



MAIL COMPETITION FORUM

RESPONSE TO POSTCOMM'S JUNE 2005 CONSULTATION PAPER
"2006 ROYAL MAIL PRICE AND SERVICE QUALITY REVIEW – INITIAL
PROPOSALS"
NON-CONFIDENTIAL

Introduction – competition for the long-term benefit of customers

1. The Mail Competition Forum ("MCF") represents the interests of entrants to the UK postal market. The MCF's objective is to give customers choice by creating the conditions for fair, vibrant and sustainable competition within a stable and undistorted UK postal market. It is only through effective competition in a market that customers will be able to reap real long-term benefits by way of greater choice, genuine innovation, value-for-money and postal services that continually reflect customers' changing needs. To the extent that competition is in its earliest stages in the UK, the MCF's aim at this crucial time is to highlight the features of the market - and the regulatory regime that is instrumental to shaping it - that might hinder its development, and to suggest workable solutions where the MCF has major concerns.
2. In this submission the MCF has set out its views on Postcomm's June 2005 consultation paper "2006 Royal Mail Price And Service Quality Review – Initial Proposals", in which Postcomm sets out proposals that in its view meet the four main objectives of:
 - Maintaining the universal service at an affordable geographically uniform tariff,
 - Promoting effective competition where possible,
 - Regulating through incentive regulation where necessary, and
 - Achieving transparency and objectivity.
3. In this response we have sought to provide high-level comments on the various proposals under each of the objectives. As a result, our response is structured to cover firstly some general comments, and then those in relation to each of the four objectives. As the MCF is naturally best placed to provide more detailed views on the aspects of the control that have bearing on entry in the market, our comments are principally focussed on the main competition effects of the control.

General comments

4. First and foremost, the MCF welcomes the fact that Postcomm has proposed a range of amendments to the current price control on Royal Mail which are specifically designed to support competition within the market and to prevent the foreclosure of emerging competition. Notably, the proposals include new controls over the introduction of zonal pricing; controls to prevent the cross-subsidisation of competing services from revenues from "captive services" whose customers are not currently



MAIL COMPETITION FORUM

enjoying the benefits of effective competition and controls to stop further margin squeeze of operators who access Royal Mail's wholesale services.

5. The MCF believes that a price control which includes these aspects is essential not least because there is insufficient effective competition to protect customers' interests, even some 50 months after the first licences were granted to competitors of Royal Mail. By our estimation the total combined revenues of the licensed competitors (including amounts collected from customers for payment to Royal Mail by access operators) amount to less than 5% of total licensed postal revenues. The revenues relating to services actually provided by licensed operators are less than 2% of total revenues with Royal Mail controlling the remaining 98%.
6. Moreover, market entrants seeking to compete against such a monopolist, suffer from a tremendous distortion as a result of the existing VAT regime. The current legislation gives Royal Mail a commercial advantage over "up to half the total letters market by value" (Postcomm: Competitive Market Review, September 2004) and, despite efforts from Postcomm and market entrants, this distortion over one letter in every two remains.
7. In the main, the MCF believes that these initial proposals are more helpful than the current control in terms of promoting effective competition and that the amendments are a crucial step-forward in the design of the control that should benefit customers in the longer-term. Notwithstanding this, however, we fear that certain aspects of the control may still be insufficient to redress the balance of competitive provision in the market and the fundamental distortion of competition arising from the current VAT legislation.
8. As a result, our comments and views in relation to the regulation of new services, access services, zonal pricing and around margin squeeze protection address these remaining, fundamental competitor concerns.

Maintaining the universal service

9. The MCF has reviewed carefully Postcomm's proposals designed to safeguard the universal service, including allowing Royal Mail sufficient revenues to finance its activities, giving it the incentive to invest in the business, giving it a profit allowance (and an allowance for its current pensions deficit), putting in place a four year control and putting in reopening provisions. We set out our comments on each in turn.
10. The MCF accepts that Royal Mail should be allowed sufficient revenues to finance its activities and should be given the right incentives to invest in its logistics infrastructure. A healthy Royal Mail at the heart of the market is essential not only for the delivery of the universal service, but also for the operations of those competitors relying on Royal Mail for the final delivery of their mail. It is also important for the market not to be artificially suppressed in value by a price control that is too harsh on Royal Mail: although providing short-term price reductions to customers, a control



MAIL COMPETITION FORUM

that is too restrictive would limit not only Royal Mail's incentives to invest and innovate but also that of the other competitors in the market. This in turn would have the long-term effect of inhibiting competitive entry, thus restricting real choice for consumers and preserving a status-quo that was unresponsive to customers' evolving needs. An unduly harsh price control benefits no-one in the long term. It is worth noting here that, amongst the EU-15, postal prices are among the lowest within the UK.

11. In this context, the MCF notes the revised approach and level of the price control proposed by Postcomm, alongside Royal Mail's concerns on the return proposed for it (of the order of £285m a year) and the estimation of its regulatory asset base (at £2.2bn). Although the MCF is not well placed to comment on what precisely the appropriate asset base should be for the company, we would support a position where the proposed return was sufficient to allow Royal Mail to invest adequately in its business. We also note that Postcomm expects to exclude intangible assets and leased assets from the regulatory asset base. However, the MCF would urge Postcomm to consider carefully its treatment of such assets which we believe are crucial to the operations of all postal businesses and on which operators would generally expect to earn a rate of return. In summary, although we accept that customers should not be forced to pay for inefficiencies of any provider, where a price freeze for four years (through the proposed RPI-3% control on captive customers and RPI-2% on non-captive customers) limited Royal Mail's incentives to invest, then we believe such a control would be unduly restrictive on it.
12. The MCF has no comments on the proposed allowance for Royal Mail's pensions deficit. In addition, the MCF has no strong views on the proposed duration of the control or the proposed re-openers, except to note that as regulatory certainty in the market is of paramount importance to all competitors, the MCF would not welcome any material changes to these proposals (i.e. a significant shortening or lengthening of the control or an increase in the number of re-opening provisions).

Promoting effective competition

13. The MCF has reviewed carefully Postcomm's proposals in relation to the reduction in the scope of the control, the regulation of access services, the restructuring of the tariff baskets and the safeguards for customers where prices are not geographically uniform. We set out our comments in relation to each of these in turn.
 - a) Scope of control and treatment of new services
14. The MCF has one fundamental concern about the proposals in relation to the proposed treatment of new services that Royal Mail may introduce over the next four years. We believe that in its proposed form, the current controls can be largely circumvented by Royal Mail as it is free to introduce services that will be left unregulated, even where the "new" services simply replace an existing service that is currently within the control.



MAIL COMPETITION FORUM

15. The MCF can point to clear examples of services which are considered by Royal Mail as being “new” services but which are not genuinely new and which are certainly not subject to effective competition:

- Mailmedia is a combination of a Mailsort service and a Response Services (Business Reply/FREEPOST) which is priced differently (assuming a pre-set response rate). Royal Mail’s own literature makes no secret that all that is new is the pricing: “This exclusive service combines the cost of your outbound advertising mailing with that of your inbound replies”¹ – and the key selling point is that customers “could make big savings” through “substantial discounts.”;
- Mailsort 3 120 is simply a different sortation requirement for the third class Mailsort service. Mailsort 3 700 and 1400 already existed when the current price control came into effect, as did a 120 way sortation variant for Mailsort 1 and 2 services;
- Presstream Walksort is merely a different sortation requirement for Presstream – no different from the existing Walksort variant of the Mailsort services;
- Response Plus - this is a minor variant on an existing response service;
- Packetsort Premium – this is a minor variant of the existing Packetsort service; and
- Big Book – is no more than a new name for a Mailsort 3 service with a sortation requirements identical to Mailsort.

16. These examples clearly show that the services are not new or innovative but can be used as a means of bypassing regulatory controls. Indeed, allowing these services to remain outside the control could pave the way for a new service which replaces the “First Class” service to be offered at any price (as long as it is not “excessive” or “unaffordable”) or for a whole range of new zonally priced retail or access services to be introduced (without any reference to Postcomm).

17. There is a real risk that many further services with minor variants similar to those mentioned in paragraph 15 are likely to be introduced by Royal Mail over the next four years, principally in order to circumvent the price control and related anti-competition controls. While these services may give short term benefits to customers (which may actually be unfair commercial advantages) – such products are not innovative but are merely ways of charging cheaper prices for existing services and are, in our view, designed to undermine emerging competition. Naturally, customers of existing services will migrate to cheaper equivalent services and Royal Mail will make less revenue. Given that Royal Mail will lose revenues from upstream competition with the various discounts being offered, the natural conclusion is that these prices are designed to foreclose competition.

¹ “the sum of it” An easy-to-use guide to our new postal rates, April 2005 at page 17



MAIL COMPETITION FORUM

18. Market entrants are forced to compete in a distorted market which already hinders the emergence of effective competition. To ensure that customers are truly protected, the MCF believes that no service provided by Royal Mail should be outside the price control until it is absolutely clear that the service is exposed to effective competition. To do otherwise would create an arbitrary and indefensible two-tier form of control which depends more on the age of the product and less on the competitive conditions in which it is provided.
19. Postcomm states that, until there is effective competition, it will protect consumers by acting as a surrogate for competition. In its role of surrogate, Postcomm will act to prevent excessive pricing (in the short term) and to prevent anti-competitive pricing (in the medium and long term). In this way, Postcomm will ensure that customers benefit from sustainable competition. However, we fundamentally disagree with Postcomm's statements that "new products are unlikely to reduce the level of customer protection offered by the price control" and that "the current policy of not immediately price controlling new products introduced by Royal Mail during the present price control has provided an incentive for Royal Mail to innovate, thereby increasing customer choice." While it may be true that customers are protected in the context of controlling excessive pricing (short term) such an approach fails to take into account that competition is essential if customers are to benefit in the long term.
20. The MCF fully supports the Postcomm position that services may be removed from the price control if Royal Mail can establish that "competition is sufficiently developed to protect the interests of customers." The MCF accepts that if services faced effective competition, such concerns immediately disappear. Postcomm has devised some essential safeguards for the promotion of effective competition and should not, therefore, allow a sizable loophole which makes the safeguards redundant.
21. We welcome and encourage innovation. But we cannot accept that differentiation for the purpose of regulatory evasion be allowed to achieve its deliberately anti-competitive impact.
22. In considering whether any "new service" from Royal Mail is indeed new, we would suggest that Postcomm is required to apply the EC Postal Directive (97/67/EC). This unequivocally defines a new service as one which is "quite distinct from conventional services". Given this definition, it should not be possible for any "new service" that was no more than a revision to mail presentation requirements, a bundling of existing services, a modification of service specification or a separation of existing services to be considered "new" under these provisions.
23. We would, therefore, ask Postcomm to reconsider its proposal on new services on the basis that new services are, a priori, within the price control (i.e. subject to both price caps and pro-competition controls on access and zonal pricing) and subject to the anti-trust control provisions of the licence unless Royal Mail can demonstrate that the new services are genuinely new.



MAIL COMPETITION FORUM

24. In order to determine which services are genuinely new (i.e. distinct from conventional services), Postcomm could apply criteria which would need to include, at least, carrying out the following three tests:
- Are the features of the “new” product replicable to customers through existing products (e.g. can a customer purchase a bundle of existing products to replicate the new service)?
 - Does the service simply differ in the presentation requirement or the price of similar existing services?
 - Does the new service involve the same processes and costs as an existing service for its delivery?
25. If the answer to any of these questions is yes, then the service cannot be deemed to be distinct from conventional services and thus should be subject to the price control and anti-trust provisions of the licence. The above tests are initial thoughts and we would be interested in working with Postcomm and other relevant stakeholders to develop an appropriate definition of new services.
26. Where a service appears to be a “new” service, as a minimum, Postcomm should seek to consult stakeholders before the introduction of the service and to put in place a mechanism for the speedy resolution of complaints around the introduction of a service
27. These are the very early days of competition. Innovation will come: but it needs to be driven by customers and not by a desire to avoid regulatory control in order to be in a position to starve competition of essential volumes at this critical time.
28. Although Postcomm proposes that Special Delivery 9am and Presstream services are outside the price control, we are not convinced that these services meet “effective competition.”
- b) Regulation of access
29. The MCF notes Postcomm’s main proposals in relation to the regulation of access services:
- “bringing access products into the price control;
 - regulating the minimum margin between a benchmark set of access products and the corresponding retail products in pence per item or percentage. The benchmark access products should be Access 1400, Access 700, Access 120 (letters) and Access 120 (flats and packets);
 - basing the margins on cost reflective differences, including future efficiency savings, as indicated by Postcomm’s approach to cost attribution. These differentials will take account of the conclusions of LECG’s work about the change in margins, following further verification of the analysis. Postcomm will also take account of competition and regulatory certainty;



MAIL COMPETITION FORUM

- bringing the existing quality of service and compensation arrangements for the benchmark products into Royal Mail's licence;
- requiring Royal Mail to provide quality of service information to all operators and customers using the benchmark products; and
- requiring Royal Mail to publish the intended prices at the same time as price controlled retail products, which is by 31 December prior to each 1 April".

30. The MCF very much welcomes Postcomm's proposals to include access services within the price control and to regulate the minimum margins between retail services and access services. Indeed, this is essential since downstream access has been introduced as a key regulatory tool to introduce competition in the United Kingdom. Whereas in the long-term the MCF would expect there to be separate controls on access and retail services (i.e. Option 3, page 56 of Postcomm's proposals), we accept that at this stage (i.e. for the next four years) we would find our concerns on margin squeeze mitigated through the control of the margins between retail, wholesale and access services. Postcomm has noted that to date margins have already been squeezed by Royal Mail, making it difficult for operators to compete within the market. The MCF also welcomes the incorporation of the current contractual access quality of service targets (i.e. 95%) within the licence and the publication of intended prices.

31. In coming to its clear position on how to avoid further margin squeeze, we would ask Postcomm to bear in mind the following issues:

- There must be no chinks in the armour. If there are retail products against which consolidators are competing, there need to be corresponding access services – otherwise an exodus to a new retail service with no “access twin” could easily lead to new margin squeeze.

This may mean that the number of services considered may go beyond a basic benchmark of access services.

- It is very important that access terms, compared with corresponding retail services, must be accessible in practice and that the margin squeeze protection is no less effective following an evolution in Royal Mail's services.

32. The MCF would also like to offer its assistance to Postcomm (and its various consultants) in helping to determine the appropriate access services to be used as benchmarks, the likely volumes of access services and for the determination of margin differentials. As to the relevant benchmark access products, these should include all current access services i.e. Access 1400, Access 700 CBC, Access 120 (letters); Access 120 OCR (letters); Access 120 CBC (letters); Access Walksort; and Access 120 (flats and packets). These benchmarks will need to evolve as new access services are introduced which, as we state below, should always happen when a new retail service is introduced



MAIL COMPETITION FORUM

33. The second concern of operators in the market is that, with access terms impacting nearly all emerging competition, it is essential that Royal Mail charges the same prices internally as it does externally. This is yet another reason why new services should remain within Postcomm's anti-trust control net, to ensure that such intrinsic principles are adhered to. Wherever possible, this check on non-discrimination should be carried out ex ante – rather than allowing unlawful pricing to enter and disrupt market conditions only to be removed at a later date, having done the intended damage to emerging competition.

c) Tariff baskets

34. The MCF would like to note that it welcomes the separation of the tariff baskets as between captive and non-captive customers as this crucially prevents Royal Mail from funding anti-competitive discounts from higher prices on its captive domestic customers.

35. Royal Mail has argued, during the current price control that, having increased prices in some areas it has no option but to reduce other prices. It is no coincidence that, while stamp prices for services facing no significant competition have increased, prices of services facing competition have reduced. We, therefore, believe that the proposal to limit the ability to fund price cuts for competing services from revenues and profits from non-competing services is essential.

36. We agree that the two basket approach proposed by Postcomm is a sensible approach to achieving this objective. We are however concerned that Postcomm's proposal to impose a tighter cap on basket A (RPI-3%) than on basket B (RPI-2%) fails to take account of recent developments in the market, and is likely to prove both dangerous and counter-productive to Postcomm's own objectives. It is clear from Royal Mail's regulatory accounts that stamped items remain heavily loss making, a legacy from years of political interference with the price of the stamp. It is no less clear that, within the twin constraints of an RPI-3% cap and a limited product range in basket A, if Royal Mail are to secure headroom for even modest rebalancing of stamp prices, they will be driven to a substantial sacrifice on the price of metered traffic, well beyond the differential that may be justified by cost differences between the two payment channels. This would be to exchange one damaging market distortion for another. Basket A needs sufficient headroom for the stamp price to make at least modest progress towards cost reflectivity over the period (thereby also achieving a justifiable differential with metered prices) without requiring the backwards step of offsetting distortions in metered and/or other products.

d) Geographic uniformity

37. Zonal pricing is at the core of the market entrants' concerns. We recognise that Postcomm has addressed the issue of zonal pricing but we strongly believe that the proposals will be insufficient to ensure the promotion of effective competition.



MAIL COMPETITION FORUM

38. The primary, if not exclusive, motive for zonal pricing appears to be the elimination of competition. At its most benign, it will lead to opaque, profile prices which, with an extremely large number of possible outcomes, Postcomm will find difficult, if not impossible, to unpick. Royal Mail has already sought to dissuade customers from moving to the licensed consolidators by offering its customers direct zonal access arrangements, if they deal direct with Royal Mail. Royal Mail's proposed zonal pricing involves 10,000 regions to each of which Royal Mail assigns one of five delivery zone classifications. This leads to a matrix of prices that will be both costly to monitor and difficult to analyse to ensure that Royal Mail is not breaching any of its various licence conditions.
39. In Sweden, where zonal pricing was introduced as a reaction to CityMail's entry into the market, it is important to note that there was no VAT distortion and, even still, CityMail struggled for years to make ends meet. Once mail delivery competition has reached maturity, however, and the VAT distortion is corrected, then we accept that zonal pricing might be reviewed. Until then, zonal pricing should not be permitted as its negative impact on mail delivery competition will be extremely significant.
40. Based on the experience of customer behaviour in using Presstream services, which are priced according to mailing profile, we believe that customers would progressively de-select the more expensive zones and they would not necessarily use other Royal Mail services. As a result, mail recipients in the more expensive zones would no longer receive certain types of mail. This is a highly undesirable outcome and a direct dilution of the universal postal service. From the viewpoint of the recipients, they are not receiving a universal service if mailers decide not to use mail to distribute items to some parts of the country. In addition, this decrease in mail volumes would increase substantially the unit cost of delivery to these expensive zones, funded we would anticipate, by further increases in stamp prices and from other captive services.
41. Until such time as market and legislative conditions would be appropriate to permit zonal retail pricing, we would ask Postcomm to ensure that no zonal prices, either retail or access, are introduced. At this stage of the market's development, if Postcomm were to allow Royal Mail to introduce zonal pricing, there would be a profound and negative effect on the emergence of competition.
42. The MCF wishes to note that it is extremely disappointed to see that, despite its repeatedly voiced concerns over the effect of zonal pricing on emerging competition, Postcomm had not proposed to include any assessment of the effect of a zonal pricing proposal on competition (draft paragraph 18 of Condition 19 of the Royal Mail licence). The only proposed criteria for review were revenue neutrality; more cost reflective prices; no unreasonable changes for users; no provision of a narrower range of services; prices geared to costs and affordable. These criteria do not sufficiently discharge Postcomm's second statutory duty, to further the interests of users of postal services wherever appropriate by promoting competition between postal operators. Moreover, we restate our position that the issue of zonal pricing should be treated separately from the question of whether a service is a universal service. In its proposal



MAIL COMPETITION FORUM

to remove certain services, Postcomm should ensure that they remain uniformly priced.

Incentive regulation in order to protect customers

43. The MCF has reviewed carefully the proposals set out by Postcomm in terms of the individual price caps on tariff baskets, the rationalisation of quality of service targets and the introduction of a C factor to incentivise Royal Mail to meet these targets.
44. As stated above, the MCF welcomes the proposal to separate services into captive and non-captive baskets.
45. In addition, as noted above, the MCF welcomes the access quality of service regime that has been proposed along with the provision of information to operators proposals – both of these are crucial to the development of access providers operations.

Transparency and objectivity

46. We recognise that Postcomm has made information available, in the context of the size based pricing consultation, and welcome this move. While we do not expect to have full insight into Royal Mail's inner workings, we do believe that it is essential that Postcomm has such an insight and that it has the power and the will to analyse that information to ensure that no abusive practices take place. We urge Postcomm to continue and broaden its analysis so that it has the relevant information to follow up complaints of anti-competitive practice as promptly as possible.
47. Transparency of prices, as well as of underlying costs, is critical to the proper operation of the market. Publication of high-level rates is not sufficient. To have transparency, it is essential to know the actual prices which are being charged; to understand how discount structures operate; to see how service credits are calculated and reclaimed and to be able to examine how profile based pricing is operated. [By way of illustration, the recent proposal to allow a form of credit for customers who will have to pay a higher price to reflect Royal Mail's costs as a result of the introduction of Pricing in Proportion (so-called "losers", rather than "historic winners") can easily operate as a loyalty discount. When granted by a dominant player this may be contrary to competition law. Any such actions are prohibited by competition law and should be stopped, rather than endorsed, by Postcomm.]

Conclusion

48. The MCF can appreciate why the current price control was designed to help Royal Mail, given its failing business at the time. However, following Royal Mail's turnaround, it is vital that Postcomm sees this price control as being critical to the success of competition – especially given the heavily distorted market conditions. We



MAIL COMPETITION FORUM

recognise that, once the regulatory distortions in the market are gone and competition has a solid foothold, there will be less scope for controlling Royal Mail's behaviour. That day, though, is some way off and we ask you to take the voice of competition into account in your current deliberations.



MAIL COMPETITION FORUM

1 September 2005