

30<sup>th</sup> March 2007

Sarah Chambers  
Chief Executive  
Postal Services Commission  
Hercules House  
6 Hercules Road  
LONDON  
SE1 7DB

Dear Sarah,

**Request for review of Royal Mail price control under Royal Mail Group plc  
Licence Condition 21 paragraph 5, (i)(bb)(aa)**

Further to my letter of 23<sup>rd</sup> March, requesting Postcomm to review aspects of the Royal Mail 2006-2010 Price Control (the "Price Control") under this provision of Royal Mail's Licence, I am writing to provide information on the principal reasons for that request.

UK Mail has requested that Postcomm review two aspects of the Royal Mail 2006-2010 Price Control:

- a) the values of the headroom between access charges and comparator Royal Mail Retail services (the values of  $D_{sy}$ ) be reviewed for the period from April 2008; and
- b) the extension of this protection against margin squeeze between access charges and retail prices to all Royal Mail retail services where UK Mail may reasonably request comparable access services or against which UK Mail may compete or reasonably be expected to compete.

In relation to these two aspects, UK Mail (UKM) makes the following points:

Access headroom

1) The difference between access prices and RM retail prices must be consistent with the difference in costs between access and retail services. UKM believes that the following cost savings associated with access mail compared with retail mail have not been properly allowed for and that access charges should therefore be reduced:

- a) The use of Inward Mail Centre automation equipment at times of the day when it is not otherwise being used for processing of RM retail mail (i.e. in

the early afternoon when where as Mail Centre equipment is used in the evening and early morning for RM retail mail) allows RM to realise efficiencies in use of its equipment and staff costs are lower as additional payments (e.g. "Night Duty Allowance") are avoided;

- b) The greater forecasting requirement for access mail (7 day rolling forecast and 24 pre-notification by IMC) allows RM to realise staffing and machine utilisation efficiencies not available for retail mail (where the volume of mail to be received by each IMC is not known until at the earliest the previous evening); this is reinforced by the requirement that access mail forecast be split by specification and format;
- c) A significant effect of the role of access operators is to concentrate volumes of mail to RM. Given that most access mail is currently mail that would otherwise have been posted using an RM retail service, RM no longer has an interface with each originating mailer now using access but only with the access operator and RM only has to collect revenue from the access operator, not from each originating customer. This means an important revenue management saving to RM (and probably in practice also a reduction in bad debt right-off and / or cash flow impact of late payments);
- d) RM spends significant amounts of money each year in making commission payments to mailing houses (e.g. though the QMP scheme) when the mailing houses are being used to produce mail posted under RM retail services but there is no such payment when the mailing houses are producing mail posted under RM access services – even though the presentational requirements are at least as stringent;
- e) RM incurs cost in providing equipment for mail to its retail customers (Yorks and trays) but does not do so with access mail as these items must be purchased by the access customer. But the Access Agreement between UKM and RM states that Yorks and trays will be provided without extra charge, so the cost of providing these items would have been included in the access charge but are not being incurred;
- f) The information provided for access mail (e.g. items, format and weight per bag) is more detailed and more specific than for retail mail, allowing cost savings in Revenue Protection activities as it is easier to confirm the actual mail is as described and will be charged correctly. And the ease by which access dockets can be amended to reflect any errors found by Revenue Protection means RM is able to achieve fuller revenue invoicing for access mail than for retail mail, so there is less cost to be recovered in access mail due to foregone revenue;
- g) When access was first introduced in May 2004, RM was concerned that the loss of volume from its upstream activities would result in stranded costs in that part of its network. UKM believes that these expected, stranded costs

were to an extent included in the costing of access mail (if only through recovery of general overheads that could not otherwise be recovered). Given the operational savings that RM has in fact been able to make in its upstream activities (e.g. through rationalisation of the Regional Distribution Centre network), this should reduce the general allocation of costs to access mail.

2) The comparison between access and retail prices is inconsistent and counter-intuitive between different access and analogous retail specifications:

- a) The access headroom was established as part of the first Condition 9 Access Agreement between Royal Mail (RM) and UKM (in February 2004). This was not formally recorded in terms of a percentage difference but UKM is confident that both parties saw the agreed access price in terms of a percentage difference comparison with the analogous retail service, as well as an absolute price. At that time, there was only one access specification and one analogous RM retail service, which was Mailsort 2 1400.
- b) Since February 2004 other access specifications have been added, analogous to other RM retail services. However, the headroom is not the same for each access service (currently they range between c24% and c29%). As it is the lower priced services (e.g. Access 700 CBC) which have the lower headroom percentages but are competing with lower priced RM retail services (e.g. Mailsort 2 700 CBC), there is a doubling reducing effect on the absolute headroom lower. The headroom on the 700 CBC specification is 1.7p less for the 120 Manual specification.
- c) UKM believes this tightening of the access headroom is inconsistent with RM's costs, in that the costs associated with the highly automation compatible 700 CBC specification must be significantly lower than for the 120 Manual Specification, as the costs associated with these specifications can only be different in terms of final sortation and delivery and it is just those RM activities which are relevant to access – but this is not reflected in the access prices.
- d) Hence UKM believes that the access price for the more automation compatible specifications should be reduced, such that the percentage headroom (the  $D_{sy}$ ) is at least consistent with that for other specifications.

3) The price control regime on RM assumes a certain level of ongoing efficiency improvements. But for access mail, the major initiative that should have delivered costs savings – the move to one daily delivery – perversely resulted in costs increases. Access mail costs have not therefore benefited from the efficiencies required from RM though the price control regime and access charges should now be reduced to recognise efficiencies that should have been achieved.

4) A comparison of access charges with RM Mailsort 3 prices shows that Mailsort 3 prices are only a few pence (e.g. 2.6p for 700 CBC, 3.0p for 120 OCR) more than the corresponding access charges. The operational handling and costs for Mailsort 3 mail are just the same once it reaches the Inward Mail Centre as for Mailsort 2 mail and access mail (the difference between Mailsort 2 and Mailsort 3 is in the upstream activities). On the basis that the price of Mailsort 3 will cover its costs (including all the upstream collection, sortation and distribution costs as well as the central, sales, marketing etc costs that are not relevant to access mail) there is a clear indication that access charges are too high in comparison.

5) UK Mail notes that Alan Barrie, Royal Mail's Operations Strategy and Design Director was quoted in the February issue of Courier (the Royal Mail 'house newsletter') saying that it costs about 8p to deliver a letter. An additional 5p per letter for inward sortation must then be more than adequate.

6) In its evidence to the Trade & Industry Select Committee in October 2005, RM said that access prices were "about right". If they were "about right" then they must be too high now, or RM has failed to meet the efficiency improvement requirements of its price control.

#### Extending headroom provisions to all RM retail services

The existing headroom provisions in the price control relate to only five RM retail services – all 2<sup>nd</sup> class bulk mail services. But as competition develops and access operators seek to respond to customer needs by offering a wider range of choice, there will be requests for access-equivalents of many other RM retail services.

Unless the same principles of headroom protection – and at similar percentages – apply to all RM retail services where UKM may reasonably request comparable access services or against which UK Mail may compete or reasonably be expected to compete, any opportunity to extend competition will be stifled.

Postcomm have already recognised this. In the final proposals for the price control (January 2006), Postcomm stated that, although using only a limited set of benchmark products in the margin squeeze provisions of the licence, this

“... would implicitly provide information to the market as to what [Postcomm] broadly considered to be the appropriate margin for other products”.

This statement (while welcomed by UKM) clearly does not provide sufficient *ex ante* protection. Instead, Postcomm must proactively extend the access headroom provision to all relevant RM retail services i.e. at least to all the services in the “Non-Captive Tariff basket”.

Royal Mail request to reduce headroom

UK Mail has seen the request made by Royal Mail (20<sup>th</sup> March) that the Price Control is reviewed to reduce the headroom from April 2008 and to introduce an annual adjustment thereafter.

I will provide information and comments from UKM on that request as contribution to Postcomm's consideration of it. This will include commercially sensitive, and therefore confidential, information.

UKM looks to the up-coming consultation to address the concerns raised and to ensure that the RM price control provides the necessary protections to promote the development of effective competition.

Regards,

**Ian Paterson**

*Strategy & Regulatory Affairs Director  
UK Mail Ltd.*