MAIL COMPETITION FORUM

Review of certain aspects of Royal Mail's 2006-2010 Price Control

MCF response to Postcomm's industry letter of 22 March 2007

1. The Mail Competition Forum (MCF) welcomes the opportunity to comment on the four issues set out in Postcomm's 22 March industry letter, namely:-

   (a) the request from TNT Post and UK Mail for a decrease in access prices;

   (b) the request from TNT Post and UK Mail for an extension of *ex ante* margin squeeze protection to a wider range of services;

   (c) Royal Mail Group Limited's ("Royal Mail") request for a decrease in minimum headroom between retail and wholesale prices; and

   (d) Royal Mail's request to re-balance prices by increasing the sub-caps within each of the captive and non-captive baskets.

2. Current membership of the MCF consists of Citipost AMP Ltd, DHL Global Mail (DHL), DX Network Services (DX), Racer Consultancy Management Services Ltd (Racer), Secure Mail Services Ltd (SMS), Target Express Parcels (Target Post) TNT Post UK Ltd (TNT Post) and UK Mail Ltd (UK Mail).

3. To summarise our position on the industry letter:

   Access – retail headroom

   - Any change in the price control which reduces headroom on access services could severely damage upstream competition and remove a very significant element of customer choice. Many of our members have based business decisions and multi-million pound investments on the current level of headroom. Any squeeze of those margins could undermine those investments.

   - We support the request by two of our members for an extension of the principles of the margin squeeze protection to all Royal Mail retail services for which there is or could potentially be a wholesale equivalent. Condition 10.5 of the Royal Mail licence, which requires internal transfer pricing, is almost entirely ignored. The request would not harm the universal service but would benefit customers and promote effective competition.

   - We support the request by two of our members for an increase in - and greater consistency of - headroom for certain services (notably 120 and 700 Access services). This might be secured entirely by a reduction in access prices but, where necessary, this protection from margin squeeze should be achieved through an increase in retail prices. That would be necessary if an excessive reduction in access prices would lead to artificially low pricing and, thus, damage existing and potential delivery competition. Although artificially low access prices may benefit customers, in the short term, it would not promote effective delivery competition and would not be an acceptable means to secure headroom.

- Our concerns about artificially low prices were deepened by the statements by Royal Mail's Regulation Director on 24 April at the Postcomm workshop that most of the business mail services Royal Mail provides are loss making but that to increase prices would be "commercial suicide". In other words, it is better to offer loss making services than face competition.

Sub-cap increase

- An increase in sub-caps: would impact the most vulnerable customers; creates greater uncertainty about future pricing; is supported by scant supporting data and will be used to enable price dumping where there is (a threat of) competition.

General

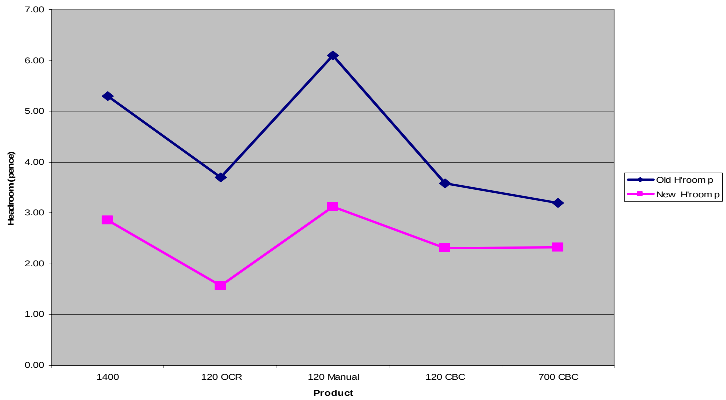
- The MCF notes Royal Mail's persistent plea that it be allowed to move to more "cost reflective" prices. While the MCF might recognise the commercial sense of such an aim, we have grave concerns that Royal Mail seeks to adopt this approach only where it is facing competition and not as a consistent policy. Royal Mail seeks to give its aim the status of a "key regulatory principle" but the real principle of regulation is to encourage the right commercial behaviours from a (super) dominant supplier in the absence of sufficient competitive pressure. That is the purpose of a regulatory price control. It is contrary to regulatory principle to allow a massively dominant supplier to lock inefficient costs into prices on the basis those prices are then more "cost reflective". Royal Mail should be striving to make its costs efficient, not its prices merely cost reflective (and selectively so). The MCF believes the key principle is for a supplier to be customer responsive, not cost reflective.

- In putting forward its request, Royal Mail again promotes its view that its commercial products should be removed from sector-specific regulation, which should remain in force only for a set of basic universal service products. The MCF disagrees profoundly with this argument. We do not dispute that in the fullness of time this may become a reasonable objective. At the present time however it is at far too early a stage in the market opening process - and with a 99.8% share of the licensed mail market Royal Mail remains far too dominant - for any relaxation of the present regulatory control to be even considered. To do so would not only be entirely inappropriate but would run the very real risk of driving from the market the very limited amount of competition which is still today struggling to establish itself on a playing field already heavily tilted in

Royal Mail's favour through its VAT advantage, its economies of scale and its universal service infrastructure.

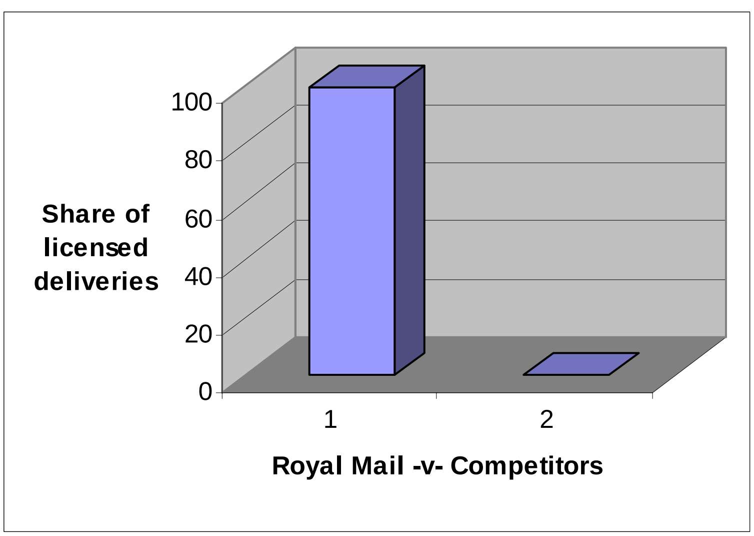
Access headroom

4. The Royal Mail request to reduce headroom would lead to around a 50% reduction in margin for access operators (the top line represents current headroom levels and the lower line the proposed headroom levels).

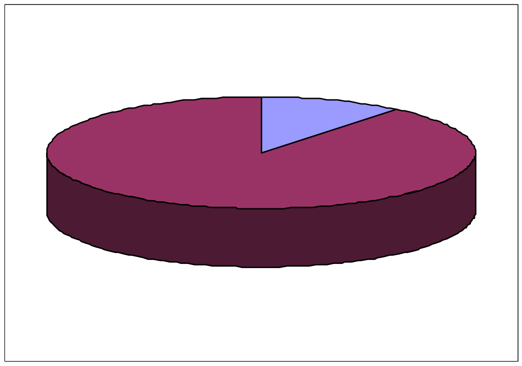


5. As explained by UK Mail and TNT Post at Postcomm's workshop on 24 April, this would undermine the businesses and investments, in both jobs and infrastructure, made by a number of our members. Market exit would be a very real possibility and Royal Mail would be returned to its former position as monopolist, having removed any customer choice, bar that which already existed from before Postcomm's measures designed to liberalise the market. This would undermine Postcomm's vision of the postal market and would, to be blunt, constitute a failure on the part of the regulator to exercise properly one of its statutory duties.

6. End to end competition in the licensed area is tiny:



and Postcomm must not, therefore, allow Royal Mail to undermine the significant new competitive activity in upstream services, as illustrated below:



Competitors handled 2.4 billion items – shown in blue (2006/07)

Royal Mail states in its request that, as a justification for less regulation "the market has already successfully opened up to the extent that postal prices are now regulated by the market, with the possible exception of stamped mail." This statement is clearly not supported by the facts.

7. Any form of margin squeeze protection must take into account the ability of a reasonably efficient operator, in reality and not merely in theory, to compete profitably. Current market conditions require our members not only to compete among themselves and against other market entrants but also to offer discounts to win business from Royal Mail. Royal Mail's entire pricing package – including payments to mailing houses and TMI's to customers – need to be addressed by Royal Mail's rivals as does the VAT distortion which adds 17.5% to the upstream prices charged by Royal Mail's rivals. Postcomm must take these issues into account when assessing if there is adequate headroom to compete on a profitable basis.

8. We have some particular issues we would like to address in the Royal Mail business case underlying its request for an increase in access prices:

- the current level of headroom distorts competition by "artificially encouraging end to end competition" – we simply cannot comprehend this statement.

- "price competition is dampened" by the current headroom and a decrease in headroom would allow "customers to benefit more fully from the effects of competition" – the Royal Mail proposals would have the effect of eliminating price competition altogether and returning Royal Mail to a monopoly situation. We fail to see how customers would benefit from this.

- Condition 21(5b) "reduces incentives for upstream cost reductions" – for the very significant proportion of mailers who use Royal Mail services, any cost reductions upstream would flow straight through to Royal Mail's results. This ought to be more than an adequate incentive to reduce upstream costs. More importantly, Royal Mail needs to focus on its downstream costs – and is intending to do so – as indicated by the CWU letter to its members of 20 April where the vast majority of efficiency measures identified relate to downstream, not upstream, activities. Increasing access prices would remove the incentive for these essential downstream efficiencies to be realised.

- the EU telecommunications rules on margin squeeze specifically acknowledge that an appropriate measure of margin squeeze is whether the headroom between, in this current case, Royal Mail retail and Royal Mail wholesale prices is "insufficient to allow a reasonably efficient service provider [providing an access service] to obtain a normal profit." As has been presented by TNT Post and UK Mail, there is currently insufficient headroom across all products to enable them to make a normal profit and any reduction to that headroom would make profitable trading impossible.

- VAT remains a major distortion – the VAT issue has by no means "largely disappeared" as a result of the newly negotiated agency downstream access agreement. A disbursement treatment had previously existed from April 2004 to January 2006 for one of our members, so there is no particularly new development. A very considerable volume of downstream access mail comes direct from customers with direct agreements with Royal Mail (CDA Customers) who paid VAT on the upstream services. The reality remains that upstream services are still subject to VAT which is unrecoverable by those who send 40% of business mail. This has the effect of depressing the prices an upstream operator can offer. There is no change in this respect.

- Royal Mail seek to use 05/06 costs, adjusted for 06/07 volumes, in a formula using 07/08 retail prices, to set 08/09 access charges ("Royal Mail's Position on the Interim Review", Annex 1, 3.2, 1st para [page 37]). This can not be a valid, transparent or permissible basis for a change with such immense impact. It would mean 05/06 inefficient costs were allowed to determine prices 3 years later. It is also highly questionable if Royal Mail's unit costs of upstream activities have decreased, even if there has been a reduction in overall upstream costs.

9. Virtually all pre-sorted and unsorted Royal Mail retail services face competition from access. We support the UK Mail and TNT Post request to extend the principles of the current Mailsort 2 benchmark services to these services. This will enable an ex ante protection against margin squeeze and serve to set clear parameters for retail and wholesale pricing for any new retail services which may be introduced.

Sub-cap change within baskets

10. Royal Mail seeks to increase the sub-caps within each of the two baskets from its present limit of 3% to a new limit of 8.5% to assist in a more rapid rebalancing towards cost-reflectivity of individual products. The MCF opposes this request on a number of

grounds. First, as a general point, the current sub-cap of 3% gives Royal Mail some scope to re-balance prices progressively but a sub-cap of 8.5% would allow some prices to rise unreasonably steeply over a very short period causing difficulty or hardship to users of those services. Second, Royal Mail has given no indication of which services would face price increases, and which would benefit from lower prices. Third, and following from the previous point, there is at the present time no basis for assessing whether the claimed cost-reflectivity justification in each case would stand up to rigorous (and preferably independent) scrutiny. Fourth, and perhaps the biggest concern to market entrants, is that without such scrutiny the risk is that increases will simply fall on products for which Royal Mail faces least competition in order to finance lower prices where competition exists or is more likely to emerge.

Zonal retail pricing

11. The MCF has responded separately to Royal Mail's proposal for zonal retail pricing and re-states its position that zonal retail pricing will:

- Lead to a spiral of decline of mail to rural areas and create enormous pressure on the funding of the universal service;
- Create tremendous disruption and uncertainty for customers who simply do not want retail zonal pricing;
- De-stabilise the entire postal market and halt investment by other operators, given the enormous scope for future pricing changes;
- Cause a dramatic decrease in Royal Mail revenues as customers change mailing behaviour and/or arbitrage among different services;
- Undermine end-to-end competition (which must compete with Royal Mail's tremendous competitive advantages and which remains fully hampered by the VAT distortion and business mail prices which are, according to Royal Mail, mostly loss-making).

MCF
May 2007