

# **Annex 11**

## **The Valuation of the Royal Mail: A Statement by Professor Colin Mayer on the Note Written by Professor Martin Cave**

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As Martin Cave has noted, there are two components to the valuation of privatised firms. The first is the valuation at privatisation and the second is the valuation of new investment. A regulatory asset base (RAB) is the sum of the initial valuation of firms at privatisation indexed to current prices plus new investment. Investments that are included in the RAB are rewarded at the cost of capital. Appropriate incentives to undertake new investment are therefore provided irrespective of the valuation attached to assets at privatisation. The criteria by which initial valuations should be determined cannot therefore include incentives to new investment since these are appropriately provided irrespective of the initial valuation.

Instead initial valuations are determined by two factors, the first are distributional considerations, i.e. equity and fairness, and the second are competition and entry. In determining the appropriate valuation of firms at privatisation the main consideration that dominated most of the privatisations was avoidance of discrete changes in prices. Initial valuations were essentially set to avoid large movements in customer charges around privatisation. Thus in the case of the water industry valuations were less than 10% of current cost because existing charges could not justify anything like the amounts that current cost valuations would imply.

In the case of the Royal Mail, distributional considerations are of far less significance since the valuation determines the allocation between the government and customers not between private investors and customers. In principle, a high valuation could be offset by the government paying a corresponding subsidy to Royal Mail customers leaving them indifferent to the size of the valuation. Unlike privatisations, there are therefore no necessary distributional implications of initial valuations.

Instead, the primary consideration is one of competition and entry rather than distribution and equity. The most effective check on pricing is competition rather than regulation. However, to achieve that, new firms have to enter the market for Royal Mail services. This will occur if the value of entering is in excess of the current cost of initial investment. Competition will emerge where anticipated valuations are in excess of initial investment costs.

The potential of entry into the market will limit the returns that the Royal Mail can earn. In the absence of barriers to entry, Royal Mail will be able to command a valuation which is no greater than the current cost of its assets. If its valuation is in excess of the current cost of its assets and new firms can replicate the market demand and costs of the Royal Mail then entry will occur driving down returns to the point at which entry is no longer profitable.

Where barriers to entry exist then Royal Mail's valuation can exceed the current cost of its assets. Barriers to entry arise where new firms cannot replicate either the demand or cost conditions of the incumbent. In the case of the Royal Mail there are several factors that may contribute to a market or cost advantage of the incumbent. First, the Royal Mail has a reputational advantage in the market and has created a

national network of customers. Second, it has established the physical infrastructure required to provide a national mail service. Third, it has the knowledge and managerial skills to organize the service.

An entrant will have to build a customer base, acquire the infrastructure and acquire the knowledge and skills to manage a mail system. In addition to the current cost of Royal Mail's physical assets, an entrant will therefore incur marketing costs in attracting customers, purchase costs of acquiring and installing assets, and learning and implementation costs in establishing the managerial skills. There will furthermore be a delay before the entrant has created a viable customer base and efficient modes of delivery of services. These upfront costs and delays create barriers to entry that allow the Royal Mail to earn returns that are in excess of normal returns on the current cost value of its physical assets without encouraging entry into the industry.

To promote entry, charges will have to be set at a level that reflects the entry costs of new firms coming into the industry which will be in excess of a normal return on Royal Mail's existing assets. The difference between the value that is required to encourage entry and the current cost of Royal Mail's physical assets is what I will term the intangible value of Royal Mail.

How should this intangible value be measured? There are two approaches that can be taken. The first is what might be termed a "bottom-up" approach of trying to establish the costs that an efficient entrant would incur in gaining access to the industry.<sup>1</sup> This requires an evaluation of the modern equivalent value of the assets required to provide services that replicate those offered by the Royal Mail. It should be noted that the modern equivalent value is the most efficient configuration of assets using current technology to deliver existing services at lowest cost. It is this, rather than the existing configuration or technology, that is the appropriate basis on which to value Royal Mail's assets and it is the valuation that should be used for the current cost estimates to which I referred above.<sup>2</sup>

In addition to these physical assets, an entrant will incur costs of installation, initial advertising and marketing expenditures, recruitment and training, systems development, managerial induction etc, which will have to be incurred before it can start operations. These will not in general be the same as those that the Royal Mail has incurred on these activities in the past. A separate estimate will be required of an entrant's costs together with the present value of the revenue that it will forgo before it gains market share and operates in steady state.

There is inevitably a significant element of subjectivity associated with the determination of these valuations and costs and so a second "top-down" approach

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<sup>1</sup> For details on this see Edwards, J., J. Kay and C. Mayer (1987), *An Economic Analysis of Accounting Profitability*, Oxford: Oxford University Press and Office of Fair Trading (OFT) (2003), *Assessing Profitability in Competition Policy Analysis*, a Report Prepared for the OFT by Oxera.

<sup>2</sup> In practice, optimised valuations are not easy to determine and approximations of varying degrees of sophistication are employed. The Royal Mail may not yet feel in a position to undertake a full modern equivalent valuation exercise and instead wish to restrict itself to adjusting existing valuations for identifiable inefficiencies.

should be used as a check on the validity of the estimates. This involves determining the costs that new entrants in similar markets for mail, courier and delivery services have incurred and the valuation that existing firms in these markets have achieved. In particular, the difference between the market and modern equivalent value of the physical assets should be measured as estimates of the intangible value of incumbents. The validity of these estimates will hinge critically on demonstrating that (a) the markets in which these firms operate are indeed similar to those of Royal Mail and (b) that unlike the Royal Mail at the present time, these firms are subject to truly competitive conditions.

In principle therefore the approach that the Royal Mail has taken to the determination of its valuation combining bottom-up with top-down estimates is appropriate. It will be important to establish whether these approaches have in practice been correctly implemented. Such an assessment should in particular critically evaluate the determination of current cost valuations, i.e. whether efficient configurations of assets and modern technologies have been considered or appropriate adjustments to existing valuations been made, the assessment of the additional costs incurred by entrants and the identification of comparators for determining brand values. The consistency of the results emerging from the different approaches will provide an indication of the reliability of the estimates of Royal Mail's valuation.