

**Postcomm's strategy review – emerging themes  
TNT Post UK Limited response**

We interpret the document as asking three key questions:

- How should Royal Mail's prices be controlled?
- How should Royal Mail be structured?
- What should the universal service look like?

**1. How should Royal Mail's prices be controlled?**

- 1.1 Market forces should set the upper limit on Royal Mail prices. This would apply equally to retail and access prices. Any exceptions to this rule must be extremely limited as price caps act to distort competition.
- 1.2 Allowed revenue price controls and RPI-X formulae artificially hold prices down – removing value from the market and making investment decisions by all operators less attractive. Investment will create choice and choice will create the pressure for efficiency on all operators.
- 1.3 Two appropriate exceptions to the market setting upper limits are:
  - (a) Stamp prices being subject to a specific affordability measure – taking into account that the average UK family spends a tiny 50 pence per week (£26 per year) on postal services; and
  - (b) Rural surcharges (where non uniform pricing is introduced) being capped to prevent damage to the universal service.
- 1.4 Prices must be based on a transparent, commercial, fully allocated cost basis. This would then set the lower limit on Royal Mail prices. Legacy pricing has distorted the market for too long: it has to go.
- 1.5 It is critical that the system of cost allocation of direct and shared costs is transparent and properly reflects the costs of each service i.e. fully allocated, market conform and in accordance with Article 14.3 of the EU Postal Directive.
- 1.6 Any cost allocation system should be used for both business and regulatory purposes: Royal Mail should not be keeping two sets of books.
- 1.7 Access services are being used for 17% of mail volumes and will, for the next few years, be the primary form of competition to Royal Mail. It is critical that margins of access operators are not squeezed.
- 1.8 The difference between wholesale and retail prices on all services must reflect a level which permits reasonably efficient market entry.

- 1.9 The difference must take account of (a) the VAT distortion (for so long as it continues to exist) and (b) the market conditions which deter switching behaviour.
- 1.10 The current system (while arrived at pragmatically) of setting access prices by reference to retail prices is not sustainable in the longer term.
- 1.11 Every single Royal Mail retail price must be based on transparent, arm's length, access prices (and terms) to which retail costs and margin are then added. The access prices and terms which are available to Royal Mail Retail must be available to operators and customers alike.
- 1.12 The greatest threat to emerging delivery competition will be unduly low prices. Provided that prices are neither predatory nor exclusionary e.g. they are fully commercial and cost justified and are not funded by rural surcharges or permitted arbitrage (e.g. by allowing customers to avoid paying rural surcharges), Royal Mail should be free to price at that level.
- 1.13 Rural surcharges will have a very negative effect on rural and, therefore, universal postal services. Postcomm has recently stated<sup>1</sup> that postal prices are relatively elastic (i.e. relatively small price increases will result in significant decreases in volume). Any form of control over non-uniform pricing must take this into account.
- 1.14 TNT Post advocates allowing Royal Mail to respond proportionately to competition where it introduces non-uniform pricing i.e. through a simple urban and non-urban pricing system. Existing five zone pricing is too complicated and opaque; introduces unnecessary cost and/or operational requirements and is commonly used alongside nationally priced services to arbitrage prices which have discounts but no surcharges.

## **2. How should Royal Mail be structured?**

- 2.1 In order to achieve commercial prices based on fully allocated costs, there needs to be much greater cost transparency and proper incentives at all levels to drive efficiency and generate profit. This would require equivalence of pricing from Royal Mail Wholesale to Royal Mail Retail and a very clear division among Royal Mail Operations, Royal Mail Wholesale and Royal Mail Retail. These could be established, at one extreme, as separate legal entities through autonomous business units to divisions at the other extreme. A diagram showing how the three Business Unit structure would work is shown in the Annex.
- 2.2 There needs to be complete transparency and equivalence of wholesale pricing and terms whether the services are being provided to Royal Mail Retail or to third party customers / operators.

---

<sup>1</sup> Annex 1, Competition Market Review 2007 – in the context of modelling the impact on volumes of an undistorted VAT system which is equally applicable to all operators.

- 2.3 Royal Mail Wholesale needs to set its prices at a commercial and profitable level based on fully allocated costs. Royal Mail Retail will then set its prices based on the Royal Mail Wholesale prices and its own costs and then applying a commercial margin.
- 2.4 Royal Mail Retail must also be incentivised to offer new, customer-driven services and to make a commercial margin in its own right. Royal Mail Retail needs, therefore, to be completely separate from Royal Mail Wholesale which, for the reasons stated below, in turn needs to be separate from Royal Mail Operations.
- 2.5 Royal Mail Wholesale must be incentivised to generate as much business as possible; to launch new services, in response to demand from its customers (i.e. Royal Mail Retail and third parties) and to procure the most cost effective operational solutions.
- 2.6 Royal Mail Wholesale must be fully incentivised to make as much commercial profit as possible and to exert as much pressure as it can to secure the best possible value for money i.e. procure the most cost effective collection, sortation, transportation and delivery services possible. This means that Royal Mail Wholesale must be able to exert commercial pressures on all suppliers, in particular on Royal Mail Operations, to extract the best possible value for money. Royal Mail Wholesale must be allowed and incentivised to make the most of the competitive offerings available from market liberalisation.
- 2.7 If operations were to be part of Royal Mail Wholesale, there would be insufficient pressure on Royal Mail Wholesale to seek service offerings from third parties and insufficient ability to put pressure on its key supplier (Royal Mail Operations) to match competing offers. Royal Mail Wholesale would become a key pivot to driving efficiency in Royal Mail Operations. There will, therefore, be inevitable tensions from this relationship which require complete separation of management structures.
- 2.8 For this to work, Royal Mail Wholesale management must be completely independent and free from pressures to meet the goals of Royal Mail Retail or Royal Mail Management. It would not be legitimate for Royal Mail Wholesale to try to maintain a monopoly of supply within Royal Mail Operations e.g. by charging wholesale prices which are not commercial and thus deterring competition. Nor would it be appropriate for the choice of supplier to be made by the business unit which has a vested interest in using its own services (i.e. Royal Mail Operations).
- 2.9 For its part, under this proposed structure, Royal Mail Operations would be under pressure from (a) Royal Mail Wholesale and (b) other suppliers to provide all services from collection to final delivery at the most efficient level, while making a commercial return. This would need to be reflected by arms' length pricing between Royal Mail Operations and Royal Mail Wholesale against which third party operators would seek to compete when seeking to supply to Royal Mail Wholesale. In the absence of real pressure from third

party suppliers, there is a continuing risk that Royal Mail Operations will not take the necessary steps to become more efficient.

- 2.10 In this model, it is expected that the universal service, like other services, would be physically provided by Royal Mail Operations and third party operators, procured by Royal Mail Wholesale and sold to end customers by Royal Mail Retail (subject to a uniform tariff obligation) and potentially by third party retailers (presumably not subject to a uniform tariff obligation). The competitive procurement function of Royal Mail Wholesale would put downward pressure on the cost of the universal service and, thus, reduce the future need for any form of state funding for a service of general economic interest and/or funding from other operators.
- 2.11 From the perspective of the Government as shareholder, there will be a strong desire to see that any reorganisation will create a commercial return on any shareholder investment and not interfere with the modernisation of the Royal Mail business. That modernisation is critical for the efficiency of the postal industry and its success as a medium of communication. This will be achieved from the suggested structure through Royal Mail Operations (a) charging a commercial, arm's length rate to Royal Mail Wholesale, taking into account the cost of shareholder capital and (b) being incentivised to modernise its business as soon as possible, in the face of competition from third party operators. Reorganising the different activities into separate, independently incentivised business units will assist, therefore, in creating the right commercial incentives and management mind-set to undertake Royal Mail's long overdue modernisation.
- 2.12 End to end competition is near to non-existent but, as it grows to an effective level, it may well be appropriate to review the degree of enforced separation if the market is starting to function as a normal competitive market and Royal Mail is adopting a commercial – rather than its current protectionist – stance.

### **3. What should the universal service look like?**

- 3.1 For too long, the issue of the extent of the universal service and the obligation to provide it at geographically uniform prices have been confused. Zonal pricing must be tackled as a separate issue.
- 3.2 The universal service should be confined to providing a basic postal service, available to absolutely everyone (i.e. it would not cover services requiring a franking machine or a meter account). All bulk mail and other non single items services should be provided under market conditions.
- 3.3 The universal service should comprise a reliable single item letter and parcel delivery service (domestic and international) – with no specific requirement that a certain existing service be continued - and a registered and insured service (domestic and international) – to meet the requirements of the EU Postal Directive.

- 3.4 Over time, if mail volumes diminish (as is expected for transactional mail, in particular), Royal Mail and other providers of the universal service must have the ability to provide it in a way which is cost effective and sustainable. This means that reducing costs will be important and may involve providing the service five – rather than six – days per week (as is currently the case for the universal service obligation for parcels). It may also be confined to delivering to letter-boxes which are sited close to the highway, rather than actually through the door of houses. This is common and specifically required by regulations in a number of countries such as The Netherlands, France, Canada and the USA.
- 3.5 Of course, any change is often considered to be bad simply because it is different but if a regular, cost-effective, universally available service is to be provided with lower volumes, it is clear that a reduction in costs and/or increase in prices will be required. To achieve this, cost transparency and good cost control are absolutely essential.
- 3.6 It is critical to build in sufficient flexibility to allow Royal Mail and other providers of the universal service to offer the universal service as effectively and efficiently as possible, within the constraints of the EU Postal Directive and UPU Conventions.
- 3.7 It is also critical, as mentioned above, to ensure that any form of rural surcharging is analysed in extreme detail to ensure that its introduction would not lead to a material reduction in rural mails volumes and, thus, undermine Royal Mail's ability to provide a universal postal service.
- 3.8 As mentioned above, the universal service would be physically provided by Royal Mail Operations and other operators; procured as efficiently as possible by Royal Mail Wholesale and sold to end customers by Royal Mail Retail and other retailers.
- 3.9 While it is to be hoped that a compensation fund would never be required, if more than one operator is providing the universal service, each operator would need to demonstrate that the net burden of providing (their element of) the universal service was such as to justify state subsidy or a contribution to the fund. On the basis of competitive tendering, this should mean that costs will always be set at market conform pricing, thus eliminating any need for state subsidy or a compensation fund.
- 3.10 Any compensation fund could have a very significant effect on competition. Any fund would, therefore, need to be independently administered and audited and subject to rigorous conditions to ensure that it does not distort competition and that it only funds the independently verified burden of providing the USO i.e. it must not fund inefficiency so, for example, outsourcing of burdensome areas must first be fully considered and only the efficient costs of the providing the service should be relevant (not inefficient, actual costs if they are higher); it must not apply if pricing is below affordable levels or if any discounts are being offered; contributions must not be due on any services outside the scope of universal service and all operators must contribute on an

Submitted version 30 11 2007

equal basis (including Royal Mail); all other less distortive measures must have been exhausted e.g. state funding; and any additional restrictions imposed by the third EU Postal Directive would need to be observed.

TNT Post UK Limited  
November 2007

## ANNEX

This suggested structure reflects a possible model to create transparency, cost reflectivity and efficiency.

Collection, transportation to sort centre, sorting, transportation to delivery office and final delivery would be carried out by a combination of Royal Mail Operations and third party suppliers. These would be sold to Royal Mail Wholesale.

Royal Mail Wholesale would perform two key functions:

1. procuring the most efficient collection, transportation, sorting and delivery services from Royal Mail Operations and third party suppliers; and
2. selling those services packages to Royal Mail Retail, customers and third party operators on arm's length, equivalent terms.

Royal Mail Retail would re-sell the services to end customers, at a commercial rate, taking into account the prices charged by Royal Mail Wholesale.

Royal Mail Retail would be competing against third party operators who provide both upstream (Operator Access) and end-to-end services.

### Royal Mail Separation 2010+

