

**Postcomm's Review of
Certain Aspects
of the Price Control:
The Postwatch Response**

30th April 2007

1. OVERVIEW

- 1.1 Postwatch welcomes the opportunity to respond to this consultation on certain aspects of the price control.

Purpose of the existing price control

- 1.2 The purpose of price control in the postal services industry is fourfold:
- (a) To protect consumers from exploitation by Royal Mail as the incumbent operator with very substantial market power.
 - (b) To promote efficiency on the part of Royal Mail through a mixture of incentives and penalties.
 - (c) To allow competition to develop.
 - (d) To protect the universal service (USO - the obligation to make daily deliveries and collections at a uniform affordable tariff across the UK) by ensuring that Royal Mail has the financial strength to support and maintain the service
- 1.3 Essentially, the first three aspects of the price control should exert effective pressure on Royal Mail to deliver value for money quality services, while the final aspect permits Royal Mail sufficient financial freedom to maintain the USO. Accordingly, in setting the price control Postcomm has to reconcile these potentially conflicting aims and achieve a fair balance between them.
- 1.4 During consultation on what became the current price control, Postwatch accepted the need for a balanced price control and quality of service package. It is therefore of serious concern that Royal Mail has applied to revisit certain aspects of the price control which was agreed little more than a year ago, in particular, to request further flexibility in rebalancing prices.
- 1.5 Royal Mail has freedom under the current control to increase prices. Further pricing flexibility is not of obvious benefit to customers, and should be refused unless there is an overwhelming need. That need has yet to be demonstrated. Additionally, it cannot help long-term planning and investment by competitors if financial controls are to change at such frequent intervals.
- 1.6 Reopening the price control risks altering the other incentives contained within it, particularly those related to efficiency. Granting relief to Royal Mail when times are tougher or (particularly) when management is weaker deters the company from acting commercially to solve its problems.
- 1.7 We believe the appropriate course is for Postcomm to proceed with a rigorous review of the costs and benefits of the USO, investigating the access regime and access prices, and of the postal services market generally. The aim should be to determine how far the difficulties which have led Royal Mail to make this application are within its own control to alleviate, or are beyond its control but due to reasonable and predictable competitive pressures, which Royal Mail should respond to with improvements in efficiency and in products offered, for which customers should not be required to pay. Postcomm should consider granting

Royal Mail's requests only for those difficulties which are not of such nature, and only to the extent that the long term gain for consumers expressly outweighs any short term pain.

Changes since price control was set

- 1.8 We recognise that market changes (mainly volumes, mail mix, levels of competition and levels of e-substitution) and other external changes beyond Royal Mail's control (mainly increases in pension deficit costs) appear to have affected Royal Mail's business more than was foreseen when the price control was introduced. The effect of the applications by Royal Mail and UK Mail/TNT is to require the impact of these changes to be addressed earlier rather than later.

Postcomm's assessment of the applications

- 1.9 For Postwatch (and for Postcomm also) it is imperative that the outcome of these applications should be a price control that is balanced fairly between the objectives outlined in paragraph 1.2 above.
- 1.10 To achieve this, Postcomm needs:
- (a) sufficient and reliable data on Royal Mail's internal workings;
 - (b) sufficient and reliable data on trends in (and beyond) the mail market; and
 - (c) to apply a rigorous, independent and transparent analysis of such data to test the applications by Royal Mail and UK Mail/TNT.
- 1.11 It is not yet evident to us that Postcomm has available the required levels of accurate, relevant and transparent data to support a robust analysis of this kind. Certainly, the publicly available information supplied by Royal Mail and TNT/UK Mail in support of their applications falls far short of that required. It is Postcomm's responsibility to ensure delivery of sufficient data, of sufficient quality, properly to assess these applications, and to deliver an independent economic impact assessment of the applicants' cases. With anything less, any decision made by Postcomm will lack validity. And Postwatch can give a considered view only once these steps have been taken and the results made available.

2. THE POSTWATCH VIEW

Background to the applications

- 2.1 Royal Mail's application seeks three forms of relief against the current price control:
- (a) greater rebalancing within the price control (changing the level of the price caps, changing the value of X for each basket, forming a single basket for calculating revenues and altering the level of the sub-caps) -raising the possibility of higher prices for consumers;

- (b) reducing the differential, or 'headroom' between retail and access products-making it more difficult for competitors to compete on this smaller margin; and
 - (c) differential charging on a geographical basis for non-USO bulk mail products ('zonal pricing', on which our response will follow).
- 2.2 TNT/UK Mail's application seeks an increase in the retail/access headroom.
- 2.3 These applications reflect the opposing interests of Royal Mail as the incumbent operator seeking to defend its position, and UK Mail/TNT as competitors seeking to maximise their opportunities. Competitors of Royal Mail such as UK Mail/TNT, or 'customer-competitors' with access arrangements with Royal Mail, can capture a substantial amount of Royal Mail's higher margin upstream business, and generally decline to compete with Royal Mail's downstream business. Unsurprisingly: this is characterised by lower margins, higher fixed-costs and tight price-control. In a stable market, efficiency gains in its delivery business may be sufficient to compensate Royal Mail for its loss of upstream business. In a declining market (which appears to apply currently) this is less likely.
- 2.4 The concern for consumers, and thus for Postwatch, is this. On the one hand, it is in consumers' interests for upstream competition to flourish - acting as a spur to efficiency and innovation and providing improved quality and customer choice on price and non-price terms. On the other hand, it is vital to safeguard the final mile delivery business which underpins the USO.
- 2.5 In other words, the price control and the access regime must keep Royal Mail's prices at a level which:
- (a) promotes upstream competition: prices must not be so low as to operate as a barrier to entry or to restrict competitors' ability to compete ; and
 - (b) protects the less/non-competitive downstream business: prices must be high enough to sustain that business, but not so high as to be detrimental to consumers.

The challenge for Postcomm is to reconcile these objectives.

Current problems for Royal Mail, and changes since the price control was set

- 2.6 On the face of it, the pricing flexibility which Royal Mail seeks would not be of benefit to consumers. Accordingly, Postwatch believes that Postcomm should apply the following tests in deciding the application, and should grant the application only to the extent that the answers to **all** of them are in favour of Royal Mail:
- (a) Do the problems Royal Mail is encountering give rise to an urgent and overwhelming need for such flexibility?

- (b) Were these problems, and their extent, anticipated and provided for in the price control (in other words, how far did Royal Mail accept the risks by agreeing to the terms of the price control?)?
 - (c) How far are the problems of Royal Mail's making or within their control to relieve?
- 2.7 Conversely, Postcomm should consider whether and the extent to which any of the difficulties Royal Mail now faces arise from circumstances genuinely beyond Royal Mail's control, such as:
- (a) Serious, irreversible and long-term reductions in the total mail market, and changes in mail profile/mix, not anticipated in the price control, to the extent that these have resulted in Royal Mail's volumes falling significantly below the reductions allowed for in the price control. Such reductions should be distinguished carefully from loss of market share in a static or growing market, or loss of business due to avoidable inefficiency.
 - (b) A serious, irreversible and long-term increase in the cost of servicing Royal Mail's pension deficit, to the extent that this increase was due to unforeseen circumstances and is significantly beyond that envisaged in the price control.
- 2.8 Postwatch notes that the recent decline in mail volumes and changes in mail mix have been greater than expected by Royal Mail or Postcomm. We accept that these declines are likely to be irreversible and could accelerate:
- (a) overall, according to Royal Mail's half year report to September 2006, total volumes in the UK mails market have declined by 2% compared to the same period a year ago¹;
 - (b) e-commerce has made inroads into the mail market and this is likely to continue: Ofcom's latest published survey² shows that 50% of adults live in households with broadband³ and 80% of those with Broadband use it for sending/receiving mail;
 - (c) mail mix is changing as consumers increasingly downtrade from 1st to 2nd class.
- 2.9 As to the increased pension deficit, Royal Mail argue that the price control assumed an annual funding commitment of £735m, on the basis of a £4.6bn accounting deficit, with a pass through mechanism if the deficit were to exceed that. The deficit is now approximately £6.6bn⁴, significantly up on what was

¹ ftp://ftp.royalmail.com/Downloads/public/ctf/rmg/Interims_2006-07_5-02-07_V8.pdf: pg 2

² <http://www.ofcom.org.uk/research/cm/cm06>

³ this has increased from 39% the previous year and 23% of those without internet access expect to go online in the next 12 months with 76% saying that they would go straight to Broadband

⁴ ftp://ftp.royalmail.com/Downloads/public/ctf/rmg/Interims_2006-07_5-02-07_V8.pdf

anticipated in the price control. Royal Mail complains that the delayed effects of pass-through mean that sums paid to the pension fund cannot be recouped until one year later; and more importantly, that because of the unanticipated volume decreases and changes in mail profiles, price increases do not generate proportionate revenue increases.

- 2.10 In general these factors are beyond Royal Mail's control. Postcomm must assess the effect of each so far and their likely effect in the future. And - equally important - Postcomm must distinguish such factors from those which are or should be within Royal Mail's control, which are due to reasonable and predictable competitive pressures, which Royal Mail should respond to with improvements in efficiency and in products offered, and for which customers should not be required to pay.

3. CONCLUSION

- 3.1 Essentially Postcomm is being asked to re-set:
- (a) the price control,
 - (b) Royal Mail's charges for access to its upstream business (through access arrangements), and
 - (c) Royal Mail's charges for use of its downstream delivery business, and the apportionment of those charges between wholesale and retail customers (zonal pricing).
- 3.2 These issues affect every aspect of Royal Mail's business and go to the heart of the mail service as a regulated industry. Accordingly, the approach outlined in this response echoes the principles already provided to Postcomm in our response to its Strategy Review. We urge Postcomm to apply these principles, to undertake a transparent and objective analysis not only of the data supplied in these applications but also of the data omitted from it - and to publish the results of this analysis before they make their decision.
- 3.3 At that point, and only at that point, Postcomm will be in a position to determine how far granting or refusing these applications will reconcile the aims of protecting the universal service, promoting efficiency within Royal Mail and ensuring the maximum consumer benefit from competition. Until then, it is difficult to look favourably at an application which seeks major changes to a price control agreed little more than a year ago.

Postwatch

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