costs (by as much as 55%).

- 3.12. On point (b), of the 60 price points listed in our consultation document (including those on which no additional rebalancing was proposed), 26 data points were queried, but these affected only around 2.7% of total Basket A volumes. Of the data point queries only 10 relate to price points on which we propose allowing Royal Mail additional pricing flexibility, accounting for around 1.6% of total Basket A volumes.
- 3.13. Royal Mail provided a qualitative explanation of the apparent discrepancies in the costs of these price points and a worked example, but was unable to provide Postcomm with compelling supporting evidence. We sought separately an independent view from a costing expert. The explanations from Royal Mail and the expert indicate two causes for the apparent cost discrepancies that follow from Royal Mail's cost allocation methodology: (a) associated characteristics, and (b) the mapping of costing system costs to product costs.
- Associated characteristics are used to derive average costs for a given product. For example, within the broad scope of a first class stamped letter weighing between 0 and 100g, there are many individual items, varying by weight, size, whether machine readable etc. Depending on the quantity of items with each set of distinct characteristics, the cost of an average item for the product will vary. This helps explain some of the apparent cost anomalies that have been highlighted.
 - The mapping issue is that Royal Mail's core costing system has a different definition of formats from that used for product pricing (following the introduction of PiP). This means that a set of calculations is necessary to map the former (costing system) onto the latter (products prices), creating what initially would appear to be counter-intuitive outcomes.

3.14. We carried out some sensitivity analysis and found that even large adjustments to the cost data, to allow for the maximum likely effect of any potential anomalies that might result from cost inaccuracies, still left Royal Mail's costs at least 6% above its prices for those products on which we propose additional pricing flexibility.

Conclusion

3.15. **The items on which anomalies have been identified comprise a small percentage of volume of the products on which we proposed a higher pricing sub-cap. Even if some amendments in costs are needed, we assess that costs will still outweigh prices by more than 6% in most instances. Evaluating this evidence, we consider that the anomalies are insufficient to change our proposal and that we should, therefore, continue to allow a higher sub-cap on the price points identified in our August proposals.**

Price stability

3.16. The MUA argued that price uncertainty will force customers to look to other forms of communication, with the risk that greater price increases will lead to a downward spiral of volume decline and further price increases. The DMA also supported this view and stated its concern that Royal Mail is being allowed simply to increase prices rather than requiring them to focus on reducing costs.

3.17. The MCF said that a 4-year price control should offer competitors a realistic degree of certainty and that, even without the additional Interim Review provision, the current price control appears to have allowed Royal Mail far too much flexibility to achieve this objective. Creating more flexibility and uncertainty makes it very difficult for market players to make "*sound investment decisions*".

Conclusion

3.18. **Postcomm takes these concerns over market uncertainty and the impact on customer business plans very seriously. However, it is also important to allow Royal Mail additional pricing flexibility to achieve greater cost reflectivity - this should create the right conditions to promote economic efficiency and effective, sustainable competition.**

Presstream price increases

3.19. Thirteen publishers (including the Periodical Publishers Association) have argued that the potential increase in Presstream prices is too great, with what they consider too short a notice period, and that this would be damaging to their business models.

Conclusion

3.20. **The scope for changes to the sub-cap part way through the price control was provided for in the current price control.¹⁴ Postcomm, in its final proposals¹⁵, considered that there are prospects for competition in Basket B services and the fact that Presstream may be keenly priced might be a reason for the current lack of competition for magazine distribution. Commercial pricing decisions are an issue for Royal Mail within the agreed pricing framework, though the under-recovery in 2006/07 by Royal Mail of the revenue allowed to it in the price control suggests that the scope for price rises is limited. Furthermore, Royal Mail's indicative prices as provided to Postcomm show that it does not currently propose to use the additional flexibility to increase Presstream prices (its planned increases could be achieved using the existing 3% sub-cap). However, these were only indicative**

¹⁴ Licence condition 21:15,16

¹⁵ Royal Mail Price and Service Quality Review, Final Proposals for consultation, December 2005

prices. Royal Mail published its final set of prices at the end of December 2007.

Customers should not have to pay for Royal Mail's management failures

- 3.21. Postwatch stated that "*where Royal Mail is suffering financially owing to management failure to address issues which are foreseeable and within its control, consumers should not be penalised through higher prices*".
- 3.22. Postwatch stated that it was not persuaded by the arguments presented in favour of increasing the rebalancing threshold to 8.5%, given the management failures of Royal Mail. Both Postwatch and the MUA argued that the price control already contains mechanisms to safeguard Royal Mail's interests in relation to its pension deficit and volume risks. They consider that customers should not be required to pay for management failures.

Conclusion

- 3.23. **It is in Royal Mail's commercial interests to use any increased price flexibility responsibly. Postcomm's decision to allow additional pricing flexibility is designed to promote economic efficiency. In addition, any unreasonable price adjustments are subject to ex post regulatory scrutiny as detailed in Royal Mail's licence.**

Additional pricing flexibility will allow Royal Mail to fund price reductions where it faces competition and affect the development of end-to-end competition

- 3.24. The MCF and other operators raised concerns that additional pricing flexibility will allow Royal Mail to fund price reductions where it faces competition. The MCF is concerned about the lack of transparency over the price reductions Royal Mail intends to make, and the implications this will have for competition. The MCF expressed its strong view that, given the very substantial degree of price flexibility sought by Royal Mail, and Postcomm's proposal largely to accept this, Postcomm "*should in return*

have obliged Royal Mail to publish its proposals for the actual prices it wishes to impose on the market’.

- 3.25. Though the MCF recognises that Royal Mail clearly needs to bring prices more into line with its costs in the case of its second class services, the operators the MCF represents are concerned about where the offsetting price reductions are likely to occur. They have specific concerns about possible reductions in metered and PPI mail prices, which would affect other operators’ plans to compete against these products both in the end-to-end market and access.
- 3.26. TNT Post claimed that if Royal Mail is given greater rebalancing flexibility (from 3% to 8.5%), this would allow Royal Mail to finance cuts in first class PPI and Metered mail prices, further squeezing the margins available for other operators in these markets.
- 3.27. Some operators have claimed that additional price flexibility will make the emergence of end-to-end competition more difficult. The MCF also explains that it becomes highly problematic *“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”.*

Conclusion

- 3.28. **Royal Mail may choose to use higher prices to ‘fund’ price reductions on competitive products. Such reductions are subject to anti-competitive pricing conditions in its licence and general competition law. In terms of market impact, it is in Royal Mail’s best interests not to engage in commercial activity that might cause further volume reductions in the market or a reduction in its revenues. Postcomm is committed to considering complaints of anti-competitive behaviour in a timely manner, in accordance with its statutory duty to promote effective competition. It is not,**

however, Postcomm's role to micro-manage Royal Mail's commercial decisions.

The extent of rebalancing that is appropriate

- 3.29. On Basket A, Royal Mail argued that the 8.5% re-balancing sub-cap should be extended to more price points than those proposed by Postcomm. It argued that the same price-cap should apply to all price points within a controlled service and for several (but not all) of the Controlled Services as a means to maintain coherent commercial pricing. Consistent with this aim, it proposed instead that Postcomm extend the 8.5% re-balancing sub-cap to around 60 price points rather than the 26 we proposed in our consultation document.
- 3.30. Royal Mail argued that Postcomm applied a restrictive accounting rule (our measure of cost reflectivity) to determine the 26 price points that may merit additional pricing flexibility. It argued that this approach does not take account of some of the past relationships between prices for some of Royal Mail's products that it would like to maintain.

Conclusion

- 3.31. **Postcomm notes that some of Royal Mail's prices are significantly out of line with costs, mainly for historical political reasons which meant that Royal Mail kept prices low for certain major products.**
- 3.32. **Customers using products in Basket A require regulatory protection against unduly fast price increases. Equally, Royal Mail needs additional sub-cap flexibility to address this historical misalignment of prices with costs for certain products.**
- 3.33. **Postcomm continues to believe that these aims are best served by adhering to the principle of cost-reflective pricing, and allowing a higher rebalancing sub-cap for a selected group of price points. Within this framework, it is for Royal Mail to decide if it wants, or is**

able to use, the additional pricing flexibility as part of its wider commercial pricing strategy.

Directly related prices - Response Services

3.34. Royal Mail says that Response Services are calculated as an additional charge on first and second class PPI services. Additional flexibility proposed by Postcomm should, therefore, be extended to the equivalent Response Services. This would add 7 price points, affecting only an additional 3.5m items per year.

Conclusion

3.35. **There is a clear and direct price and cost relationship between products on which we propose an increase to an 8.5% sub-cap and the equivalent Response Service; it seems reasonable, therefore, to extend the 8.5% sub-cap to those services.**

Summary of Postcomm's decision

3.36. Following careful consideration of all consultation responses, Postcomm has decided that its August 2007 proposals should remain unchanged except to extend the scope of the additional rebalancing sub cap in Basket A to cover relevant Response Services. This means that Postcomm has decided to make the following changes in relation to the rebalancing sub-cap in Royal Mail's licence:

- For products in Basket A, the 'captive' basket, whose prices are currently at least 6% below fully allocated costs, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year. As an amendment to the proposals made in August, this 8.5% sub-cap will now also apply to Royal Mail's related Response Services. For the remaining products in Basket A, the sub-cap will stay at 3% per year for the remainder of the price control; and

- For products in Basket B, the 'non-captive' basket, an increase in the price rebalancing sub-cap from 3% per year to 8.5% per year.
- 3.37. This greater pricing flexibility will allow Royal Mail, if it so chooses, to raise prices on certain loss-making products in both April 2008 and April 2009, such as second class stamps, by more than was permitted when the price control was set.
- 3.38. In our August proposals, we estimated that the higher sub-cap of 8.5% would allow Royal Mail to increase the price of a second class stamp by 2p to 26p in April 2008. We noted, however, that this would be dependent on the outcome of inflation to the end of September 2007 and several technical factors. We can now confirm that Royal Mail will actually be able to increase the second class stamp price by 3p to 27p, if it so wishes.
- 3.39. The August proposals also noted that the second class letter stamp price could have risen to 26p by 2010 under the pre-existing arrangements and with the changes proposed after our Interim Review it could rise to 29p by 2010. These figures are subject to actual inflation over the period and other technical factors such as the 'G' factor¹⁶. The latest estimates based on these technical factors, indicate that prices for second class letter stamps might increase to 30p. However, this will only become clear towards the end of next year (2008).
- 3.40. The limit on the first class letter stamp price is unaffected by Postcomm's proposals (the sub-cap will remain at 3%), although under the latest estimates for the 'G' factor and inflation this may increase to 39p by 2009/10.

¹⁶ The 'G' factor is the adjustment within the price control for changes in mail volumes.

3.41. Annexed to this document is a Direction allowing Royal Mail greater pricing flexibility (see **Annex A**). This Direction will come into effect for implementation of Royal Mail's new prices on 1 April 2008.

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

Introduction

- 4.1. Postcomm's August 2007 proposals recommended that there should be no change to the levels of minimum access headroom for 2008/09, and that the scope of headroom regulation should not be extended to cover a broader set of Royal Mail products.
- 4.2. This section sets out our assessment of the issues raised by stakeholders in response to the August consultation document.
- 4.3. Having taken these responses into consideration, Postcomm considers that no changes are needed to the August proposals in concluding its decision on access headroom.

Summary of Royal Mail's, TNT Post's and UK Mail's requests

- 4.4. In its application, Royal Mail argued that the level of access headroom for a number of products was too high, making it too easy for competitors to undercut its bulk mail retail prices. It also claimed that the current control of access headroom restricts Royal Mail from passing on savings it makes on its upstream activities to its retail customers, without also passing on those savings to competitors (who ought not to benefit from them) through lower access prices.
- 4.5. TNT Post and UK Mail argued the opposite. They claimed that headroom levels needed to be increased as the current level of access headroom offered insufficient scope to enable long-term investments by access operators and thereby promote effective competition in the longer term. They argued that any reductions in headroom would have a

substantial negative impact on their businesses and may make them unsustainable.

- 4.6. In addition, both TNT Post and UK Mail asked that the regulatory safeguard of headroom regulation be extended across a broader range of access products than those used by Postcomm in setting Royal Mail's price control in early 2006. Both argued that the alternative of *ex-post* anti-competitive investigations would take too long, such that they might be forced out of the market before any investigation was concluded.

Responses from stakeholders to Postcomm's proposal

The overall response to the proposal

- 4.7. The overall response to the August 2007 proposal was mixed. The applicants (Royal Mail, TNT Post and UK Mail) reiterated the positions set out in their applications, calling for Postcomm to reconsider its proposal in favour of their respective arguments. The MCF supported its members' positions, calling for an increase in the access headroom, while the CWU supported Royal Mail's position, expressing disappointment that Postcomm had not chosen to reduce access headroom.
- 4.8. The majority of mail users either remained silent on the issue of access headroom or expressed support for Postcomm's proposal of no change. Postwatch stated that it agreed with the proposal, noting that in its opinion no compelling case had been made for any change to access headroom.

4.9. This section sets out the main issues raised by respondents in relation to the August proposals on access headroom and Postcomm's conclusions on these matters. The main consultation responses concerned:

- *Postcomm's explanation of its analysis;*
- *Royal Mail's data quality;*
- *The disclosure of data;*
- *The ex ante access headroom control;*
- *Ability to introduce new retail offers;*
- *Volume declines and financing the universal service;*
- *Standardising headroom levels;*
- *Royal Mail's ability to reduce losses on access;*
- *Materiality of barriers to entry;*
- *Forecasting requirements for access; and*
- *Extending the scope of access headroom regulation.*

Postcomm's explanation of its analysis

4.10. Royal Mail questioned Postcomm's proposal to delay any changes to access headroom until April 2009 at the earliest, arguing that changes should be made from April 2008, based on the level of headroom suggested by applying a "margin squeeze" test. UK Mail and TNT Post were concerned that their applications had been rejected on the basis of poor quality Royal Mail data, and that their own data should have been used instead.

4.11. There are two variants of the margin squeeze test, each of which uses a different cost benchmark:

- the 'as efficient' test considers whether a dominant company's own upstream operations could trade profitably on the basis of the downstream price charged to its competitors by the downstream operating arm of the dominant company; whereas,
- the 'reasonably efficient' test considers whether a reasonably

efficient upstream operator could at least earn a normal profit when paying input prices set by the dominant company.

- 4.12. The August proposals noted that Postcomm has focussed on the 'as efficient' test, based on Royal Mail's costs. The 'as efficient' test takes Royal Mail's upstream costs as the benchmark for the postal industry. The principal reason for using Royal Mail's costs in this way, rather than the costs of its competitors (who may be more efficient) was to ensure that competitors are put on an equal footing with Royal Mail. It would be unreasonable to require a new entrant to be more cost efficient than Royal Mail in order to be able to compete, especially as Royal Mail is likely to benefit from advantages of scale.
- 4.13. The proposals explained that the 'as efficient' test suggested that headroom may be too low for some products and too high for others; but that these results were subject to a considerable margin of error due to the relative unreliability of Royal Mail's cost data. Postcomm set out its concerns in relation to Royal Mail's cost data in the August proposals document.
- 4.14. Given the concerns in relation to reliability of the data supplied by Royal Mail, Postcomm also considered the 'reasonably efficient' test at a high level. This was done to address the concern that new entrants' costs may be higher than those of Royal Mail such that it is not able to make a normal profit.
- 4.15. Our high-level findings on the 'reasonably efficient' test differed from that argued by UK Mail and TNT Post, both of which suggested that a margin squeeze test based on their own costs would fail, mainly because of the discounts they need to offer Royal Mail's existing customers in order to persuade them to switch from Royal Mail. TNT Post and UK Mail indicated therefore that they would be unlikely to trade profitably at the access prices charged by Royal Mail, thus requiring access headroom to be increased. However, the margin squeeze tests disallow the switching

discounts because these tests only require that competitors can trade profitably at the retail prices charged by Royal Mail; not that they can trade profitably at a discount to those retail prices. As Postcomm noted in its August proposals document, the upstream costs for these new entrants are lower than Royal Mail's upstream costs, indicating that the headroom levels may be sufficient.

Conclusion

- 4.16. Neither the 'as efficient' nor the 'reasonably efficient' tests provided clear evidence that changes are needed to access headroom.**
- 4.17. Postcomm maintains that Royal Mail's cost data is not sufficiently robust to make small changes of fractions of a penny in access headroom with any degree of confidence, the implications of which could be significant for the development of access competition.**
- 4.18. The current access headroom control is designed to prevent upstream margin squeeze by Royal Mail. Postcomm will need to consider the most appropriate way to ensure the continuation of effective upstream competition when the current price control is replaced in April 2010. We are keen to explore different mechanisms to the current access headroom control as part of our work for the next price control.**

Royal Mail's data quality

- 4.19. Royal Mail, in its response, has highlighted several shortcomings in its own cost data. First, it states that revenue derived volumes (necessary for the 2006/07 cost analysis) were not available in time for Postcomm's analysis. This meant that Postcomm had to project forward Royal Mail's 2005/06 costs to allow margin squeeze analysis for subsequent years including 2006/07. Royal Mail says that, "*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.” This reaffirmed Postcomm’s view in helping conclude its proposal for no change to access headroom based on the data made available by Royal Mail.

- 4.20. Royal Mail has stated that it *“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”*. Royal Mail also stated in its response that, *“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.”* Together, these statements support the concerns we had about the quality and robustness of Royal Mail’s cost data.

Conclusion

- 4.21. **Royal Mail’s 2005/06 costing system contains inconsistencies and irregularities relating to the treatment of access products and their analogous retail products. Whilst Postcomm has sought to work with Royal Mail to improve the underlying cost data, inconsistencies still remain. The responses from Royal Mail confirm our concerns over the quality and robustness of Royal Mail’s cost data for a decision to change access headroom levels by fractions of a penny.**

The disclosure of data

- 4.22. Royal Mail has argued that Postcomm has not provided sufficient detail either on the adjustments it has made to Royal Mail’s cost data or on the results of its margin squeeze analysis.

4.23. Detailed analysis of access headroom involves the assessment of data that is considered commercially confidential by participants in the upstream market, including Royal Mail and the other operators. This limits the level of detail that can be disclosed in a public document and to the individual applicants. However, over the last few months Royal Mail has been given additional details of the adjustments and calculations made by Postcomm in relation to Royal Mail's costs. Postcomm has also held a meeting to discuss the key adjustments in detail with Royal Mail and a redacted version of the model used to inform the conclusions in the consultation document was sent to Royal Mail in September 2007.

Conclusion

4.24. **Postcomm believes that it has been fully transparent with regard to its analysis, subject to ensuring that commercially confidential information has not been disclosed.**

The ex ante access headroom control

4.25. Royal Mail argued that an *ex ante* control over access headroom is disproportionate and that a more proportionate regulatory response would be to use an *ex post* margin squeeze test to police any apparent anti-competitive behaviour by Royal Mail. Conversely, TNT Post claimed in its response that it is essential to protect operators from margin squeeze by applying *ex ante* measures. It believed that Postcomm should create a mechanism to prevent margin squeeze and argued that "*ex post remedies against a super-dominant incumbent at a very early stage of market opening are likely to be too little, too late*".

4.26. The issue of whether access headroom should be regulated on an *ex ante* or *ex post* basis was considered at the time of the last price control review. Postcomm decided that access products should be brought within the price control because, in the absence of an access code, bringing access within its control would increase stakeholders' certainty about the future levels of access prices, address concerns regarding the

negotiating of access terms and be consistent with developments in other regulated sectors. In accepting the overall price control package Royal Mail implicitly agreed to the inclusion of the *ex ante* access headroom control within the price control.

Conclusion

4.27. We can well understand that Royal Mail may dislike the current form of regulation for access, which we acknowledge is a relatively blunt tool. Postcomm will revisit the issue of access regulation more broadly in the context of the next price control review. However, there is very little evidence at the moment to suggest that ex ante regulation of access can be removed at this early stage of a liberalised mail market. Some of the key considerations are the degree of assurance new entrants can have that Royal Mail would not engage in damaging anti-competitive practices, absent a greater degree of transparency in its costs, and the fact that Royal Mail apparently regards access seekers as rivals rather than business partners.

Ability to introduce new retail offers

4.28. Royal Mail expressed concern that it cannot introduce new products based on greater avoided upstream costs (e.g. in collection) without being forced to pass on such upstream cost savings in downstream access prices. It claims that the proposals do not deal with this issue.

Conclusion

4.29. As stated in the August consultation document Postcomm does not reject the principle behind Royal Mail's concern but reiterates that it requires objective cost evidence to support additional discounts. However, Royal Mail has neither supplied this evidence, nor been able to provide detailed quantified cost evidence for its existing volume related discounts.

Volume declines and financing the universal service

- 4.30. Royal Mail argued that “*Postcomm’s proposals for access headroom continue market distortions that have led access volumes to exceed those forecast by Postcomm when setting the control*” and that access volumes demonstrate that headroom levels are “excessive”.
- 4.31. As noted above, there is no reliable cost evidence that current access headroom is set at an inappropriate level. It is not, therefore, possible to conclude, on the basis of the cost evidence, that current access headroom creates any “market distortions”.
- 4.32. It is true that access volumes have exceeded the central forecast by Postcomm when setting the price control, but one cannot conclude that this is due to excessive headroom. The take up of access is a function of several factors, not just the level of headroom. For example, it is possible that new entrants have lower costs and/or lower profit margins than assumed in the forecasts, that non-price factors have a greater impact or that customers are more price sensitive and have a lower brand allegiance to Royal Mail than assumed.
- 4.33. In its application, Royal Mail estimated that its requested reduction in access headroom would generate additional net cash flow of £52m a year on average over the last 2 years of the price control.

Conclusion

- 4.34. **Postcomm believes that if there is excessive access headroom, it should be eliminated, both for reasons of Royal Mail’s financial position and for the broader development of effective competition. However, currently there is no conclusive evidence to suggest that access headroom needs to be adjusted.**

Standardising headroom levels

- 4.35. In the August proposals document, Postcomm recognised that access headroom varies from one product to another and that there may be scope for commercial negotiations between Royal Mail and the other operators to adjust access prices without regulatory intervention. Both Royal Mail and TNT Post have submitted that Postcomm should address this issue by standardising headroom levels. TNT Post felt that a voluntary solution to agree more uniform headroom levels over the range of access services was not a “realistic prospect”.
- 4.36. We would note that the variability which does exist has been created by negotiations between Royal Mail and the other operators without any regulatory intervention and, therefore, is an issue for Royal Mail and the other operators to resolve. We do not accept that this issue cannot be resolved through commercial negotiations. The PiP implementation required similar negotiations on which Postcomm observed that satisfactory agreements were made to the benefit of Royal Mail and other operators.

Conclusion

- 4.37. **Postcomm would urge Royal Mail and the other operators to conduct commercial negotiations in relation to standardising headroom levels.**

Royal Mail's ability to reduce losses on access

- 4.38. Royal Mail argues that Postcomm is mistaken in its claim that Royal Mail could reduce the losses on access identified by its own costing analysis by around 80%. Royal Mail says that “*access prices are currently at or close to the level of the maximum allowed access prices (a constraint imposed by the headroom requirement).*” It also argues “*that 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”.

- 4.39. The main barrier identified by Royal Mail to reducing access losses by increasing its access prices and by extension its retail prices is that this would lead to a weakening of its competitive and financial position. This confirms that a principal reason for the losses on retail products where competition is extremely limited, is not Postcomm's regulation but Royal Mail's desire to keep retail and access prices low. The nature of the access headroom control means that an increase in the prices of retail services and their equivalent access service will lead to an increase in the absolute price difference (which could allow operators more margin within which to operate).¹⁷ It could be the case that this is a factor behind Royal Mail not wanting to raise retail prices so as not to increase the available access headroom.

Conclusion

- 4.40. **We do not think that it is reasonable for Royal Mail to raise concerns that it is making losses on its access services when these could be partially addressed by raising its retail prices or by reducing its costs overall. We also think that Royal Mail should consider changing access prices, where currently it is not charging the maximum access price available under the current price control provisions.**

Materiality of barriers to entry

- 4.41. Royal Mail argued that the barriers to entry cited by Postcomm in the August proposals (VAT and the QMP Accreditation Scheme) are not material. Royal Mail suggests that “*the fact that access volumes have*

¹⁷ The converse is also true, any decrease in the prices of retail services and their equivalent access service will lead to a decrease in the absolute price difference (which could allow Royal Mail a competitive advantage).

exceeded Postcomm's expectations is evidence that, even if they exist, these are not material barriers to entry (if indeed they are real barriers)" and that the VAT exemption derives from UK law and is consistent with EU law. In relation to the QMP scheme, Royal Mail argued that it "*is only relevant at the retail level and does not entail discounts*", pointing out that Postcomm has carried out a preliminary investigation and found insufficient reason to conduct a full investigation.

Conclusion

- 4.42. **The level of access volumes achieved may indicate that barriers to entry are lower than previously thought. However it is not evidence that there are no material barriers. The fact that the VAT exemption derives from UK law does not prevent it from being a barrier.**¹⁸
- 4.43. **The access headroom control seeks to prevent distortion in the market for upstream services. The fact that the QMP scheme is offered to retail customers but not to downstream customers makes it an upstream cost for an "as efficient" operator.**

Forecasting requirements for access

- 4.44. In the consultation document, we stated in relation to forecasting requirements on access operators that Royal Mail had claimed that there is no offsetting cost saving from imposing these extra requirements. Given that access operators find these requirements onerous we proposed that Royal Mail either justifies the cost/benefit or discontinues them.
- 4.45. A number of respondents commented on forecasting requirements. The DMA asked Postcomm to consider whether they do provide any benefit for Royal Mail and noted that they would not want to see them brought in for retail products. UK Mail stated that Postcomm should not consider

¹⁸ The European Commission has recently published its Reasoned Opinion against the UK, Germany and Sweden (see EC press notice at <http://www.europa.eu>).

any further access headroom requests from Royal Mail, among other things, until Royal Mail had ceased the forecasting requirement.

- 4.46. Royal Mail claims that the forecasting requirements placed on access customers are similar to those placed on Mailsort customers, and that forecasting requirements for large customers are, in general, justified by the need for resource planning.

Conclusion

- 4.47. **Under the scope of this review Postcomm is not in a position to conclude whether or not the forecasting requirements are compliant with Royal Mail's licence and hence to justify Postcomm stating whether they should or should not be continued. It should however be noted that this does not preclude an operator, or customer, from making a formal complaint under Royal Mail's licence in relation to the forecasting requirements, if it wishes to do so.**

Extending the scope of access headroom regulation

- 4.48. TNT Post, UK Mail and the MCF have reiterated their requests for the scope of access headroom protection to be extended to other services.

Conclusion

- 4.49. **As outlined in our August proposals we consider that the case for expanding the scope of regulating access products has not been made. There is scope within Royal Mail's licence for operators to seek access to Royal Mail's postal facilities (Condition 9) and to call for the investigation of any undue discrimination or preference that may be apparent (Conditions 10 and 11).**

Summary of Postcomm's decision

- 4.50. Following careful consideration of all consultation responses, Postcomm has decided that its August 2007 proposals should remain unchanged. This means that no changes to access headroom regulation will be allowed for implementation from April 2008.
- 4.51. Postcomm's August proposals made it clear that Postcomm believes that Royal Mail should receive, and other operators pay, a cost reflective price for the use of its delivery network through downstream access arrangements. However, unfortunately the quality and reliability of the data that Royal Mail submitted in support of its application was a significant limitation to this review.
- 4.52. For Postcomm to make such a major pricing decision it requires data of sufficient quality and robustness. Postcomm has therefore concluded that no changes to access headroom regulation will be allowed for implementation from April 2008. In addition, unless significantly better quality and more robust data can be submitted to Postcomm in early 2008, Postcomm is unlikely to be able to allow a change to the access headroom regime within the current price control period.

ANNEX A

POSTCOMM
(The Postal Services Commission)

Postal Services Act 2000
Sections 11 and 13

Licence granted to Royal Mail Group Ltd
Schedule 2 Condition 21
Paragraphs 15 and 16

Direction to permit increased tariff
rebalancing

January 2008

POSTCOMM

(The Postal Services Commission)

Postal Services Act 2000
Sections 11 and 13

Licence granted to Royal Mail Group Ltd
Schedule 2 Condition 21
Paragraphs 15 and 16

Direction to permit increased tariff rebalancing

Whereas

- (1) Royal Mail Group Ltd registered in England and Wales as company number 4138203 and having its registered office at 148 Old Street London EC1V 9HQ (“Royal Mail”) is the holder of a licence (“the Licence”) granted under section 11 of the Postal Services Act 2000 (“the ACT”) by the Postal Services Commission (“Postcomm”).
- (2) The Licence was amended on 1 April 2003, 2 November 2005 and 25 May 2006.
- (3) Condition 21 in Schedule 2 to the Licence (“Condition 21”) controls the prices which may be charged by Royal Mail for postal services which are Controlled Services for the purpose of that Condition.
- (4) An overall control on average prices for Controlled Services is provided by paragraphs 5 to 14 of Condition 21.
- (5) In addition a limit is provided in paragraphs 15 and 16 of Condition 21 on the extent to which the price for each Price Range for each Controlled Service can be increased in each Formula Year.
- (6) With effect from 1 April 2006 the general limit on the extent to which the price for each Price Range for each Controlled Service can be increased in each Formula Year was 3 percentage points above the average percentage level of price increase provided by paragraph 5 of Condition 21, except as Postcomm, on the application of Royal Mail, may by direction in writing approve otherwise.
- (7) On 20 March 2007 Royal Mail submitted an application to Postcomm asking Postcomm, among other things, to enable

Royal Mail to move towards more cost-reflective pricing, by making one of three changes to the way in which prices for Controlled Services are controlled, including making a direction under paragraph 16 of Condition 21 to change the limit on the extent to which the price for each Price Range for each Controlled Service can be increased in each Formula Year.

(8) Following –

- the publication of a letter to parties with an interest in the postal industry on 22 March 2007,
 - the conduct of a workshop involving a number of those parties on 24 April 2007,
 - the publication on 9 August 2007 of a consultation paper indicating how Postcomm was minded to respond to Royal Mail’s application, and
 - consideration of responses received from Royal Mail and other parties to that consultation paper,
- Postcomm has decided to approve Royal Mail’s application to the extent set out in this Direction.

(9) Full details of the reasons for Postcomm’s decision are set out in the Decision Document in which this Direction is published.

Now therefore, in accordance with its duties under the Act and pursuant to paragraph 16 in Condition 21, Postcomm hereby directs as follows.

1. In this Direction –

(a) The Relaxed Price Ranges are

(i) the following Price Ranges for Controlled Services s = 1 to 13:

Controlled Service	Size (P - Packets LL – Large Letter L-Letter)	Weight (Grams)
1 (1 st Class)	L	1-100
1	LL	101-250
1	LL	251-500
1	LL	501-750
1	P	501-750

2 (1 st Metered)	LL	251-500
2	LL	501-750
3 (2 nd Class)	L	1-100
3	LL	101-250
3	LL	251-500
3	LL	501-750
3	P	251-500
3	P	501-750
3	P	751-1000
4 (2 nd Metered)	L	1-100
4	LL	251-500
4	LL	501-750
4	P	501-750
4	P	751-1000
10 (1 st Response)	LL	251-500
10	LL	501-750
11 (2 nd Response)	LL	251-500
11	LL	501-750
11	P	101-250
11	P	251-500
11	P	751-1000
12 (1 st PPI)	LL	251-500
12	LL	501-750
13 (2 nd PPI)	LL	251-500
13	LL	501-750
13	P	101-250
13	P	251-500
13	P	751-1000

and

- (ii) all Price Ranges for all Controlled Services in Basket B, and
 - (b) except where the context requires otherwise, words and expressions used in this Direction shall be interpreted in the same manner as they are interpreted for the purpose of the Licence.
2. There shall be an exception from the obligation provided by paragraph 16(c) in Condition 21 in respect of the Relaxed

Price Ranges in Formula Year $t = 3$ and in subsequent Formula Years to the extent that, in place of that obligation, in relation to each of the Relaxed Price Ranges, Royal Mail shall take all reasonable steps to ensure that in each such Formula Year the following conditions are met –

- (a) in Formula Year $t = 3$ and, if this Condition then applies, in Formula Year $t = 5$

$$\sum_{t-1}^t \Delta p_t \% \leq (RPI_{t-1} + RPI_t - 2X + 11.5 - c_t + c_{t-2} + pp_t - pp_{t-2} + g_t - g_{t-2})$$

and

- (b) in Formula Year $t = 4$

$$\sum_{t-1}^t \Delta p_t \% \leq (RPI_{t-1} + RPI_t - 2X + 17 - c_t + c_{t-2} + pp_t - pp_{t-2} + g_t - g_{t-2})$$

The common seal of Postcomm
hereunto affixed is authenticated
by –

Authorised for that purpose by
Postcomm

Date: 10 January 2008

ANNEX B

A list of the organisations that provided non-confidential responses to the consultation

Archant Life

British Broadcasting Corporation

Communications Workers Union

Direct Marketing Association

Emap

Future Publishing Limited

G Howse

Haymarket

HM Revenue & Customs

Mail Competition Forum

Mail Users Association

Periodical Publishers Association Ltd

Postwatch

Reader's Digest

Reed Business Information

Royal Mail

Simon Rickman

TNT Post

UK Mail

ANNEX C

Basket A Price Ranges that qualify for the rebalancing sub-cap of 8.5%

Controlled Service	Size (P - Packets LL – Large Letter L-Letter)	Weight (Grams)
1 (1 st Class)	L	1-100
1	LL	101-250
1	LL	251-500
1	LL	501-750
1	P	501-750
2 (1 st Metered)	LL	251-500
2	LL	501-750
3 (2 nd Class)	L	1-100
3	LL	101-250
3	LL	251-500
3	LL	501-750
3	P	251-500
3	P	501-750
3	P	751-1000
4 (2 nd Metered)	L	1-100
4	LL	251-500
4	LL	501-750
4	P	501-750
4	P	751-1000
10 (1 st Response)	LL	251-500
10	LL	501-750
11 (2 nd Response)	LL	251-500
11	LL	501-750
11	P	101-250
11	P	251-500
11	P	751-1000
12 (1 st PPI)	LL	251-500
12	LL	501-750
13 (2 nd PPI)	LL	251-500
13	LL	501-750
13	P	101-250
13	P	251-500
13	P	751-1000