

REVIEW OF CERTAIN ASPECTS OF ROYAL MAIL'S 2006-2010 PRICE CONTROL

CWU SUBMISSION

Introduction

1. The Communication Workers Union (CWU) represents around 250,000 employees in the postal, telecom and related industries. It is the recognised union in Royal Mail Group for all non-management grades including those responsible for the collection, sortation and delivery of mail.
2. On 22 March 2007 Postcomm wrote to mail operators and other interested parties to inform them that it had started a review of two key features of Royal Mail's 2006-2010 Price and Service Quality Control. Postcomm is seeking views on the following:
 - a. the size of the headroom available to those using Royal Mail's downstream access service, and
 - b. Royal Mail's pricing rebalancing flexibility within, and between, its captive and non-captive tariff baskets.
3. The CWU believe that the two requests from Royal Mail and TNT reflect a deeper problem with the UK's regulatory system. It is now clear that Postcomm's last price control settlement was predicated on a number of false assumptions – overall mail volumes have declined and the regulator seriously underestimated the likely growth in downstream access and overestimated the growth in end-to-end competition.

4. Against this backdrop, we believe it is right that Postcomm revisits the issues of access headroom and price rebalancing. But we don't believe this limited review will suffice and we are calling for a full parliamentary review of the impact of liberalisation to date - in line with the Government's manifesto commitment. This review should not only look at the role of the regulator in defending the USO but give serious consideration to the establishment of a Universal Service Support Fund to help finance Royal Mail's future universal service obligations. This could be funded either directly from contributions from all licensed operators or via some form of supplement to the access price.

Access headroom

5. The CWU opposed the introduction of downstream access on the grounds that the 'cream-skimming' of Royal Mail's most profitable business would leave the company in a poor financial position, unable to meet its Universal Service Obligation (USO). Downstream access is now well established (accounting for 40% of all bulk mailings) and we are seeing Royal Mail lose business to competitors at an unprecedented rate, far in excess of Postcomm's projections. The 2006-2010 Price Control was based on the mistaken assumption that mail volumes would grow by 1% or 2% a year when in fact overall volumes have declined. As a result Royal Mail is now facing significantly lower than anticipated cash flows. We believe the way Postcomm have introduced competition gives Royal Mail's competitors an inbuilt competitive advantage (allowing them to benefit from the USO without paying for it) and ultimately threatens the company's ability to fund its operations and deliver the universal service.
6. The current regulatory regime, which requires Royal Mail to maintain a 'controlled margin' between the access price and the prices it charges for comparable retail products, is preventing the company from competing effectively. We agree with Royal Mail that the access price headroom should be reduced to better reflect underlying upstream costs; the margin should be based on the cost difference between retail and wholesale products. As it stands Royal Mail's retail prices are kept artificially high, preventing them from

passing on upstream cost savings without also lowering access prices. This is bad for Royal Mail, customers and the industry. It encourages inefficient entry into the market based on unsustainable business models and means customers are paying more than necessary for bulk mail products. TNT has argued that customers want pricing stability in the medium term. We are not convinced that customers value this stability over and above lower prices.

7. The union disagrees fundamentally with the arguments presented by TNT and UK Mail at Postcomm's Stakeholder Forum on 24 April 2007. They say they need to set prices 10% lower than Royal Mail Retail in order to avoid 'incumbent inertia' and to encourage customers to switch, arguing that the current headroom margin should therefore be increased. Essentially TNT believe that Royal Mail's retail prices should be artificially inflated in order to make their own prices more competitive. They go on to argue that the headroom should be increased to enable them to cover their costs and ensure a healthy return for shareholders. Instead we believe customers should be able to enjoy the benefits of Royal Mail's cost savings through lower prices.
8. The CWU believe that the access headroom level needs to be monitored regularly and altered, when necessary, to reflect changes in Royal Mail's costs. We are in favour of an annual review resulting in a potential headroom change. However, we also believe there should be a mechanism to enable the level to be re-examined in the interim if a significant change in Royal Mail's costs could impact materially on its ability to compete within the given pricing structure.
9. The CWU do not accept TNT and UK Mail's suggestion that access price headroom should be extended to cover all of Royal Mail's non-USO products. We do not believe Postcomm should be seeking to extend the regulatory burden placed upon Royal Mail. We have not seen convincing evidence of margin squeeze occurring between access products and retail products not already covered by headroom protection. Moreover, we do not believe that the situation has materially changed in this regard since the price control was agreed less than a year ago. Royal Mail are expected to lose 4bn items to downstream access this year; competitors are well established in the

downstream access market and further restrictions on Royal Mail's flexibility are not needed to protect them.

Pricing flexibility

10. Postcomm has asked stakeholders to consider the following three alternatives in relation to Royal Mail's price rebalancing:

- Changing the level of the sub-caps;
- Changing the value of X within each basket and potentially the sub-caps within each basket;
- Creating a single tariff basket for the calculation of allowed revenues and alter the level of sub-caps.

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

12. We have consistently argued that the restrictive RPI-X pricing approach adopted by the regulator would materially damage Royal Mail's core business activities. We maintain that an RPI+Y approach is required to enable Royal Mail to make the necessary level of investment in its operations. Consequently we would oppose any increase in the value of X applied within each tariff basket.

13. In order to remain financially viable and provide a universal service, Royal Mail needs to be able to compete effectively in the current market. To do this it

needs to have greater flexibility to rebalance prices within the price controlled tariff baskets. We therefore support Royal Mail's application to change the sub-cap value from 3% to 8.5%.

14. Postcomm's primary statutory duty is to protect the USO. As competition bites, cross-subsidies are removed and Royal Mail's profitability is undermined and its ability to maintain the USO is threatened. The CWU believe the time has come for Postcomm to consider spreading the financial burden of the USO across all licensed mail operators. This could take the form of a USO support fund or, in the absence of significant end-to-end competition, an uplift of the access price. Postcomm rejected the introduction of such a fund in 2002¹ on the grounds that competition would be the most efficient means of protecting the USO. Competition is now clearly undermining Royal Mail's ability to finance the USO and we believe Postcomm must take action to prevent its erosion.

15. The CWU have argued from the outset that the way Postcomm have chosen to liberalise the market would ultimately hit Royal Mail's revenues and undermine its ability to deliver the USO. Our concern is that Postcomm are elevating the pursuit of competition ahead of their primary duty to protect the USO. We believe the risks to the USO are such that we need a full parliamentary review of the impact of liberalisation to date – in line with the Government's 2005 manifesto commitment.

¹ Postcomm Competition Decision Document (May 2002)

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