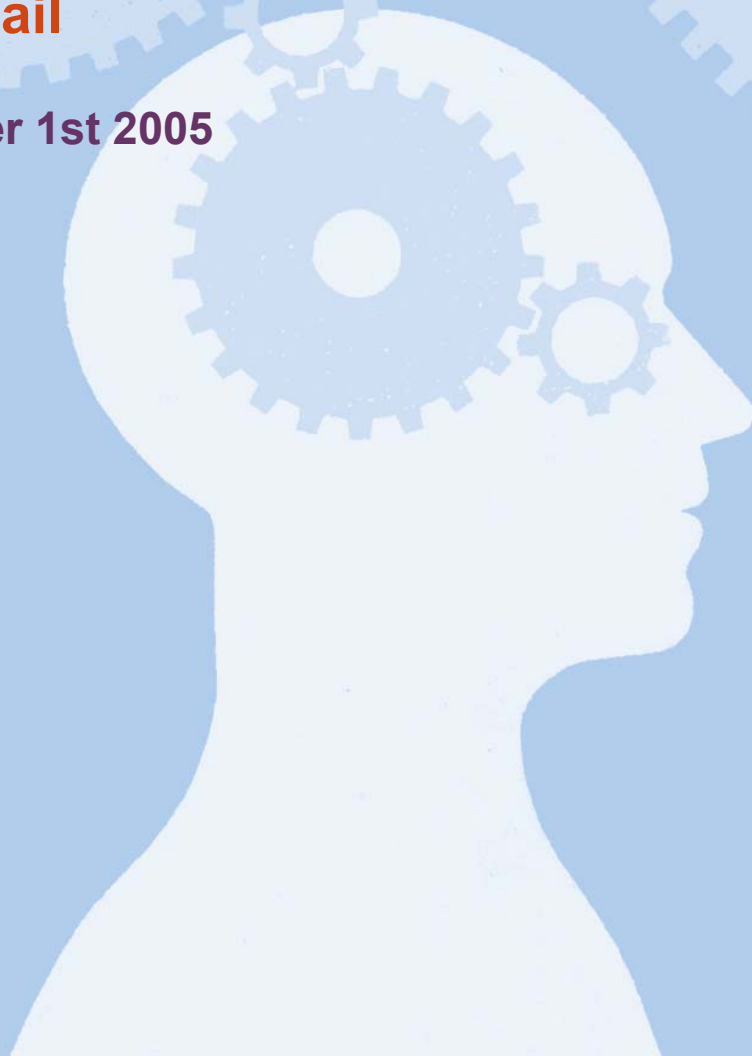


Determining the scope of Royal Mail's price control: regulatory precedent

Report prepared for
Royal Mail

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Executive summary

This report analyses the evidential basis for Postcomm's proposal to change the scope of Royal Mail's price control, and presents a summary of the regulatory precedent set by Ofcom (and previously by Oftel) for removing services from a control (or reducing regulation). This is particularly relevant to the case of Royal Mail because of the reference to this approach within the report by Frontier Economics.¹

The evidence presented by Postcomm falls well short of the evidence and analysis undertaken by Ofcom (Oftel) for the removal of services. The need for further work and evidence appears to be recognised in Frontier Economics' report, but has not been taken forward in Postcomm's Initial Proposals, published in June 2005.

The issue is not therefore that the proposed scope of the control is problematic, but rather that Postcomm has not applied its own process on the basis of the necessary evidence to support its decision. As a market liberalises, an incumbent firm needs to make significant adjustments to its business model if it is to make a successful transition to a competitive market. This transition is in the interest of the company, consumers and the regulator. A key element of the success of this process is the certainty around the regulatory framework. This is essential to both entrants and the incumbent. Without good evidence-based decision-making on the scope of the control, it is difficult for any market participant to judge likely developments in pricing for a given product. This can hinder entry and investment by any participant.

In addition to considering the scope of the control, Frontier Economics' report touches on issues related to the number of sub-controls. As acknowledged by Frontier Economics, the categorisation of products is based on a significant degree of judgement and limited evidence. Furthermore, although a set of three sequential criteria for establishing separate controls is considered, the two options considered in the final step are not based on clear objective guidelines that would enable a choice to be made between the options. Other options could also have been considered, as there appears to be no guiding principles for the choice other than simplification.

Postcomm has made substantial effort to establish some guidelines for removing services from the control. It is necessary to follow these guidelines and investigate in more depth actual behaviour in the market. Evidence on market conditions for individual products is an essential aspect of good (de)regulatory decisions. This same message was given to Postcomm by its own consultants in 2004.

¹ Frontier Economics (2004), 'Scope of the Price Control: A Final Report Prepared for Postcomm', October.

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1 Introduction

In its decision document in March 2003 for the current price control, Postcomm stated that it:

carefully considered the extent to which competition was developed for Presstream and Special Delivery products, to permit an alternative treatment for such products under the control, but concluded that there was insufficient evidence that competition was sufficiently developed to merit such treatment²

Postcomm's view of the competitive constraints on Presstream and Special Delivery (Next Day) has changed significantly since March 2003, as it stated in June 2005 that it is:

proposing to maintain the same coverage as the current price control, except for the removal of:

- Special Delivery (next day) for large and medium business customers (those who pay on accounts); and
- Presstream products.³

In reaching this conclusion, Postcomm refers to the work of Frontier Economics and reports some limited statistics about the market. The conclusions on the scope of the control with regard to these two products in the Frontier Economics report is:

There may be a case for also excluding Presstream and Special Delivery (Standard) from the control. Further analysis of these products is warranted during the course of this review ...⁴

The approach advocated by Postcomm to determining the scope of the control is based on an assessment of whether competition for a given product is sufficiently developed that the interest of consumers would be protected without the need for price control. This regulatory approach ensures both that consumers are protected and that unnecessary regulation is removed in a timely fashion, allowing markets to develop unhindered and without potential distortions caused by regulation.

The issue is then how to determine whether competition is sufficiently effective. A decision to remove regulation is important and should be accompanied by appropriately rigorous evidence. Without this evidential basis, market participants (both the regulated company and potential entrants) face significant regulatory uncertainty over assessing the likely response of the regulator to market developments. This hinders an ability to plan for the changes that liberalisation will bring.

Oxera has provided supplementary evidence in support of Postcomm's conclusion that competition is sufficiently developed for Special Delivery (Next Day) and Presstream. This report considers the process through which, and evidential base upon which, Postcomm draws its conclusion that the conditions for sufficiently developed competition were met for these products. While evidence presented in separate reports by Oxera supports the conclusion that these products can be removed from the control, Postcomm has not followed the guidelines it has itself set out, because it has not supported its conclusion with

² Postcomm (2003), 'Price and Service Quality Regulation: Second Price Control, Quality Service Targets and Compensation—Licence Modification and Decision Document', March, paragraph 4.8.

³ Postcomm (2005), '2006 Royal Mail Price and Service Quality Review, Initial Proposals', June 1st, paragraph 3.29.

⁴ Frontier Economics (2004), *op. cit.*, p. 57.

appropriate evidence related to the stated criteria. This lack of evidential basis was highlighted by Frontier Economics in its own recommendations to Postcomm.

This report is structured as follows.

Section 2 looks at the regulatory precedent and level of evidence gathered in support of a decision to remove services from regulation in the telecommunications sector. This is particularly relevant to the case of Royal Mail because of the reference to this approach within Frontier Economics' report (page 63) and Oftel's (and Ofcom's) published documents setting out the regulator's approach to removing services from the control.

Section 3 examines the actual evidence relied upon by Postcomm, either itself or through reliance on the Frontier Economics analysis, to support the change in position between March 2003 and June 2005 as presented. The evidence is found not to be of a similar standard to that relied upon elsewhere.

Frontier Economics' report not only covers the scope of the control, but also touches on issues related to its structure, especially on the criteria that the regulator could consider if separate price controls were introduced. Some of these issues are considered in section 4. Section 5 concludes.

2 Regulatory precedents in the telecommunications sectors for removing services from a control

In 2000, Oftel presented an approach to reviewing whether effective competition exists in a market.⁵ The aim of its review was to determine whether sector-specific regulation could be removed, leaving only a reliance on general competition laws to promote competition.

The proposed assessment of the effectiveness of competition in a market has two main strands:

- **market analysis**, focusing on the extent to which effective competition in the market segment is feasible and effective; and
- **assessment of the outcomes for consumers** to establish whether they are receiving benefits consistent with an effectively competitive market.

The guidelines considered a number of criteria to assess the degree of competition in a market. These were grouped as follows:

- **consumer outcome**—eg, availability of a wide range of products, customer satisfaction with the service quality, set of prices broadly reflecting costs;
- **consumer behaviour**—eg, consumers able to access information, absence of switching barriers;
- **supplier behaviour**—eg, active competition in price, meeting consumers' needs, recent entry;
- **structural factors**—eg, limited entry barriers, change in market structure over time.

In 2002, the approach was modified in accordance with the requirements established by the European Framework Directive for electronic communications. However, this approach to assessing when a market is effectively competitive is still at the heart of Ofcom's analysis.⁶ Based on the revised guidelines, to undertake such market analysis, Ofcom employs a series of criteria (see Table 2.1 below). When interpreting the criteria in the table, Ofcom considers the following factors:

- the relationship between indicators;
- the relationship to other competition assessments;⁷
- the impact of existing regulatory controls in the market segment;
- the weighting of different indicators; and
- the quality of the data sources.

⁵ Oftel (2000), 'Effective Competition Review Guidelines', August.

⁶ Oftel (2002), 'Oftel's Market Review Guidelines: Criteria for the Assessment of Significant Market Power', August.

⁷ Market influence determinations, Competition Act and licence condition investigations, and SMP reviews.

Table 2.1 Effective competition criteria

Criterion	Implication for assessment of market power
Market shares	Market shares are not conclusive on their own. The persistence of a high market share over time, and the ease with which new entrants might erode that market share, are relevant
Overall size of the undertaking	This refers to the advantages that may arise from the large size of an undertaking relative to its competitors (eg, scale economies, finance, etc), and the sustainability of these advantages
Control of infrastructure not easily duplicated	One example is control/ownership of a large network that a competitor would find costly and time-consuming to build
Technological advantages or superiority	These may represent an entry barrier
Absence of, or low, countervailing buying power	The existence of customers with a strong negotiating position may restrict the ability of providers to act independently of their customers
Easy or privileged access to capital markets/financial resources	This may represent a barrier to entry
Product/services diversification	Bundling may support dominance by foreclosing the market for part of the bundle to other suppliers
Economies of scale	These can act as an entry barrier as well as providing an advantage over existing competitors
Economies of scope	These can act as an entry barrier as well as providing an advantage over existing competitors
Vertical integration	This can promote dominance in two ways: by making new market entry harder; and through the potential ability to lever market power into upstream or downstream markets
A highly developed distribution and sales network	This may represent a barrier to entry as well as an advantage over existing competitors
Absence of potential competition	This refers to the prospect of new competitors entering the market within the timeframe considered by the review
Barriers to expansion	There may be more active competition where there are lower barriers to market growth and expansion
Ease of market entry	The threat of potential entry may prevent the incumbent from raising prices above competitive levels. Structural barriers plus any evidence of both potential and actual entry are relevant to the assessment
Excess pricing and profitability	The ability to price at a level that keeps profits persistently and significantly above the competitive level is relevant
Lack of active competition on non-price factors	Non-price competition refers to differentiation between products and providers
Barriers to switching	Limited customer ability to switch between providers increases the extent to which providers can act independently of their customers
Customers' ability to access and use information	Limited customer access to, and use of, reliable information on prices and other service aspects can dampen competition by reducing the degree to which customers act upon differences between providers

Note: The table presents single dominance criteria listed in European Commission guidelines and additional criteria by Oftel.

Source: Adapted from Oftel (2002), op. cit.

A key consideration in assessing effective competition is the impact of existing regulation on promoting competition in the market segment. Ofcom examines whether competition would be self-sustaining if these controls were lifted. This determination requires a view to be taken about future behaviour. Ofcom considers a three-stage process of assessing whether competition is sustainable without regulation:

- the indicators must point to effective competition findings;
- the current regulations relevant to the market segment must be identified;
- their impact must be assessed.

In the last stage, there are three possible findings:

- the market has superseded regulation;
- the impact of regulation is uncertain;
- the market still relies on regulation.

If Ofcom finds that the market has superseded regulation, it will remove regulation and monitor the continuing effectiveness of competition. If the impact of regulation has been uncertain, Ofcom will assess the risk of removing the current regulation and explore the scope for phased relaxation of the current regulation towards light-touch regulation. Where the market continues to rely on regulation, Ofcom will evaluate whether the regulation itself is creating dependency and will carry out a cost–benefit analysis of the scope to reduce or eventually remove regulation.

In setting out the indicators presented in Table 2.1, Oftel made it clear that it is not appropriate for these indicators to be used mechanistically. Moreover, in making its assessment, the regulator will need to consider the relevance of each indicator with respect to the market segment being assessed.

As it is quite possible that not all of the indicators will point to the same conclusion, a final judgement will involve weighting various criteria, with greater weight placed on those that are of greater importance to the market being assessed. Ofcom (then Oftel) acknowledged that the weighting of different criteria is unlikely to be a precise exercise, given the value of the assessment involved. The assessment may therefore take the form of identifying the relative importance of the various factors.

To date, detailed effective competition reviews, in line with the European Commission guidelines on market assessment for electronic communications services, have been undertaken in 13 telecommunications markets, including fixed telephony, number translation services, the mobile markets, dial-up Internet access, and wholesale broadband access.

Box 2.1 summarises the history of Ofcom’s (then Oftel) review of the fixed telephony market, which represents the major direct intervention into retail markets by Ofcom. Oftel conducted a thorough analysis in 2002, including primary survey evidence on consumers, analysis of entry and development of rivals, performance of BT in this segment, and evidence on quality of service. On the strength of all this analysis, Oftel determined that retail regulation could be reduced, as competition was increasingly effective. Ofcom confirmed this finding in its reappraisal in 2003. In addition, Ofcom’s 2005 review of BT’s network charge controls is summarised in Box 2.1. In this case, the regulator conducted a detailed market analysis that allowed it to relax regulation in one market and to completely deregulate another.

Box 2.1 Fixed telephony reviews

From the different effective competition reviews carried out by Ofcom or Oftel, perhaps the two most relevant for Royal Mail, in terms of the competition-based approach for removing services from the control, are the 2002 review of the fixed telephony market under the retail price control review, and the subsequent re-examination of this under the Framework Directive in 2003, and the 2005 review of BT’s network charge controls. Both cases assessed the level of competition in the residential market and decided on the measures needed to promote competition and protect consumers.

Retail price control

As part of the review, Oftel examined several competition indicators. Survey evidence was employed to gauge the level of customer satisfaction, the awareness of phone bill and comparable performance information sources, the awareness of the option to take up indirect access, and the levels of switching for residential telephone suppliers.

BT accounts data provided information on the profitability of access services, geographic calls, and calls to

mobiles. There was no evidence that BT's rates of return on calls had declined. One exception was calls to mobiles, where BT's retention is capped. However, the impact of the loss of market share and falling prices was reflected in a decline over time in the absolute values of BT's profits on calls. Market information on BT's market share of retail access and retail calls and the level of entry into the market by broadband and other operators was also used, as well as the level of complaints about the quality of service.

Oftel's initial view and conclusions were that the access and calls markets were not yet effectively competitive (with the exception of the competitive business international direct-dial market, identified in a separate review). However, this view was moderated by the fact that competition in the provision of fixed calls had steadily increased, BT's market share for calls was gradually being eroded, and its call profits had been falling (in absolute terms) over time.

This led to the conclusion that immediate withdrawal from regulation would put some consumers at risk. Oftel believed that, as well as some continued price regulation, new measures were needed to promote competition from other service providers, and that, since the additional competition increased commercial pressures on BT to reduce its prices, the price control regime could, and should, be relaxed.

BT accepted Oftel's proposals for modified price controls and new measures to increase competition in the residential calls market. Among other conditions, these required BT to adhere to an RPI-RPI safeguard price control on those services used by the lowest-spending 80% of BT's residential customers. Oftel also stated that this price control would be removed automatically when prices fall by a significant amount due to competitive pressures. This replaced the RPI – 4.5% price cap that was in place until July 31st 2002. The new licence conditions came into effect on August 1st 2002.

The significant market power (SMP) findings and remedies were reaffirmed in 2003 and will be re-examined in 2006. Ofcom identified that once a fit-for-purpose wholesale line rental product was in place, there would be scope for relaxing the safeguard cap to RPI – 0.

Network charge controls

Ofcom's review of BT's network charge controls examined competition indicators similar to those mentioned above. As part of the review, Ofcom undertook a market analysis of wholesale narrowband markets and, based on the available evidence, decided to completely deregulate one economic market (inter-tandem conveyance and inter-tandem traffic) by removing charge controls and other regulations. Furthermore, in another market (local-tandem conveyance and local tandem transit), the regulator is relaxing the controls by moving the control to a 'safeguard' cap of RPI – 0%.

As part of the review, Ofcom looked at evidence taking into account the European Commission's guidelines for market analysis. In particular, some of the factors contributing to Ofcom decision to relax regulation in the local-tandem market included market information on BT's market shares, the level of entry, and the convergence of local-tandem conveyance charges towards costs.

Similarly, some of the factors contributing to Ofcom's decision to withdraw regulation from the inter-tandem conveyance and inter-tandem market included a downward trend in BT's market shares, plus a reduction in the size of the transit market, ease of market entry, and whether the price cap is binding. (The evidence indicated that BT did not always price up to its regulated price cap.)

Source: Oftel (2002), 'Protecting Consumers by Promoting Competition', January 31st; Oftel (2003), 'Fixed Narrowband Retail Services Market: Final Explanatory Statement and Notification', November 28th; Ofcom (2005), 'Review of BT's Network Charge Controls: Explanatory Statement', August 18th.

3 The approach to the scope of the control presented by Postcomm

Postcomm states in its Initial Proposals that it:

identified five criteria that it would use as the basis for its assessment of the development of competition:

- Barriers to entry. This includes legal and economic barriers;
- Scale and nature of competition. This includes the number of companies entering the market, volumes, market shares, range of prices and service quality offerings, and degree of innovation;
- Customer awareness and behaviour. This includes evidence of customers' awareness of competition options and the extent of actual switching;
- Behaviour of Royal Mail. This includes Royal Mail's reaction to competition, including pricing behaviour and the degree of innovation; and
- Other factors. For example, the need for ex ante price and quality of service regulation to ensure the continued provision of the universal service. (paragraph 3.5).

At a high level, therefore, Postcomm's approach is similar to the categories identified by Oftel in 2000.

As background, in its September 2004 consultation, Postcomm presented Frontier Economics' initial application of Postcomm's approach to assessing the scope of the control.⁸ Postcomm advocates placing existing price-controlled products into four groups, ranging from Group 1 for products where there is no competition and only limited prospects of competition developing, to Group 4 for products for which there is substantial competition.

In June 2005, Postcomm referred to this analysis by Frontier Economics as follows:

Postcomm believes that Frontier Economics' analysis remains valid for considering the coverage of the price control, as the only significant market development since it was completed is the further development of access ... In addition, Postcomm has confirmed its intention to open the UK postal market to competition from January 1 2006. (paragraph 3.27)

Postcomm then concludes that the price control should have the same scope, save for the removal of Special Delivery (Next Day) and Presstream.

3.1 Evidential basis of decision

Postcomm does not summarise the evidence against these five criteria for Special Delivery and Presstream. The evidence supporting the decision to remove these two products from the control, drawing from Postcomm's Initial Proposals and Frontier Economics' report from 2004, is set out below.

In respect of Special Delivery (Next Day), Postcomm states:

Frontier Economics identified Special Delivery (next day) as a borderline product for remaining within the price control. Consistent with this view and previous analysis

⁸ Frontier Economics (2004), op. cit.

carried out by Postcomm,⁹ Postcomm believes that there is evidence that large and medium size businesses have a wide range of alternatives to choose from, with a variety of different delivery times, and 'track and trace' facilities offered. These services are also convenient for many users because mail items are collected direct from customers' premises. Given the extent of competitive pressure, Postcomm does not believe that this product needs to be price controlled for these customers. (paragraph 3.33)

In respect of Presstream, Postcomm states:

Postcomm believes that a combination of non-postal and post on post competition for Presstream products means that customers' interests can be protected without a price control. Frontier Economics' analysis includes some of the evidence to support this view. (paragraph 3.38)

and further:

Publishers already have alternatives to Royal Mail for delivering their product to customers. Two thirds of publications are sold through retailers, suggesting that non-postal competition is significant. While the one third of publications delivered by postal subscriptions is increasing, this market appears to be attractive to new entrants. (paragraph 3.39)

The PPA estimates that 4–5% of all publications are already delivered through operators other than Royal Mail. Frontier Economics noted that existing competition and the existence of some competition in the past suggested that the prospects for competition are good, although there is, as yet, no large alternative operator in the market. (paragraph 3.40)

The majority of customers are likely to be standard rated for VAT, as publishers are not one of the main groups (e.g. financial institutions and charities) that are unable to reclaim VAT. Therefore, this barrier to competition is not as significant for this product as it is for others. (paragraph 3.41)

In addition to non-postal options, Presstream customers could switch to Royal Mail's Mailsort 1 or 2 products if Royal Mail sought to raise Presstream prices excessively. (paragraph 3.42)

Frontier Economics' report sets out the evidence against the five criteria identified by Postcomm (see above) and a further criterion of the 'effectiveness of competition'. The source and basis of the evidence is summarised in Table 3.1 below.

⁹ The previous analysis Postcomm references is Postcomm (2003), 'Proposed Changes to Royal Mail's Standard Parcels and Special Delivery Products—Decision Document', October.

Table 3.1 Evidence to support the removal of Special Delivery and Presstream in Frontier Economics' report

	Special Delivery	Presstream
Barriers to entry	<p>General reference to VAT and data being unavailable</p> <p>Reference to the economies of scale argument used by the Competition Commission in the case of 'March UK Ltd and the home shopping and home delivery business of GUS plc'</p> <p>Reference to Royal Mail's prices being lower than others as a potential barrier, but this has not been explored</p>	<p>General reference to VAT and data being unavailable</p> <p>General reference to the nature of the service and access</p> <p>General reference to price–quality trade-off</p>
Scale and nature of competition	<p>Reference to a discussion with 'a major courier company'</p> <p>Reference to four named market players</p> <p>Reference to the operators in next-day home delivery by the Competition Commission in the case of 'March UK Ltd and the home shopping and home delivery business of GUS plc'</p>	<p>Reference to three named active market players and one previously active market player</p> <p>Reference to PPA market share estimate of other operators at 4–5%</p> <p>General reference to entry being feasible</p>
Customer awareness and behaviour	<p>Reference to the contracts in next-day home delivery by the Competition Commission in the case of 'March UK Ltd and the home shopping and home delivery business of GUS plc'</p> <p>General reference to a named market player</p>	<p>'there is no evidence of switching between postal operators' (page 113)</p> <p>Reference to discussion with PPA</p> <p>Reference to a representative body that keeps publishers informed</p>
Effectiveness of competition	No evidence	Given lack of actual alternatives at present 'an assessment of "good for competition" is not considered appropriate' (page 114)
Behaviour of Royal Mail	No evidence	Reference to Royal Mail's profile pricing
Other factors	No evidence	No evidence

Source: Frontier Economics (2004), op. cit.

This falls short of the information used by OfTel as outlined in Table 2.1 and illustrated in Box 2.1 above.

For either product, these statements do not explain or set out the evidence to support Postcomm's change from March 2003 to June 2005; nor do they explain Postcomm's view in June 2005 of how each service measures up against the five criteria.^{10 11}

For Presstream, the main piece of evidence is a reference to the market share estimate by PPA. The proposal document also states that:

Postcomm believes that a combination of non-postal and post on post competition for Presstream products means that customers' interest can be protected without a price control. Frontier Economics' analysis includes some of the analysis to support this view. (paragraph 3.38)

¹⁰ As Frontier Economics notes, it recommends that further analysis would be warranted through the review.

¹¹ Postcomm's Competitive Market Review document (September 2004) provides no specific evidence of the development of competition for Special Delivery and Presstream to validate this.

Frontier Economics' analysis actually concludes that non-postal distribution channels are not thought to be a relevant consideration (page 111). The supplementary evidence provided by Oxera supports Postcomm's conclusion that non-postal distribution channels are an important constraint on Royal Mail's pricing freedom; however, Postcomm does not have any evidence to support this itself.

For Special Delivery (Next Day), the main evidence is that many businesses already use a range of other service providers for this service, although no actual market share at an aggregate level, or by sender, is presented. Postcomm has proposed that as long as a distinction is made by sender, these services supplied to large and medium-sized businesses can be removed from the control.

Frontier Economics recommends that an ongoing assessment of Presstream and Special Delivery be undertaken through the course of the price review (page 69). It also recommends that Postcomm collect more product-specific data:

As noted in the introduction, this assessment is based on information which is currently available to Postcomm. At product level little quantitative information is available and hence, our assessment is largely qualitative in nature. We recommend that Postcomm collect, on a regular basis, more detailed information on individual products to enhance the use of the competition test in the future. (page 70)

The data that Frontier Economics indicates would be useful includes price information, market shares, volumes and revenues broken down by type of sender and receiver, VAT status of customers, data on customer switching, and evidence on non-postal alternatives. This is the type of evidence that Oxera has collated in its supplementary reports on the two products.

4 The number of separate controls

In addition to considering which products should be included in the price control, Postcomm asked Frontier Economics to 'examine how separate sub-controls might be introduced for these products, and identify the products which should be included in each sub-control'.¹²

The rationale for the recommendation that Special Delivery and Presstream products be removed from the control arises from the fact that Frontier Economics places these two products in 'Category 3: Borderline competition'. This categorisation (as recognised by Frontier Economics) is based on a significant degree of judgement and limited evidence.

Frontier Economics considers three key criteria that Postcomm could use to group products into separate sub-controls. Frontier Economics recommended that these criteria be applied sequentially to Royal Mail's products. The three steps or criteria applied to Special Delivery and Presstream are the following:

- Special Delivery and Presstream are placed into separate categories on the basis of demand substitutability. This is made on a qualitative basis (from the evidence summarised in Table 3.1), without any assessment of quantitative evidence that would inform about the degree of demand substitutability between the different products. In addition, with regard to Presstream, Frontier Economics states that:

the relevant competitive playing field is for the postal delivery of periodical subscriptions. (page 111)

However, this appears to be at odds with the statement in Postcomm's Initial Proposals, which implies that the relevant market is broader than this.¹³

- Special Delivery and Presstream continue to be in separate categories following consideration of the degree of competition:

Presstream and Special Delivery (standard) remain in separate controls [categories] as the degree of competition faced by these products is higher than for the other workshare products but there is some uncertainty about the pace at which competition will develop. (page 111)

This assessment is also made on the basis of the limited evidence of the degree of competition, as summarised in Table 3.1.

- Finally, the third step considers options for simplifying the categorisation through the grouping of services into categories. In one option, Special Delivery and Presstream are kept in separate categories and placed outside the control; in another option, Special Delivery and Presstream are included in Category B ('non-captive' cap) with several other services and placed within the control. Frontier Economics refers to these as the 'transparency' options and concludes:

If Postcomm decides that it is appropriate to proceed using this transparency option we recommend that it considers excluding products from the control if the risk of inclusion—arising from the potential distortionary impact on competition—exceeds the risk of exclusion. For products that are in the 'borderline competition' category (Special Delivery (Standard) and Presstream) exclusion is likely to be a preferred option. A more

¹² Frontier Economics (2004), op. cit., page 1.

¹³ Postcomm (2005), op. cit., paragraph 3.38.

detailed risk assessment of such exclusion would be warranted before a final decision is made however. (page 66)

Postcomm adopts the recommended exclusion option for its June 2005 document, and places Special Delivery and Presstream outside the control.

It is unclear whether the two options considered as part of the application of the transparency criterion are based on objective guidelines that would allow a choice to be made between options. Other options could have been presented (eg, a combination of categories A and B), as there appear to be no guiding principles for the choice other than simplification.

Frontier Economics' report refers to a trade-off between the need to reduce complexity in the regulatory regime and the risk that Royal Mail will rebalance prices and limit the degree of competition faced by some products through price rebalancing (pages 60 and 66). However, this trade-off appears to be judged without reference to, or review of, the regulatory precedence and economic literature supporting the need for at least some price rebalancing prior to competitive entry.

Finally, to the extent that Frontier Economics considers there to be a distinction for Special Delivery and Presstream, it deems this to be 'borderline', thus recognising the need for further work and evidence to be undertaken before a decision is made (page 66).

The limitations of the exercise as a result of the limited quantitative evidence are also recognised by Frontier Economics in its document:

We emphasise that, given, the limited quantitative information available on individual products, the assessment is largely qualitative in nature and some judgement is used to assign scores to each criterion. (page 37)

Furthermore:

Our analysis of potential sub-controls is also only a first step for Postcomm. Further consideration needs to be given to how these sub-controls will be designed and to the implications of changing the licence condition. (page 70)

However, no further analysis or evidence has been provided in Postcomm's June 2005 document.

5 Conclusion

This report has analysed the evidential basis for Postcomm's proposal to change the scope of Royal Mail's price control, including presenting a summary of the regulatory precedent for removing services from a control (or reducing regulation) by the communications regulator, Ofcom (and its predecessor, Oftel). This is particularly relevant to the case of Royal Mail because of the reference to this approach within Frontier Economics' report.

The evidence presented by Postcomm falls well short of the evidence and analysis undertaken by Ofcom (Oftel) for the removal of services. The need for further work and evidence appears to be recognised in Frontier Economics' report, but has not been taken forward in Postcomm's June 2005 document.

The issue is not therefore that the proposed scope of the control is problematic, but rather that Postcomm has not applied its own process on the basis of the necessary evidence to support its decision. As a market liberalises, an incumbent firm needs to make significant adjustments to its business model if it is to make a successful transition to a competitive market. This successful transition is in the interest of the company, consumers and the regulator. A key element of the success of this process is the certainty around the regulatory framework. This is of central importance to both entrants and the incumbent. Without good evidence-based decision-making on the scope of the control, it is difficult for any market participant to judge likely developments in pricing in that product. This can hinder entry and investment from any participant.

In addition to considering the scope of the control, Frontier Economics' report touches on issues related to the number of sub-controls. As acknowledged by Frontier Economics, the categorisation of products is based on a significant degree of judgement and limited evidence. Furthermore, although a set of three sequential criteria for establishing separate controls is considered, the two options considered in the final step are not based on clear objective guidelines that would enable a choice to be made between the options. Other options could also have been considered, as there appears to be no guiding principles for the choice other than simplification.

Postcomm has made substantial effort to establish some guidelines for removing services from the control. It is necessary to follow these guidelines and investigate in more depth actual behaviour in the market. Evidence on market conditions for individual products is an essential aspect of good (de)regulatory decisions. This same message was given to Postcomm by its own consultants in 2004.

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