MAIL COMPETITION FORUM

MCF RESPONSE TO POSTCOMM'S CONSULTATION ON ITS AUGUST 2007 STRATEGY REVIEW DOCUMENT "THE POSTAL MARKET 2010 AND BEYOND – EMERGING THEMES"

Introduction

1. The Mail Competition Forum ("**MCF**") very much appreciates the timeliness of this consultation, forming as it does the backdrop to the commencement of work on the Royal Mail price control regime from 2010.

2. Whilst there is a wide range of external factors that could exert considerable influence on the development of the UK postal market – possible examples might include a sudden flight to electronic substitutes caused by prolonged disruption to Royal Mail's services, the impact of environmental pressures on the volumes of direct mail advertising, or the removal of Royal Mail's VAT advantage – the reality is that by far the largest influence over the past few years has been Royal Mail's pricing and the regulatory regime put in place and operated by Postcomm which has controlled it. We expect this to remain true for the foreseeable future.

3. Postcomm's regulatory regime, and in particular its ability to control Royal Mail, manifests itself not only through its overriding statutory duties imposed by Parliament but also through the various conditions contained in Royal Mail's licence, and these conditions stem in turn from the negotiations leading to the price control in force at any given time. If circumstances arise that cannot be adequately resolved within the scope of a licence condition, the remaining recourse is then to the standard provisions of competition legislation through the OFT, the Competition Commission, the courts or the European Commission as appropriate.

4. The remainder of this paper therefore concentrates on reviewing the effects of the present price control, and Postcomm's implementation of it, on the UK postal market; and on drawing from that review a series of conclusions which we believe should inform the shape, scope and content of price control and regulatory framework from 2010 onwards

Lessons from the 2006 Price Control

5. It is of course all too easy to criticise with the benefit of hindsight, and the MCF readily admits that we did not at the time expect the results from the present price control which we have in practice witnessed with growing concern. Equally we fully understand that the price control itself and the subsequent modifications to Royal Mail's licence conditions stemmed necessarily from a prolonged series of negotiations, and could not have been imposed on Royal Mail by Postcomm diktat.

Regulatory stability

6. No business can expect to be shielded from normal business risks, and MCF members are no different from any other business in that regard. The UK postal market – or at least the regulated part of it – is however far from a normal and properly functioning competitive commercial market. It remains overwhelmingly dominated by a single incumbent with, amongst other advantages, a 350 year headstart, massive economies of scale and scope, and a beneficial VAT status. Any business investment proposal needs to be tested within the parameters of best case/worst case scenarios. In the context of the UK postal market this requires, above all, a clear understanding of the scope available to Royal Mail to move its prices, both individually and collectively, either upwards or downwards over the next few years; the scope available to it to introduce new services or to change existing ones; and the willingness and ability of the regulator to act quickly and decisively against anticompetitive practices.

7. Unfortunately the present regulatory regime has in practice largely failed to provide these essential pre-conditions, with the entirely predictable result that companies have held back from decisions to commit significant investment to the creation or expansion of end-to-end networks, and only downstream access, making use of Royal Mail's existing final mile delivery infrastructure, has shown an impressive potential for growth. Even here, unless end-to-end competition grows to a level where there is effective competition, the lack of competitive pressures throughout Royal Mail's value chain means that continuing regulatory intervention to prevent margin squeeze will continue to be required in the next price control and thereafter.

Cost transparency

8. The MCF believes that absolutely fundamental to a successful price control regime is the fullest possible understanding of all aspects of Royal Mail's cost base, which in turn can only flow from full transparency. This needs to cover not just a broad split between upstream and downstream costs, but each element of the pipeline separately identified. From this starting point the costs, both discrete and common or shared costs such as sales and marketing, that are properly attributable to each product or service can be identified and allocated. This in turn provides the essential foundation for setting prices across the board on a fair, consistent and non-discriminatory basis.

9. MCF members accept that certain elements of this cost information will be rightly regarded by Royal Mail as commercially confidential (though we also believe that this argument has on occasion in the past been used as an unjustified smokescreen). What is important is that we should have confidence that Postcomm has insisted on, has secured, and has maintained on an ongoing basis the necessary full cost transparency outlined above, and has a full understanding of how the resulting model works through changing time and circumstances.

10. A planned and consistently applied and implemented glide path from Royal Mail's legacy pricing model towards a regime of properly cost reflective prices based on true cost transparency as outlined above would carry a level of credibility entirely lacking from the current selective deployment of the cost reflectivity mantra by Royal Mail when and only when it suits its purposes. We believe that zonal pricing is a prime example of where Royal Mail has selectively used a cost-reflectivity argument to determine a programme which suits an agenda to drive out competition, rather than address issues within their own cost base. As has been pointed out before, zonal pricing is self-defeating, as while mailing costs to rural and other areas would rise, Royal Mail's obligation to universal service would simply result in increased unit delivery costs to these areas if, as we strongly expect, posting customers reduce the volumes sent out to these locations. Customers do not benefit (because of additional mail preparation activities), and Royal Mail itself cannot realise benefits except by retaining lower-cost urban delivery volumes at the expense of alternative service providers.

11. Royal Mail should present a programme of true cost reflective pricing that tackles issues across the board (for example Mailsort 3), and not just those areas that serve to shut out competitive challenge. This should be backed by a cost-reduction programme that clearly shows that Royal Mail is seeking to tackle its own legacy issues from within, and is not simply passing the whole problem out to customers.

Separation

12. MCF members are in full agreement that a significant level of accounting separation within Royal Mail will be needed to achieve the degree of cost transparency we believe to be essential. We have in the past argued that physical or structural separation – for example of the "final mile" delivery infrastructure from the upstream pipeline, or of the wholesale from the retail activities – is both unnecessary and a dangerous diversion of the substantial resources that would be needed to achieve it from the more immediate and pressing need to concentrate on controlling Royal Mail's clear intention to attack or pre-empt competition by any available means. More recently, however, given the absence of adequate cost accounting transparency, some members have questioned whether the pendulum of advantage may have started to move in the direction of some form of physical separation to reinforce the extensive accounting separation on which we are all agreed. Various models, each with a different balance of advantages and disadvantages, have been suggested for further discussion, but at the present time the MCF has not formed a view on which – if indeed any – offers the best prospect of achieving our commonly held objectives.

Universal Service

13. Postcomm has questioned whether it would now be appropriate to reduce Royal Mail's universal service obligation to a level which more closely reflects the minimum required by the current EU Postal Directive (which would require amendment to the

Postal Services Act 2000), and/or whether it would now be appropriate to remove from the coverage of universal service all business mail products as Royal Mail has argued.

14. The MCF takes the view that in considering these issues Postcomm should be guided above all by the wishes of customers, and by what is most likely to promote the health of the United Kingdom postal market. Our strong and continued opposition to the introduction of zonal pricing has equally been informed by these same considerations. It is clear from Royal Mail's most recent regulatory accounts that the universal service remains profitable, and we believe that the focus should be on developing new and better services that meet the needs of customers, thereby increasing the profitability of the universal service, rather than worsening services which will inevitably lead to lower volumes, higher unit costs and a downward spiral that will ultimately render the universal service unsustainable. Suggestions that have emerged from the European debate that universal service could in such circumstances be supported by some form of compensation fund bear no relationship to economic reality and would serve only to drive out any competition that remained in the market.

15. There is, in any case, a profound difference between an obligation placed on a single operator to provide the universal service and a desire to have a higher level of service that meets customer requirements and supports a commercially viable postal service. Currently, given Royal Mail’s dominance of the mail market, a reduction in the level of the universal service obligation will almost certainly lead to a migration to that level. Royal Mail is strongly motivated to reduce its costs and would allow Postcomm to take the blame for the reduction in service level. In a normally functioning market new entrants might well recognise the market opportunity presented by the reduction in service level. However, this is unlikely in the postal market without regulatory intervention. Therefore, we suggest that Postcomm should not reduce the current universal service obligation on Royal Mail without first considering how the service could be maintained in other ways, such as obliging Royal Mail to subcontract or franchise parts of its operation to other operators. We can envisage a two tier universal service, with a core service provided by Royal Mail and an added-value service provided at least in part by other operators. There may also be scope, subject to full customer consultation, for removing some historic elements from the present universal service to reduce costs without causing detriment to the customer experience.

16. However the MCF recognises that if, despite this approach, the universal service obligation as currently defined were to become untenable at some point in the future, perhaps because of a decline in mail volumes, its replacement by a controlled move to a statutory minimum confined to a social service delivered over 5 rather than the present 6 days in line with the EU Postal Directive may become the only realistic course of action.

Conclusion

17. Postcomm's strategy review provides a valuable and timely basis for kickstarting the debate on the Royal Mail price control from 2010. That price control will be critical to the development of the UK postal market, and in particular to the role of competition within it. The lessons already apparent from the present price control regime are there to be learnt, so that the more negative aspects can be avoided next time round. More specifically the price control from 2010 will need to set the clearest possible parameters within which Royal Mail must operate throughout the full duration of the price control. The most important of those parameters – those relating to Royal Mail's prices – must be based on full cost transparency of every material aspect of the Royal Mail operation, with prices built up on a consistent and non-discriminatory methodology. Protection against margin squeeze must continue to be included. The translation of the new price control into conditions in Royal Mail's licence must make clear beyond any possibility of doubt that Postcomm's statutory duties to maintain universal service and to promote competition to benefit users of postal services take precedence over any and all other licence conditions.

18. Continued tight regulatory control of Royal Mail to deal promptly and effectively with anticompetitive behaviour will remain essential until such time as sustainable competition has been established in the market. We do not believe that Postcomm is yet in a position to imply any timeplan for moving to 'light touch' or largely ex-post regulation. Competition remains vulnerable, and the large majority is still heavily dependent on Royal Mail downstream service provision (witness the impact of Royal Mail's strikes on Access services). There remains an ongoing need for Postcomm to monitor potential anti-competitive behaviour by the incumbent from the outset and assess possible consequences – not wait until such time as implementation has occurred and the damage has been done. Ex post regulation should only be considered when sustainable and substantial alternatives to Royal Mail exist. Consideration of changes to the universal service should be guided by the wishes and best interests of customers, and the future health of the United Kingdom postal market.

MCF
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