RMG's view on market definition

Annex 2 - A response to the Postal Services Commission's May 2010 consultation document

August 2010

Contents

Executive summary

1. This document sets out Royal Mail Group's (RMG) current position on market definitions with respect to packets, parcels and letters products. This document has been prepared in order to respond to the consultation questions raised by Postcomm in Annex 2 of its May 2010 Consultation Document.

2. RMG is committed to working with the regulator to help ensure that we develop a new regulatory framework that secures a vibrant and sustainable mails industry in the UK. RMG understands that any such framework must be rooted in an economic assessment of markets. Consequently, in working constructively towards the development of a new regulatory regime, we believe that it is not only appropriate, but also of considerable benefit, for RMG to provide Postcomm with a detailed description of our views on markets. This document therefore extends beyond a set of responses restricted to the consultation questions raised by Postcomm. Rather it provides a self-contained and comprehensive description of RMG's current views on market definition.

3. We recognise that, because markets evolve over time and because our understanding of those markets can also evolve, it may be necessary to further refine and develop our views on market definition over time. RMG would also like to highlight the importance of taking under consideration the pace at which markets can evolve. In recent years, the competitive landscape in post has changed rapidly and beyond industry stakeholders' expectations. We therefore ask that when considering the range of evidence and views presented in this document, Postcomm adopts a forward-looking perspective. We further urge the regulator to adopt this same perspective when making decisions regarding regulatory safeguards and the scope for deregulation.

4. RMG understands that it is appropriate to approach an assessment of market definition through the hypothetical monopolist or SSNIP (small but significant non-transitory increase in price) test. We recognise that the SSNIP test provides a robust analytical framework for assessing markets and that it is commonly employed by economic regulators and competition authorities. In this document therefore, RMG has sought to set out its assessment of market definition through an application of the SSNIP test framework. RMG understands however, that there are often practical difficulties in applying the SSNIP test in a pure empirical sense and we note that these difficulties were acknowledged by Postcomm in the Consultation Document.[1]

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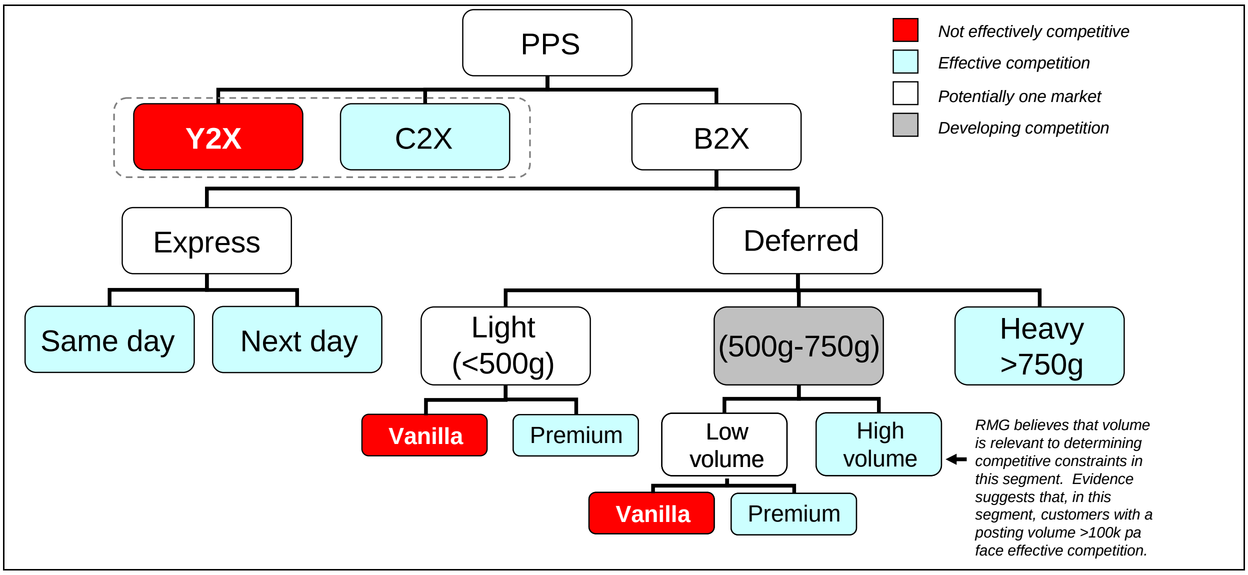
1 See 'Laying the Foundations for a Sustainable Postal Service.' Postcomm May 2010, para 1.23, in which Postcomm stated: *"defining a market in strict accordance with the assumptions in the hypothetical monopolist test is rarely possible. For example, there is unlikely to be data relating to*

Nevertheless, it is possible to evaluate the best available evidence of relevance to demand and supply side factors in order to infer what the likely outcome of a SSNIP test might be. This more conceptual approach to the SSNIP test is commonly applied by competition authorities such as the Competition Commission and the OFT and reflects the way in which RMG has sought to address market definition in this document.

Findings – packets and parcels

5. With regard to packets and parcels products, RMG believes that the currently available evidence supports a view of markets as set out in Figure 1 below.

Figure 1 RMG's current views on relevant markets for packets and parcels



6. Postcomm will note that RMG's current view of markets (from an ex-ante perspective) for packets and parcels has some similarities to its own as set out in the Consultation Document. However, it differs on some important dimensions, we take a different view to Postcomm as to the weight points around which competition has developed; and on the competitive constraints between deferred premium and deferred vanilla services. RMG would like to highlight the following points.

- RMG agrees with Postcomm that there are separate markets for Y2X/C2X (combined) and B2X services. However, we note that the C2X market is currently small; and it is possible that it may develop in such a way that it becomes a separate market from Y2X.

the extent of demand and supply side substitution following a small price rise by a hypothetical monopolist."

- RMG agrees with Postcomm that there are separate markets for express and deferred services, where express services are defined as being same day or next day guaranteed.
- With regard to deferred premium and vanilla services, RMG believes that the markets are asymmetric. We specifically believe that vanilla services are competitively constrained by premium services but not vice versa. This is because customers that need premium services (i.e. tracking) are unlikely to substitute to vanilla services (without tracking) in response to a relatively small increase in the price of premium services. However, customers using vanilla services would substitute to premium services as the price differential between those services is reduced.
- RMG believes that the extent of the asymmetric constraint placed on vanilla services by premium services differs by weight step. Starting with deferred vanilla as the focal product, evidence shows that above 750g, there would be material customer switching from deferred vanilla services to deferred premium services following a relatively small increase in the price of vanilla services. Therefore, above 750g there is a single deferred market consisting of both premium and vanilla services. This finding is based on:
    - Evidence on customer switching and choice, which shows that above 750g our deferred vanilla products are competitively constrained by deferred premium products.
    - Price differential analysis, which shows that at lower weights there are material price differences between deferred premium and deferred vanilla services (which would deter customer switching between the two); but that above 750g, the price differential is negligible.
    - Supply side differences in delivery methods, which give rise to relatively flat cost and pricing lines by weight for deferred premium products (which are typically delivered by van); but cost and pricing lines that increase with weight for deferred vanilla products (which are delivered on foot up to a certain size or weight, above which point they are delivered by van).
- The evidence shows that the deferred heavy weight market above 750g (which includes both premium and vanilla services as discussed above) is effectively competitive. This conclusion is supported by (i) evidence showing a sharp drop in our market share for deferred services at 750g; and (ii) independent research into customer switching and choice, which shows that there is effective customer choice in the market for deferred services above 750g.
- At weights below 750g, the evidence shows that the asymmetric constraint placed on vanilla services by premium services is less strong. Specifically, at 500g and below, the constraint is not currently sufficient for them to be in the same market. Thus there are currently separate premium and vanilla markets below this weight. We note that Postcomm themselves left open the possibility

of separate premium and vanilla markets; and indeed concluded that: *"the supply side evidence points to the existence of separate markets for premium and vanilla markets."*[2]

- For deferred vanilla products, the evidence is currently consistent with there being a separate low weight market for items below 500g. RMG accepts that in this market, there is not yet effective competition.
- Starting from deferred vanilla as the focal product, RMG also finds that the currently available evidence shows that some competition has developed in the 500g-750g space, but that the extent of this competition is less clear at present. We note however, that in recent years Royal Mail has been increasing the price of its deferred vanilla products below 500g and reducing prices at weights above 500g, indicating that our deferred vanilla services are competitively constrained above 500g. In addition, findings from independent research into customer switching and choice are also consistent with a material proportion of customers facing effective choice at weights down to 500g. RMG therefore believes that in this area, other factors (and in particular posting volumes) are relevant to determining the extent of competition.
- RMG's current view is that posting volumes are relevant to an assessment of market power within specific weight points of deferred vanilla markets (but that volumes do not drive competition independently of weight). We therefore suggest that volumes are likely to be of most relevance to competition in the 500g to 750g weight band of the deferred market; where (as noted above) the extent of competition (and specifically the extent to which premium services constrain vanilla services) is less clear. RMG believes that there is effective competition for larger volume customers (with an annual posting volume in excess of 100k) in this segment.
- Starting from deferred premium as the focal product, RMG believes that the evidence suggests that there is a single market for deferred premium products, which is effectively competitive at all weights. This is because the constraint between deferred premium and deferred vanilla is only asymmetric, and therefore, customers using deferred premium (tracked) services would unlikely to be willing to substitute to deferred vanilla services. We further note that with respect to deferred premium services, weight is not relevant to an assessment of competition because both RMG and our rivals generally have pricing lines that are flat, or almost flat, by weight.

7. The above reflects RMG's current views on market definition with regard to packets and parcels. We note however, that the markets we operate in are dynamic and moving rapidly over time. Consequently, over time, rivals are likely to be increasingly able to compete with us for customers with lower item weights and lower posting

2 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.248.

volumes (our sales teams are already experiencing larger customers switching low weight items away from us). Indeed, as we ourselves make changes to our pricing structure (and in particular increase prices for our lower weight packet and parcel items) it is possible that the way in which competition functions will change. RMG believes that this perspective has important implications for future decisions regarding regulatory scope; and these are set out below.

Implications for regulation – packets and parcels

8. In headline terms, our conclusions on market definitions for packets and parcels products are consistent with the regulatory scope set out in the table below. However, a detailed description of RMG's proposed amendments to the current regulatory framework is contained in our response to Annex 4 of the Consultation Document.

Table 1: RMG's current views on regulatory scope in packets and parcels for 2011/12 and beyond

Market	Direct regulation of prices (Condition 21)	Pre-notification of prices, restrictions on product changes (Conditions 7)
Express	NO	NO
Deferred heavy (>750g)	NO	NO
Deferred premium services (all weights)	NO	NO
Deferred (500g-750g) high volume customers *(sending over 100k items pa)*	NO	NO
Deferred (500g-750g) vanilla services – low volume customers *(sending under 100k items pa)*	YES	YES – but modified*
Deferred light (<500g) vanilla services	YES	YES – but modified*

**RMG is proposing modifications to our notification periods. For details see our response to Annex 4.*

9. Whilst the current evidence on markets is consistent with the regulatory scope indicated above, RMG would urge Postcomm to take a forward-looking perspective

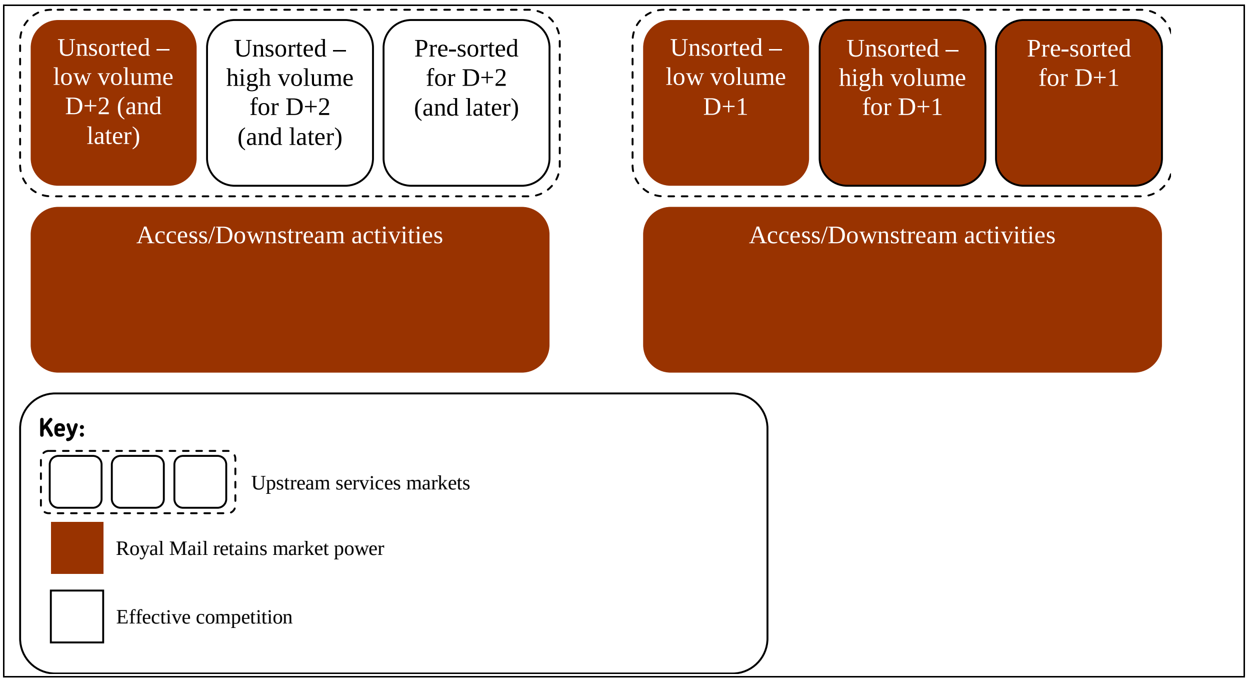
when making any decisions regarding regulatory safeguards and the scope for deregulation. We would therefore specifically ask Postcomm to consider, when making any deregulatory decisions regarding deferred vanilla packets, to go as far as it can beyond 750g; towards and potentially below 500g.

10. We note that our proposals for 2011/12 would only result in an incremental c.13% of total packet revenues being deregulated.

Findings – letters

11. With regard to letters products, RMG believes that the currently available evidence supports a view of markets as set out in Figure 2 below.

Figure 2 RMG's current views on relevant markets for letters



12. Again, RMG believes that it has much common ground with Postcomm in its current view of markets. However, we disagree with Postcomm's assessment of market power within those markets. We would like to make the following points.

- Whilst RMG agrees with Postcomm's suggested market definitions (as set out in the Consultation Document) for letter products, it is important to understand that these markets are developing rapidly. Consequently, appropriate market definitions and competitive conditions within those markets can change quickly.
- The key factor in defining unsorted high volume as a separate market is the minimum volume per posting (in the region of 250 items). Thus not all of Royal Mail's PPI and meter products would fall within this definition. Our

analysis indicates that were we to exclude the appropriate proportion of these products, our market share would be consistent with there being effective competition. Therefore, we would argue that RMG has limited market power within this market.

- We also do not agree with Postcomm's conclusion that we retain market power in the (upstream) D+2 (and later) pre-sort market (although we note that Postcomm acknowledged that this market is becoming increasingly competitive). RMG believes that our current share in the D+2 (and later) pre-sort market is consistent with it already being effectively competitive. We also note that our market share in D+2 (and later) pre-sort has been falling sharply in recent years.

Implications for regulation – letters

13. RMG believes that its view of markets (based on detailed evidence) has the following implications for regulatory scope.

- RMG accepts that retail (upstream) and wholesale (downstream) are separate markets; but we believe that the evidence indicates that the retail D+2 (and later) pre-sorted market is effectively competitive and consequently, could be deregulated.
- RMG also believes that the evidence is consistent with the high volume D+2 (and later) unsorted retail market being effectively competitive; which could therefore, also be deregulated.
- RMG accepts that effective competition has not yet developed within: wholesale markets, D+2 (and later) unsorted low volume retail markets; and D+1 retail markets. We note however, that Postcomm is concerned that RMG could leverage market power in these areas into other retail markets. We refute this finding by Postcomm and the basis on which it has been reached. We discuss this further in our response to Annex 4 of the Consultation Document.

14. Our view on proposed regulatory scope for letters in 2011/12 and beyond is set out in the following table. Postcomm will note that our proposals for 2011/12 do not fully reflect our current views on letters markets and the extent of competition in those markets. This is because RMG has identified a number of important issues relevant to short term changes in regulatory scope that also need to be considered. These issues are explained in detail in our response to Annex 4 of the Consultation Document. However, beyond 2011/12 we would expect (given the evidence on letters markets set out here) there to be no regulation of deferred bulk mail retail markets.

Table 2 RMG's current views on regulatory scope in letters for 2011/12 and beyond

Market	2011/12		Beyond 2011/12	
	Direct regulation of prices (Condition 21)	notification of prices, restrictions on product changes (Conditions 7)	Direct regulation of prices (Condition 21)	notification of prices, restrictions on product changes (Conditions 7)
Pre-sorted D+1	YES	YES – but modified*	YES	YES – but modified*
Pre-sorted D+2 (and later)	YES	YES – but modified*	NO	NO
Unsorted high volume D+1	YES	YES – but modified*	YES	YES – but modified*
Unsorted high volume D+2 (and later)	YES	NO	NO	NO
Unsorted low volume D+1	YES	YES – but modified*	YES	YES – but modified*
Unsorted low volume D+2 (and later)	YES	YES – but modified*	YES	YES – but modified*

**RMG is proposing modifications to our notification periods. For details see our response to Annex 4.*

Introduction

15. This document sets out Royal Mail Group's (RMG) current position on market definitions with respect to packets, parcels and letters products. This document has been prepared in order to respond to the consultation questions raised by Postcomm in Annex 2 of its May 2010 Consultation Document.[3] Rather than provide answers that only addressed the specific questions raised by Postcomm, RMG considered that it would be more constructive to set out a self-contained, comprehensive and robust view of its position on market definitions in their entirety within a single document. RMG is committed to working with the regulator to help ensure that we develop a new regulatory framework that secures a vibrant and sustainable mails industry in the UK. RMG understands that any such framework will, at base, need to be absolutely rooted in an economic assessment of markets. Consequently, in working constructively towards the development of a new regulatory regime, we believe that it is not only appropriate, but essential, for RMG to provide Postcomm with a detailed description of our views on markets.

16. RMG recognises that, because markets evolve over time and because our understanding of those markets can too evolve, it may be necessary to further refine and develop our views on market definition over time. Postcomm should therefore, interpret the positions expressed here as being reflective of RMG's views on market definition based on the best currently available evidence (and therefore, these views supersede those previously expressed by Royal Mail with regard to market definition).

17. The pace at which markets can evolve is also of much importance. In recent years, the competitive landscape in post has changed rapidly and in ways that industry stakeholders did not necessarily foresee. As Postcomm will be setting a price control in six months from now, it is essential that the regulator takes a forward-looking view to ensure that any regulatory framework reflects changing market realities and is fit for purpose. We therefore ask that, when considering the range of evidence and views presented in this document, Postcomm adopts a forward-looking perspective. We further urge the regulator to adopt this same perspective when making decisions regarding regulatory safeguards and the scope for deregulation.

18. The remainder of this document is structured as follows:
    - A description of RMG's approach to market definition
    - An assessment of market definition for packets and parcels products
    - An assessment of market definition for letters
    - Conclusions and implications for regulation

[3] 'Laying the Foundations for a Sustainable Postal Service' Postcomm (May 2010).

Royal Mail's approach to market definition

The hypothetical monopolist test

19. The established approach to both product and geographic market definition across most countries with mature competition law and regulatory regimes is the hypothetical monopolist test. This is more formally known as the SSNIP (small but significant non-transitory increase in price) test. RMG has therefore, in determining its position on market definitions, sought to assess the best currently available evidence through an application of the SSNIP test framework.

20. The underlying logic of the hypothetical monopolist test is that a set of products or services supplied in a particular geographic area constitute a relevant market if a hypothetical monopolist supplier of those products could profitably increase price. Conceptually, the test is applied iteratively, starting from the smallest set of products or services that one might reasonably expect to pass the test (i.e. constitute a market). Starting from a narrow group of products therefore, the test requires one to ask whether a monopoly supplier of those products could profitability increase price. If the answer is yes, then those products form the relevant market. If the answer is no, then this implies that suppliers of other products or services would impose sufficient competitive constraints such that those products might also be considered to be in the same relevant market – and so the market should be widened to include those products and the hypothetical monopolist test applied again. This iterative process is continued until a set of products or services is found that could be profitably monopolised.

21. In order to understand the net profitability impact of a SSNIP (price increase) it is necessary to analyse three factors:

a) The extent of any decline in product volumes sold due to customers switching to other products / geographic areas; or due to short-term switching of supply by rival firms.
b) Changes to the cost of production as volumes change.
c) The margins earned on the products in question.

22. The first of these three factors is, in essence, substitution and is a key area of focus for competition authorities and economic regulators when implementing the SSNIP test framework for the purpose of defining markets. In assessing substitution it is necessary to consider both the impact of:

- consumers ceasing to purchase the product after a price increase (demand side substitution); and
- suppliers currently supplying 'neighbouring' products or geographic areas switching to supply products that directly compete with those in the market (supply side substitution).

23. An assessment of demand and supply side substitution is therefore at the core of the SSNIP test. However, whilst the assessment of demand and supply side evidence allows one to form a view of the volume impact of a price change (SSNIP) it does not in of itself show whether a price increase is profitable or not. To do this, it is also necessary to understand profit margins and whether costs themselves vary as a result of the volume change (factors b and c above).

24. Whilst the principles of the SSNIP test are well established, in practice a direct empirical application of the test (in the sense of mathematically calculating the profitability impact of a hypothetical price increase) raises a number of challenges. This largely relates to whether it is practically possible to gather all the data required to directly apply the test such as:

    - sufficient sales and price data in order to accurately estimate the responsiveness of demand to changes in price (price elasticities);
    - robust data on product costs and on how those costs might vary with volumes; and
    - accurate margin measures by product.

25. Postcomm themselves acknowledged these issues in their May 2010 Consultation Document.[4] Due to these practical limitations, it is typical for competition authorities and economic regulators to apply the SSNIP test framework in a more conceptual way. This typically involves weighing up the relevant evidence on demand and supply side substitution in order to reach a view on whether a hypothetical price increase is likely to be profitable. This is reflective of the approach adopted by RMG in the present paper. Specifically, in setting out our view of market definitions for packets/parcels and letters, we have sought to collate and evaluate the best available evidence with reference to the SSNIP test framework. In other words, we have weighed up available evidence on potential demand and supply side factors in order to infer what the likely outcome of a SSNIP might be.

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4 See 'Laying the Foundations for a Sustainable Postal Service.' Postcomm May 2010, para 1.23, in which Postcomm stated: *"defining a market in strict accordance with the assumptions in the hypothetical monopolist test is rarely possible. For example, there is unlikely to be data relating to the extent of demand and supply side substitution following a small price rise by a hypothetical monopolist."*

Assessment of market definition for packets and parcels

26. In this section, we set out RMG's current views on market definitions for packets and parcels products. We have sought to structure this around a number of key issues, which we consider critical to the assessment of market definition. These issues are set out in the table below. In the following, we present the available evidence relevant to each issue and then assess that evidence with reference to the SSNIP test framework.

Table 3: Key market definition issues in packets and parcels

Key issue to be considered	Predominantly a demand or supply side issue?
Whether there are separate markets based on sender/receiver (B2B/B2C/C2B/C2C/Y2X)	Both supply and demand side
Whether there are separate markets for express and deferred	Both supply and demand side
Whether some combination of attributes give rise to separate premium/vanilla markets (tracking, speed of delivery, time certainty, compensation)	Both supply and demand side
Whether separate markets can be defined by weight	Supply side
Whether separate markets can be defined by posting volumes	Supply side
Whether separate markets can be defined by format (large letter/packet/parcel)	Supply side

Issue 1: Whether there are separate markets based on sender/receiver

Summary of Postcomm's and RMG's positions on sender / receiver

Postcomm's position	RMG's position
• B2X and C2X services are in separate markets. • C2X and Y2X are in the same market; however this may be an asymmetric market with Y2X providing a competitive constraint on C2X but not vice versa. • B2X is in a separate market from Y2X. • Distinctions between the B2B and B2C segments have become less relevant to an assessment of competition.	• B2X and C2X services are in separate markets. • C2X and Y2X are in the same market but the constraint is likely to be asymmetric (where Y2X constrains C2X but not vice versa). However, as the C2X market is, at present, relatively small, it may develop in a way that leads to it being in a separate market from Y2X. • B2X is in a separate market from Y2X. • Distinctions between the B2B and B2C segments are not relevant to an assessment of competition.

27. Here we consider whether the evidence suggests that markets could be defined based on the sender/receiver of packets and parcels. In terms of the way in which packets/parcels are sent, there are three distinctions:

- B2X: Items sent by business customers and collected from business premises
- C2X: Items sent by consumers and collected from consumer premises
- Y2X: Items dropped at a collection point such as a Post Office or pillar box

Assessment of B2X versus C2X

28. Firstly, considering the distinction between B2X and C2X, it is clear that on the demand side, substitution across these segments would be limited. This is because a single consumer seeking to have items collected from home cannot access services targeted at collection from business premises. Clearly, small businesses may sit at the margin of the B2X and C2X segments and would therefore, in some circumstances, be able to substitute between B2X and C2X services. However, the scope of such substitution is likely to be too limited for it to suggest that B2X and C2X should be in the same market.

29. On the supply side, the economics of providing B2X and C2X services differ in a number of ways. In the B2X segment operators are able to structure their services in a way that allows them to benefit from lower collection costs. There are two dimensions to this (i) that business customers will tend to be higher volume senders

than consumers; and (ii) that B2X operators can focus their offer around the location of business customers in order to drive collection density. These factors can mean that costs per collection are materially lower in the B2X segment relative to the C2X segment. Postcomm themselves have also noted this fact.[5]

30. In addition, when we examine how competition occurs within the packets and parcels space, it appears that firms tend to focus on the B2X segment rather than the C2X segment. For example, TNT's primary focus is B2X and they seem to price their C2X packets and parcels offers significantly higher than firms with a C2X focus. Specifically, based on C2X prices quoted on Collectmyparcel.com (a parcel price comparison and booking website) we found that for a UK mainland home collection and next day delivery of a single 1kg item, TNT would charge £23.95 compared to just £12.75 for DHL's Domestic @ Home service, a price difference of 88%.[6] This is consistent with a view that firms see the B2X and C2X segments as being separate and thus choose to focus primarily on one or the other.

31. We must now consider what this evidence suggests in terms of the likely outcome of a SSNIP test. Specifically we need to consider whether a 5%-10% price increase in the B2X segment would lead to sufficient substitution to the C2X segment to render that price increase unprofitable. In the round, the evidence suggests that this is unlikely. Demand side substitution would be extremely limited due to the fact that very few businesses would be able to access C2X type services and vice versa. On the supply side, the differential in collection costs between B2X and C2X services (coupled with evidence that shows that firms have tended to see these segments as separate) suggests that there would also be limited supply side substitution. In summary therefore, the evidence suggests that B2X and C2X services should be seen as separate markets.

Assessment of Y2X versus B2X and C2X

32. We next consider whether the Y2X segment should be considered to be a separate market from B2X (and C2X). The Y2X segment refers to all packets / parcels that are sent via a collection point, such as a Post Office or pillar box. Y2X services are typically used by individual customers and low volume businesses, who tend to have more limited choices for sending packets and parcels.

33. On the supply side, it is apparent that the provision of Y2X services is fundamentally different from the provision of B2X and C2X services. The Y2X service requires a large network of fixed collection points that allow customers to access the mail supply chain, whereas B2X/C2X requires firms to collect items from premises. As

5 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.81.

6 Prices quoted relate to 24 hour delivery services for a 1kg item with dimensions 20cm * 20cm * 20cm as reported on http://www.collectmyparcel.com as of August 3rd 2010.

noted in Postcomm's Consultation Document, Royal Mail has a large Y2X network consisting of 115,000 pillar boxes and 11,952 Post Offices.[7] Some other firms have also developed collection networks, albeit on a smaller scale. For example, DHL's Servicepoint network and HDN's collect+ service. In general we would expect that for a player in the B2X space to move into Y2X, there are likely to be significant investment costs. For example, as noted by Postcomm, it would appear prohibitively expensive for anyone to consider replicating Royal Mail's Y2X network. This perhaps explains why rival operators have sought to adopt more flexible models for entry into Y2X. For example, HDN's Y2X entry in 2009 via Collect+ was based on utilising existing Paypoint facilities.[8] Nonetheless, whilst these types of entry models into Y2X may mitigate the amount of investment required, the evidence would seem to indicate that moving from B2X into Y2X is not straightforward.

34. From a demand side, for large business customers, a collection point service would not be regarded as a substitute for collection from their premises. This is because, for a business customer with high volumes, it would be physically impractical (and costly) to take those items to a collection point. For smaller businesses however, it may be possible to substitute from B2X services to using collection points, although clearly there would be costs to doing so (such as travel time and/or time spent in Post Offices). In their May 2010 Consultation Document, Postcomm stated that the potential switching volumes associated with these smaller businesses would be too low to constrain the prices of B2X or Y2X services and that consequently, a price increase in Y2X services may still be a profitable strategy even if smaller businesses switch to B2X services.[9] RMG is not aware of any specific analysis that has sought to identify the size of marginal Y2X volumes that could potentially switch into B2X. Nonetheless, in the absence of such evidence, we are minded to agree with Postcomm that the competitive constraint imposed by these marginal customers is likely to be relatively small. This indicates that, on the demand side, B2X and Y2X should be considered to be in separate markets. With regard to C2X however, there could be demand side substitution to or from Y2X. This is because in some situations, consumers would regard collection point services as a valid alternative to collection from home and vice versa. Postcomm (in its Consultation Document) provided evidence of prices in the market between the Y2X and C2X segments. The regulator found that prices across these segments were sufficiently close to indicate that they could act as a competitive constraint (which perhaps could suggest that

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7 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.93.

8 See Paypoint press release: 'Collect+ Delivers for the UK Home Shopper.' (May 2009). http://www.paypoint.com/COLLECT%20DELIVERS%20FOR%20THE%20UK%20HOME%20SHOPPER.aspx

9 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.98.

Y2X and C2X were in the same market).[10] We have conducted our own analysis of price differentials between C2X and Y2X services in order to update the data presented by Postcomm. The results are shown in the table below.

Table 4: Price comparison of Y2X and C2X services

	1kg	2kg	5kg	10kg
Y2X services				
Royal Mail	£4.09	£7.34	£11.76	£15.50
DHL Service Points	£9.95	£11.95	£14.95	£16.95
Collect +	£4.49	£4.49	£4.49	£4.49
C2X services				
DHLitNow	£12.95	£14.95	£15.95	£17.95
MyHermes	£4.10	£4.10	£5.86	£6.99
Interlink Direct	£13.99	£13.99	£13.99	£13.99

Sources: All prices as published on company websites as of August 2nd 2010.[11]

35. The data shows that there is a reasonable degree of pricing overlap between the C2X and Y2X segments and that the degree of overlap increases at higher weights. This would tend to suggest that customers would be able to substitute between Y2X and C2X services based on price, depending on the weight of the item they were sending. This evidence therefore, could be seen as being consistent with Y2X and C2X services being in the same market. In the May 2010 Consultation Document, Postcomm suggested that the evidence indicated that the competitive constraints between the Y2X and C2X segments might be asymmetric. The regulator suggested that Y2X pricing appeared to constrain C2X pricing but that C2X pricing was unlikely to constrain Y2X pricing due to the small size of the C2X segment.[12] To explore this issue further, it would be necessary to examine data on customer switching between Y2X and C2X services. However, we are not aware of any existing data that could be used for this purpose.

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10 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' paras 2.98-2.103 and table 5: price comparison of Y2X and C2X products.

11 Royal Mail prices relate to 1st class recorded except for at 10kg where the Parcelforce Express 28 price is shown. DHL prices from: http://www.dhlservicepoint.co.uk/sizeprice.htm; Collect+ prices from http://www.collectplus.co.uk/send/; DHLit now prices from: https://www.dhlitnow.com/tws/; MyHermes prices from https://www.myhermes.co.uk/wps/portal/PN_CTR; and Interlink prices from: http://www.interlinkdirect.co.uk/

12 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' paras 2.102-2.103.

36. With reference to the SSNIP framework, we note that on the demand side, there is limited scope for substitution between B2X and Y2X services, with only smaller businesses potentially being able to switch. Therefore, it seems likely that a 5%-10% price increase in B2X services would not result in sufficient customer switching to Y2X to render that price increase unprofitable and vice versa. With regard to the distinction between Y2X and C2X on the demand side, the evidence is less clear cut. On balance, we would suggest that the evidence is currently consistent with Y2X and C2X being in the same market. However, we note that the C2X market is at present relatively small. Consequently, as the C2X segment grows and develops, it is possible that it will do so in a way that would lead to it being in a separate market from Y2X. It would therefore, be appropriate to reassess this issue as the C2X segment develops. On the supply side, the evidence suggests that there are material differences between the economics of providing B2X and Y2X services due to the need to have a network of collection points in order to provide Y2X services. This therefore, suggests that a price increase in Y2X of between 5% and 10% would not result in sufficient supply side switching of operators offering B2X services moving into Y2X to render that price increase unprofitable. In conclusion therefore, the evidence is consistent with there being separate markets for:

- Y2X/C2X (combined); and
- B2X.

Assessment of B2B versus B2C

37. Historically, there has been some precedent in defining markets on the basis of the receiver. Specifically, separate markets have been found for B2B and B2C. We therefore need to consider whether the evidence suggests that such a distinction remains relevant. On the supply side, operationally the provision of services to the B2B and B2C segments is largely the same for upstream activities; certainly for trunking and sortation. There may however, be differences in operational requirements in delivery for serving B2B as opposed to B2C. In particular, historically, B2C is likely to have had higher failed delivery rates and lower drop (delivery) densities than B2B, meaning that delivery costs could be somewhat higher for B2C. However, first time delivery rates to residential addresses are likely to have improved in recent years, due in part to the adoption of 'safeplace' drop facilities. For example, in 2008 23% of retailers allowed customers to add a special delivery instruction.[13] Furthermore, drop densities for B2C services are likely to have improved due to growth in e-commerce. As a consequence of these factors, it is reasonable to assume that the differences in the economics of delivery between B2B and B2C have been somewhat eroded (although we have not undertaken any analysis to assess this empirically). This is reflected by observed behaviour in the

13 Snow Valley Online Retail Delivery 2009 Report.

marketplace, where we have seen increased overlap in the provision of B2B and B2C services. In particular, as acknowledged by Postcomm,[14] traditional B2B operators are seeking to capitalise on the revenue growth potential in B2C by taking on B2C contracts (in part to offset lost B2B volumes). In addition, the purchase of DHL Express by HDNL has given the latter a B2B capability that it did not previously possess. On the demand side, RMG's commercial experience is that the needs of B2B and B2C customers have converged. Whilst historically, the B2B segment may have demanded faster and more premium services, RMG have observed that, over time, the needs of the B2C segment have evolved such that they require much the same product features as B2B customers. Consistent with the above views, we are aware that recently the OFT reported that DHL Express and HDNL (and other respondents to their investigation regarding the proposed acquisition of the former by the latter) were of the view that the B2B/B2C distinction was *"increasingly outdated."*[15]

38. In conclusion, RMGs view is that, on balance, the evidence seems to indicate that the distinctions between the B2B and B2C segments have diminished sufficiently for them to be considered to be in the same market. We acknowledge however, that there is limited empirical evidence available to directly test this. We also note that the question of whether B2B and B2C should be considered to be in separate markets is unlikely to materially affect an analysis of market power in the postal sector. Consequently this question has become less pertinent from an economic regulatory perspective.

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14 Section 7 – The Competitive Environment for Packets – Postcomm's Discussion Document (Sept 2009).

15 "In particular, the parties' view is that the distinction between B2B and B2C delivery services is increasingly outdated: they submit that the volume of B2B activity has been significantly eroded and that B2B carriers have responded to the resulting overcapacity by aggressively seeking volume in the B2C market. In this context, the merging parties submit that when legacy B2B carriers have become active in B2C, they have tended to provide premium services, consistent with the value-added types of services they have historically provided to B2B customers. In conjunction with this, B2C customers (particularly those in e-commerce) are increasingly demanding a higher level of service. As a result, according to the parties, B2B legacy carriers have been able to capture significant B2C volumes. Third party comments provided in response to the OFT's investigation corroborate this." (paragraphs 13 and 14, Anticipated acquisition by Home Delivery Network Limited of DHL Express (UK) Limited's UK domestic 'business to business' and 'business to consumer' packet and parcel delivery service – Published by the OFT on 25th February 2010).

Issue 2: Whether there are separate markets for express and deferred

Summary of Postcomm's and RMG's positions on express and deferred

Postcomm's position	RMG's position
• That the B2X market can be split into Express (same day or next day guaranteed services) and deferred (non-guaranteed next day and later services) markets. • Further segmentation of the express market is not necessary because it would not substantially affect an analysis of market power.	• That the B2X market can be split into Express (same day or next day guaranteed services) and deferred (non-guaranteed next day and later services) markets. • Further segmentation of the express market is not necessary; because the express market is already effectively competitive.

39. From a demand side, the rationale for defining markets on the grounds of express and deferred is that speed of delivery and time certainty are important factors in customer purchasing decisions. If a customer has a need to ensure that a packet or parcel arrives within a certain timescale then their choice of products would seem to be limited to those that meet this need. Intuitively therefore, one would imagine that customers purchasing express products (say with a time guarantee) would not be willing to substitute to non-express products as these would fundamentally not meet their requirements. Further, mail customers (and in particular larger retailers) often have a wide variety of mailing needs, driven by the underlying preferences of their end customers. The more varied these end customer preferences are, the more need there would be for the firm to offer a range of delivery options. For such mailers, therefore, express services would never be a substitute for deferred delivery options because of the need to offer a wide range of choice to their end customers. Further, such mailers are likely to make separate purchasing decisions for the different types of delivery services, based on the carrier that can give them the cheapest price. Below we examine the evidence that is relevant to an assessment of demand side substitution between express and deferred products.

Demand side: evidence of customer preferences

40. Firstly, on the demand side, there is evidence that shows that customers value a number of attributes (relevant to an express market definition) as being particularly important to their purchase decisions. The following chart shows some relevant results from qualitative research undertaken by Breathe Research Ltd on behalf of RMG. The purpose of this was to help RMG identify the needs and requirements of particular customer segments. The approach taken by Breathe Research was to conduct qualitative interviews with 45 Royal Mail customers, selected on the basis of them having certain characteristics regarded by Royal Mail as being potentially

important from a customer segmentation perspective.[16] Within these interviews, customers were specifically asked to identify up to 10 attributes as being of "importance" and then to rank those attributes on a scale of 1-10 (with 1 being the most important).[17]

41. In the figure below we have summarised responses to this in two ways: (i) by showing an index (out of 100%) that combines both the average rank awarded by each attribute and the number of responses in which that attribute was ranked (i.e. was considered to be in the top 10); and (ii) just the average rank out of 10 that the attribute received regardless of how many respondents included it in their top 10 (which we have re-based as a score out of 100%). The summary chart shows only the 10 highest scoring attributes on these two measures, although the survey included over 40 attributes.

Figure 3 Product attribute rankings

[✂]

42. The analysis shows that the types of attributes that one might typically regard as forming an 'express' product offer (i.e. speed, reliability of delivery, proof of delivery and time guarantees) are all regarded as important by customers. A number of these attributes are ranked above the need to get a competitive price. This then is consistent with a view that customers first identify products that meet their particular needs and then subsequently review which of those products offers the best price. In summary therefore, on the demand side, this data is consistent with there being a separate express market, defined on the basis of speed and other attributes, such as: reliability, proof of delivery and potentially guaranteed time of delivery. Interestingly however, the data suggests that certain value added attributes – and in particular tracking – are at least as important as speed or time guarantees to customers.[18] This could be viewed as being consistent with customers making purchase decisions around the need to have certain value added features. This in turn, might suggest that there could be separate premium and vanilla product markets. This question is discussed in more detail subsequently.

43. Also of relevance is some analysis undertaken by Accent on behalf of Royal Mail in 2010. The purpose of this was to help inform an internal project [✂]. Royal Mail wants to ensure that its future range of products sold through retail channels (Post

16 [✂] of which were face-to-face in the workplace and [✂] of which were conducted by telephone.

17 Question asked: Q8 *"Please prioritise your top ten considerations [for making purchase decisions]. Write number one next to your top choice, then 2 for your second, for as many factors up to ten that are important to you."* We understand that [✂] respondents answered this question.

18 In fact 'tracking' is rated as being more important than speed. However, due to the small sample size, we consider that it might be inappropriate to definitively conclude that tracking is more important than speed (or other similarly rated attributes).

Office) are better able to meet the needs and desires of customers. Consequently, research was commissioned in order to help inform us as to what product features mattered most to customers. The research had a number of elements to it, one of which one was a quantitative survey focusing on a number of important contextual questions. This survey consisted of a series of interviews, conducted by Accent, with Post Office customers:

- 562 interview with consumers (a mixture of online and telephone);
- 505 interviews with eBay sellers (online); and
- 504 telephone interviews with SMEs (telephone).

44. Because the survey was focused on Post Office customers, the results are, strictly speaking, likely to be of most relevance to the Y2X market. Nonetheless, we would suggest that it is reasonable to suppose that the types of product attribute preferences expressed by Post Office customers do allow us to make more general inferences about preferences in B2X. Of particular relevance to the question of whether there is a separate express market is a question Accent asked of Special Delivery customers. Specifically, Accent asked: *"I am going to read out some of the features of SD and I'd like you to say how important that feature is when you decide to use the service."* Figure 4 below summarises the responses by the base of Special Delivery customers.[19]

Figure 4 Features of Special Delivery valued by customers

[✂]

45. The results are broadly consistent with those from the Breathe research in that they suggest that in fact, there are a range of attributes that customers in the express market consider to be important. The results suggest that Special Delivery customers particularly value security and proof of posting in addition to the time guarantee. Interestingly, the results show that, whilst tracking is important to Special Delivery customers, it is notably less important than some of the other 'express' type features. From a commercial perspective, this distinction is important to Royal Mail because the company's aspirations for the RM Tracked product require it to not substantially cannibalise sales from Special Delivery. Consequently, the fact that customers especially value the secure and time guaranteed features of Special Delivery, would suggest that Special Delivery customers are not likely to regard RM Tracked as a close substitute. In other words, this evidence is consistent with RM Tracked not being in the express market. However, as discussed subsequently, the importance of tracking as a product feature might suggest that there is a separate

19 The sample base for this question was all customers who have used Special Delivery when posting parcels, packets or urgent letters [✂].

premium market within deferred packets and parcels (in which RM Tracked would sit).

Demand side: evidence of price differentials between express and deferred

46. In Postcomm's May 2010 Consultation Document, the regulator set out evidence on price differentials between express and deferred products as offered by online retailers to consumers.[20] The data presented by Postcomm suggested that these differentials were between 30% and 150%. This is highly consistent with express and deferred products being in separate markets as, given the size of the price differentials, it is unlikely that end consumers would regard them as being substitutable in response to a 5% to 10% change in price. Further, Postcomm found evidence of two firms (Supaperfume.com and Amazon.co.uk) offering some deferred delivery services for free. In these cases, it seems highly unlikely that the end customers making use of these free services would regard the higher priced express products as being substitutes. Across RMG there are material price differentials between our express and deferred product offers. This further suggests that they could be considered to be in separate markets. Figure 5 (following) compares average unit revenues (AURs) per item for Packetpost/sort,[21] RM Tracked and Special Delivery 1pm (the latter of which we would consider to be an example of an express product). The data presented indicates that (consistent with Postcomm's findings) there are material price differentials between the products. [✂].

Figure 5 Packetpost/sort, RM Tracked and Special Delivery AURs

[✂]

47. Given the size of the price differentials between express and deferred product offers, it seems unlikely that customers would be willing to substitute between them (to any significant degree) in response to a relative change in price of just 5% to 10%; i.e. under the SSNIP test framework this data is consistent with there being separate express and deferred markets on the demand side.

Supply side: differences between express and deferred services

48. From a supply side, the logic for finding separate markets for express and deferred products is that the operational requirements of providing both types of products differ in a number of important ways. Firstly, same day services are typically characterised by courier operators, who collect packets and parcels from a customer's premises and then transport those items directly, without any sortation or hub interface, to the receiver's premises. This is usually done by means of bike,

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20 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.142 and table below 'box 2'.

21 Both 1c and 2c of Packetpost and Packetsort are included.

car or van and is commonly referred to as a point-to-point service. This type of operation is very different from the hub and spoke distribution model, which is commonly used to supply next day express services or deferred services. Certainly substituting from the supply of services via a point-to-point operation to one requiring a hub and spoke operation could entail significant investment. It is therefore unlikely that there would be any supply side substitution between these segments.

49. In addition to the distinctions between same day and non-same day, there are generally a number of operational differences between express and deferred services. For example, Royal Mail's Special Delivery products have different operational processes from its deferred products:

- sortation of Special Delivery items takes place in separate secure areas;
- delivery is typically on a van; and
- collection of Special Delivery items is only through firms' collections or at Post Offices.

50. It is not straightforward to determine whether Royal Mail's 1st class products should be classified as being in the express or deferred markets and this uncertainty was acknowledged by Postcomm.[22] The positioning of 1st class depends very much on what features one considers most relevant to the delineation of express and deferred markets. The available evidence seems to suggest that, on the demand side, it is in fact a combination of speed and certainty (and possibly other attributes); that drive customer purchasing decisions. Whist 1st class has the speed attribute, it does not come with a time guarantee, but rather has a quality of service target of 93% for next day delivery. Similarly 1st class not have the security or proof of posting attributes of Special Delivery, which could be regarded as an important value added features. RMG's current view is that, on balance, the evidence would seem to indicate that 1st class does not have an appropriate range of attributes for it to be considered particularly substitutable for express products on the demand side. Consequently, we suggest that 1st class should not be regarded as being in the express market, but rather, should sit in the deferred market.[23]

Conclusions

51. In conclusion, on the demand side, the evidence suggests that there would be limited substitution between express and deferred services in response to a 5% to 10% change in the price of either. This is because attributes such as: speed of

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22 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' Box 1, page 42 and para 2.150, page 47.

23 We subsequently discuss whether the deferred market can be split into premium and vanilla. It is our view that 1st class is a deferred vanilla service.

delivery, time certainty and security are key factors in determining customer purchasing decisions and consequently, customers can only substitute between products that meet their particular requirements in these dimensions. This view is supported by the size of price differentials between express and deferred services. Similarly, on the supply side, speed, security and time certainty can drive operational requirements and thus result in different network configurations across the express and deferred segments. This is likely to limit the extent to which operators can substitute between the provision of express and deferred services. Consequently, taking into account both the demand and supply side factors with reference to a SSNIP test, it seems unlikely that a 5%-10% price increase in express or deferred products would lead to sufficient switching between those services to render the price increase unprofitable. Therefore, RMG concludes that there are currently separate express and deferred markets.

Issue 3: Whether there might be separate premium/vanilla markets

Summary of Postcomm's and RMG's positions on premium/vanilla

Postcomm's position	RMG's position
• That it is not necessary to define markets in terms of premium or vanilla services. • However, the supply side evidence points to the existence of separate markets for premium and vanilla services. • On the demand side, the market is asymmetric, where vanilla services (as provided by Royal Mail) are constrained by premium services. • On the demand side, although there may be some limited substitution between vanilla and premium services based on price at the upper end of the weight band (near 1kg), for the majority of customers the decision to use a premium service is based on broader considerations than price alone.	• Supply side evidence is consistent with premium and vanilla services being in separate markets. • On the demand side, the market is asymmetric; and premium services constrain vanilla services but not vice versa. • Above 750g, the extent of the constraint on vanilla services by premium services is sufficient for them to be in the same market. • At weights below 500g, the competitive constraint placed on vanilla services by premium services is insufficient for them to be in the same market; thus there are separate premium and vanilla markets below this weight. • At weights of between 500g and 750g, the extent of the competitive constraint placed on vanilla services by premium services may depend on other factors – and specifically posting volumes. We examine this issue in subsequent sections.

52. Both demand and supply side considerations are relevant to the question of whether there might be separate vanilla and premium markets for packets and parcels. On the demand side, it depends on whether customers sufficiently value certain features or attributes (which collectively might be taken to define a 'premium' product offer) when making purchasing decisions. The rationale for separate markets would thus be that, customers requiring premium product attributes would not be willing to substitute to vanilla product offerings in response to a 5%-10% increase in the price of the premium product. On the supply side, it depends on whether the provision of certain value added attributes drives operational differences for firms supplying those services. Further, we would expect that any distinction between premium and vanilla services is most likely to be relevant to

deferred rather than express services. This is in part because express products often include value added (premium) features, such as tracking.[24]

53. RMG's commercial experience is that the premium/vanilla distinction is important to customers. In particular, RMG believes that the presence or absence of tracking is a critical factor in a customer's purchase decision. This view is consistent with the data presented previously from Breathe Research (see *'Issue 2: whether there are separate markets for express and deferred'*). This showed that the attributes of 'tracking' and 'proof of delivery' were in fact some of the most important attributes to customers. From a demand side perspective therefore, the importance of tracking to customers might indicate that they are unlikely to be willing to substitute from tracked to untracked products.

54. When one considers the potential demand side constraints between premium and vanilla products, it seems logical to suppose that the constraint would be asymmetric. This is because, for a consumer currently purchasing a vanilla product, it would be rational for them to switch to a premium tracked product once the price differential between them was sufficiently small. However, starting from a customer currently using a premium (tracked) product, the opposite would not appear to be true. This is because if a customer *requires* a tracking capability, they would not be willing to substitute to an untracked product. Consequently, RMG's view is that we would expect premium products to impose a pricing constraint on vanilla products, but not vice versa. On the demand side therefore, the issue is how strong the pricing constraint from deferred premium to deferred vanilla products might be; and whether that constraint is sufficient for them to be in the same market.

Demand side: evidence of price differentials between premium and vanilla services

55. To consider this issue, it is appropriate to examine the price differentials between Royal Mail's Packetpost/sort[25] (vanilla) and Tracked (premium) products (as shown in Figure 6 below). This is because the size of the price differentials can inform us as to whether, and in what circumstances, premium products might pose a sufficient competitive constraint on vanilla products for them to be considered to be in the same market.

Figure 6 Packetpost/sort and RM Tracked AURs

[✂]

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24 Furthermore, RMG does not believe that, within an express market, a distinction between premium and non-premium services would necessarily be relevant to an assessment of competitive conditions.

25 Both 1c and 2c Packetpost and Packetsort products are included.

56. The above data shows that the price differentials between the premium (RM Tracked) and vanilla (Packetpost/sort) products differ considerably by weight step. Specifically, we find that at low weights there are quite substantial price differentials (for example, up to 500g the price differential varies from between [✂] to [✂]). However, at higher weights, the differentials are much smaller (for example, at 500g-750g the differential is [✂] and by 750g it has almost disappeared completely).[26]

57. With regard to the asymmetric constraint discussed above therefore, we would suggest that this data is consistent with deferred premium and deferred vanilla products being in the same market at weights above 750g (as above this weight, there is little price differential between the products). However, at lower weights (particularly below 500g) the differentials appear to be sufficiently large to suggest that premium and vanilla products could be considered to be in separate markets.

58. Intuitively, one might also expect that demand for deferred premium services will increase at higher weights because (i) generally higher weight items are likely to be of higher value and therefore customers are more likely to want tracking; and (ii) relative to the price of postage, the additional cost of a premium product is proportionately smaller at higher weights. These factors further explain why the asymmetric demand side constraint placed on vanilla services by premium services is likely to be greater at higher weights.

59. The difference in the shape of the Tracked and Packetpost/sort pricing lines is also likely to reflect (to some degree) supply side differences between these products. Our RM Tracked product (the premium product) is delivered by van, whereas our vanilla products are typically delivered on foot up to a certain size or weight, at which point they are also van delivered. One would therefore, naturally expect the Tracked product to have a flatter cost and price profile by weight relative to the Packetpost/sort products. This is discussed further below under our assessment of supply side issues.

Demand side: evidence of switching and customer choice for vanilla and premium services

60. In 2010, Royal Mail commissioned Accent Marketing Research to undertake an independent switching survey of packets and parcels customers using deferred products. The main purpose of this was to help RMG improve its understanding of the extent of competition in the deferred market. Details of this research and its key findings are set out subsequently in the sections titled: *'Issue 4: whether separate markets can be defined by weight'*; and *'Issue 5: whether separate markets can be defined by positing volumes'*. Some of the findings of this research are particularly

26 Specifically in the 750g to 1kg weight band the price differential is just [✂].

relevant to a consideration of the asymmetric constraint placed on deferred vanilla products by deferred premium products. In particular, we note the following:

- The evidence is highly consistent with there being a break in competitive conditions for deferred services at 750g, where the data shows:
  - A marked increase in the number of customers using alternative carriers in addition to Royal Mail (above 750g over half of customers use alternative carriers).
  - Customer switching away from Royal Mail is more prevalent above 750g
  - There is a clear increase in perceived customer choice above 750g.[27]
- RMG understands that our rivals do not generally offer deferred vanilla (untracked) services. Consequently, the Accent Research evidence, which shows a break in competitive conditions for our deferred services at 750g, indicates that our deferred vanilla services are competitively constrained by deferred premium services above 750g (i.e. we would conclude that they are in the same market above this weight).
- Conversely, we would suggest that at lower weights (below 500g), the Accent Research results are consistent with the competitive constraint placed on deferred vanilla services by deferred premium services being less strong (i.e. on the demand side, below 500g, we would conclude that premium and vanilla services are currently in separate markets).
- However, with regard to weights of between 500g to 750g, the Accent evidence is less clear. There is therefore, some uncertainty as to whether, in this segment, deferred vanilla services are sufficiently constrained by deferred premium services for them to be in the same market. In this space therefore, we consider that other factors, and in particular posting volumes, may be relevant to determining the extent of competitive constraints.

Demand side: evidence of distribution of Tracked volumes by weight

61. We have also examined the distribution of RM Tracked volumes by weight. Figure 7 shows this for 2009/10. The split shows that [✂] of the volumes are between 0kg and 1kg. With reference to the price differential evidence presented above, it would more appropriate to look at the distribution up to 750g. However, our data does not at present allow us to do this (i.e. we do not have volume data at a more granular level than 0-1kg with respect to Tracked). Nonetheless, the distribution shows that at lower weights (which we would suggest are below 750g) where the cheaper Packetpost product is available, some customers are willing to pay the premium for RM Tracked. Intuitively, if a SSNIP test were conducted on such mailers (i.e. if the price of Tracked were increased by 5%-10% at low weights) it seems unlikely that they would consider switching to the vanilla product, as they could already switch

27 See subsequent sections for full details of data and analysis to substantiate the above points.

today and save more than 5%-10%. This is also consistent with a view that the demand side constraints between premium and vanilla services are asymmetric.

Figure 7 RM Tracked volumes by weight

[✂]

Supply side: evidence of operational differences between premium and vanilla services

62. RMG has noted that Postcomm themselves have left open the possibility of there being separate markets for premium and vanilla products. Indeed on the supply side, Postcomm found that there are important differences in how premium and vanilla products are processed. For example, for Royal Mail, Tracked items are handled and processed separately from standard parcels products due to the requirement to scan at different parts of the network. Postcomm reported that rival firms had specifically developed their networks to provide premium services and it would be difficult and costly for them to also offer vanilla services. Importantly, Postcomm specifically stated that: *"E2E operators have told us that the price charged by Royal Mail for vanilla services is below the cost of their services; they are therefore unable to compete with a vanilla service on price… Indeed several e2e operators commented that they did not consider they competed against a vanilla service."*[28] Thus, Postcomm themselves concluded that, on the supply side, the evidence suggested that there were separate markets for premium and vanilla services.[29]

63. As noted above in our comparison of pricing lines between deferred premium and deferred vanilla products, delivery methods are also a key supply side factor. RMG's Tracked product is van delivered and we understand that our rival's deferred premium products are also typically van delivered. To some degree, this is likely to explain why both our and rival's pricing lines for deferred premium services are flat, or relatively flat with weight (as van delivery is likely to result in flatter cost lines by weight). Indeed, we note from the Consultation Document that rival E2E parcel operators have told Postcomm that they do not typically price on weight break points.[30] With regard to deferred premium services therefore, this would imply that weight is not relevant to an assessment of competitive conditions. However, RMG's deferred vanilla services are typically delivered on foot up until a certain size or weight, at which point they are delivered on van.[31] This is likely to lead to cost – and

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28 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.243.

29 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.248.

30 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.171.

31 Although RMG does not implement a specific volumetric or weight cut off.

therefore pricing – lines that increase more directly with weight or size relative to deferred premium products. Intuitively therefore, this supply side difference in part is likely to explain why the asymmetric constraint placed on deferred vanilla services by deferred premium services will differ by weight. At very low weights, the existing supply side differences are likely to result in large price differentials between deferred premium and deferred vanilla services. Thus relatively small price increases in deferred vanilla services at these weights are unlikely to lead to material switching into deferred premium services. At higher weights, the price differentials are likely to be smaller and thus small increases in the price of deferred vanilla services could lead to significant switching into deferred premium services.

Conclusions

64. At present, on the demand side the evidence is consistent with there being an asymmetric constraint between deferred premium and deferred vanilla services (premium products constrain vanilla products, but not vice versa). The evidence also shows that the extent of this asymmetric constraint varies by weight. In particular, we find that above 750g deferred vanilla services are sufficiently constrained by deferred premium services that we would consider them to be in the same market. This view is supported by (i) evidence on customer switching and choice, which shows a clear break in competitive conditions at 750g, consistent with our vanilla services being competitively constrained by premium services above this weight; and (ii) price differential analysis, which shows that at low weights there are material differences in price between premium and vanilla services (but at 750g, the differences are immaterial).

65. At weights below 750g, the evidence indicates that the competitive constraint placed on vanilla services by premium services is less strong, which could indicate that there are separate deferred premium and deferred vanilla markets. In particular, evidence demonstrating how competition varies with weight (see detailed evidence set out subsequently in: *'Issue 4: Whether separate markets can be defined by weight.'*) indicates that at weights below 500g, the asymmetric constraint is sufficiently low to conclude that there are separate deferred vanilla and deferred premium markets. This demand side evidence is consistent with important supply side differences between premium and vanilla services (such as the means of delivery, as described previously).

66. At weights of between 500g and 750g, the evidence suggests that deferred premium services may still place a sufficient competitive constraint on deferred vanilla services for them to be in the same market. However, RMG believes that this depends on number of other factors, which are examined subsequently. (See: '*Issue 4: Whether separate markets can be defined by weight*'; and *'Issue 5: Whether separate markets can be defined by posting volumes'*).

67. With reference to the SSNIP test therefore, we consider that at weights above 750g, it would not be possible to increase deferred vanilla prices by 5% to 10% without there being sufficient switching into deferred premium services to render that price increase unprofitable. Thus we conclude that above 750g, there is a single deferred market consisting of both premium and vanilla services (and this market is effectively competitive). At lower weights (below 500g) however, the asymmetric constraint placed on deferred vanilla services by deferred premium services is less strong, which would indicate that it would be possible to profitably increase the price of deferred vanilla products by 5% to 10%. This would be consistent with there being separate deferred premium and deferred vanilla markets below 500g. For weights of between 500g and 750g, the evidence is less clear (and we believe that other factors, such as posting volumes, may be relevant to competition). This is explored in more detail subsequently.

68. RMG also notes that we operate in dynamic markets in which competitive conditions evolve rapidly. Therefore, the weight point at which deferred premium services impose a strong competitive constraint on deferred vanilla services may move over time. The issue of whether and how markets can be defined by weight is examined in the next section.

Issue 4: Whether separate markets can be defined by weight

Summary of Postcomm's and RMG's positions on weight

Postcomm's position	RMG's position
• Initial conclusion is that there are separate markets for heavy and light PPS items, but that the boundary between these markets is difficult to determine in the absence of consideration of contract volume. • There are separate markets based on weight: Deferred Light (below 1kg); Deferred light/heavy (1kg-2kg); and Deferred Heavy (above 2 kg). • Volume is relevant to determining competitive choice between 1kg and 2kg.	• Weight is not relevant to market definition for express or deferred premium services. These services face effective competition at all weights. • The asymmetric constraint placed on deferred vanilla services by deferred premium services (which is greater at higher weights) means that there is a separate deferred high weight market for items above 750g, consisting of both premium and vanilla services. This market is effectively competitive. • There is a separate low weight market for deferred vanilla services below 500g. RMG accepts that effective competition has not yet developed in this market. • With regard to item weights of between 500g and 750g for deferred vanilla services, there is evidence of material competition; and posting volumes may be relevant to determining competitive choice.

69. Across the supply chain for packets and parcels, weight affects operational activities to some degree and therefore, is likely to drive costs. For example, light weight items are easier to deliver on foot (rather than by van) and are more likely to fit through a letter box than higher weight items (although clearly the correlation is not perfect).

70. At present, Royal Mail's costs, as derived from our costing system, are allocated in part by weight. This results in Royal Mail having cost lines that increase with weight. In turn, this translates to pricing lines that increase with weight. We are aware that our rivals tend to offer prices that are flat, or broadly flat, with weight; and that consequently, Royal Mail's prices at low weights (for deferred vanilla services) can be below those of our rivals. We note that in the May 2010 Consultation Document, Postcomm stated that rival operators had informed the regulator that they could not

profitably deliver low weight (vanilla) items using their PPS networks.[32] Postcomm specifically stated that: *"we have examined e2e operators' costs and understand that they are generally unable to compete with Royal Mail for products which weigh less than 1kg. The operational costs mean that it would be unprofitable for them to offer contracts at prices below the [Royal Mail] 1kg price."*[33] From a supply side perspective therefore, there is a clear rationale to support the view that there may be separate markets by weight for deferred vanilla packets and parcels. For express and deferred premium services however, we would expect weight to be less relevant, as the value add services support higher margins, which improves the economics of delivery, making the service commercially viable. In addition, the fact that the delivery component of express and deferred premium services is typically undertaken by van means that weight is less likely to drive costs. Consequently, RMG currently believes that weight is only likely to be relevant to market definition for deferred vanilla services.

Market shares by weight for deferred services

71. The supply side rationale also appears to be consistent with existing evidence of how competition has evolved in the market. In particular, there is evidence that shows that Royal Mail's market share differs quite markedly by weight. This evidence is based on a survey commissioned by Royal Mail in 2009, whereby we asked an independent market research company (Continental Research) to survey 1,000 packets and parcels customers. The objective was to gather information on key fulfilment spend metrics (e.g. total spend, RM share of wallet) for a representative sample of the total UK business universe in order to be able to use this insight to identify targets for Royal Mail Letters from a database of UK businesses.[34] From this survey, it is possible to estimate revenue market shares for Royal Mail by size of customer as measured by annual spend and, separately, at different weight steps for different combinations of products. The results can be shown for a number of product combinations:

- **All services** - this includes data from all customers and all the products/services in the survey
- **Standard >0%** - this includes data from all customers which said that they used the following services for some proportion of their items: Next Day non-guaranteed, 2 day+ delivery and 5 day+ delivery

32 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.164.

33 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.192

34 Before using this dataset to estimate market shares, we have sought to clean the data e.g. remove "don't know".

- **LTND >0%** - this includes data from customers which said they used Later Than Next Day (LTND) services for some proportion of their items. LTND services are defined as the following services: 2 day+ delivery and 5 day+ delivery

- **Standard 100%** - this includes data from customers which said that they only used the services defined as standard above for 100% of their deliveries

- **LTND 100%** - this includes data from customers which said that they only used LTND services for 100% of their deliveries.

72. Figure 8, which summarises the survey results, shows Royal Mail's revenue market shares for different weight steps for All Services, Standard and later than next day (LTND) services. The results are consistent with a view that there is a break in competitive conditions at around 750g, as Royal Mail's market share drops at this weight point. The drop is particularly pronounced for LTND services, and it is also noticeable for Standard services and All Services combined.[35] The fact that the drop in market shares is greater for LTND services is consistent with a view that weight is more relevant to competition within a deferred market.

Figure 8 RM market shares by weight

[✂]

73. The above shares could be seen as being consistent with customers managing their mailings around weight and choosing to send low weight items with Royal Mail, where they are cheapest. Indeed, Postcomm provided evidence that customers consider weight to be an important factor in their purchasing decisions and that they actively manage the average weight of items sent through Royal Mail in order to benefit from their lower prices at low weight points.[36] This may also be consistent with customers choosing to multi-source their contracts, splitting them out by weight. Under this approach, customers may choose to separate out their low weight items and put them with Royal Mail (if it is cheaper) whilst using other carriers to deliver higher weight items. This issue is discussed subsequently in the assessment of whether markets can be defined based on posting volumes.

35 While these results are intuitive results, the low Royal Mail market share observed in the 0-100g weight band is not what we would have expected. When we excluded 'Documents and Tickets' from this weight band we observed a significant increase in Royal Mail's market share. Hence this appears to be a factor in causing the low market shares for 0-100g.

36 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.175.

Demand side: evidence of customer switching and choice by weight

74. In 2010, Royal Mail commissioned Accent Marketing Research (Accent) to undertake a switching survey of packets and parcels customers using deferred products (this was referred to previously in our discussion of whether there might be separate premium and vanilla markets). The overarching objective of this was to help RMG improve its understanding of the extent of competition in the deferred market for senders of over 30,000 items pa. Further, the research was designed to help RMG understand whether the extent of competition (and in particular, the amount of demand side substitution options customers have) varies in dimensions such as weight and posting volume, which we might expect to be relevant to competition.

75. To be in scope for the research, respondent companies had to send at least 30,000 packets or parcels by 'a non-guaranteed service' (in other words a service which doesn't guarantee delivery by a certain day or time, but could include added value services such as tracking) using either Royal Mail or another carrier. We note that the evidence set out previously indicates that there are separate express and deferred markets, under which time guarantee could be a key distinguishing factor. Consequently, given this definition, the results of the Accent analysis are of relevance to the deferred market. Further, of the respondents in the sample that make use of RMG's deferred products, the majority use our vanilla products (Packetpost and Packetsort).[37] Consequently, the results from the Accent Research provide insights into the extent to which our deferred vanilla services are competitively constrained. As RMG understands that our rivals do not generally provide deferred vanilla (untracked) services, the results specifically allow us to assess the extent to which rival (deferred premium) services compete with our deferred vanilla services. This is particularly relevant to considering the potential asymmetric constraint placed on deferred vanilla services by deferred premium services as discussed in the previous section of this paper (see: *'Issue 3: Whether there might be separate premium/vanilla markets'*).

76. The key elements to Accent's methodology are as follows:

- A sample of potential respondents was provided by Royal Mail; this included both known users of packet services and also companies believed to be packet and parcel users, but without spend on Royal Mail packet and parcel products.
- The approach taken was a semi structured interview, which included a number of open-ended questions. A target was set of 70 interviews; 103 interviews were achieved. 92 interviews were conducted by phone with a further 11

37 For example, respondents were asked: "Which of these particular Royal Mail services do you use for sending packets and parcels?" In response to this, 84% stated Packetpost/Packetsort, the deferred vanilla products.

interviews conducted face to face. Fieldwork took place between the 14th July and the 4th August 2010.[38]

- Respondents were given an incentive of £20 to take part in the telephone interview, £40 to take part in the face-to-face interview, with the additional incentive for all respondents of entry in a prize draw to win an iPad.

77. As the Accent study specifically asked respondents to state the "typical weight" of the items they send out, it is possible for us to review customer responses by weight. This then allows us to examine whether customers have more or less choice in the market depending on the weight of items they are sending. Importantly, with regard to all of the questions in the survey summarised in the following passages, it should be noted that customers were asked to respond with regard to non-guaranteed services (i.e. deferred) only. Note that of the 103 respondents included in the survey, 82 were able to classify their typical weight. Therefore, the base size for the following data is 82 unless stated otherwise.

78. Using the Accent data, we have examined how responses varied by weight for a number of key questions. Figure 9 shows the proportion of respondents that use both Royal Mail and other carriers to supply their deferred parcels/packets requirements [the residual being customers that either (i) only use Royal Mail; (ii) only use other carriers; or (iii) didn't know]. This shows that, at weights above 750g, there is a sharp increase in the percentage of customers that use other carriers in addition to Royal Mail. Specifically, 58% of all respondents with a typical weight of 750g-1kg used other carriers and Royal Mail to meet their deferred product needs. The proportion of respondents using other carriers in addition to Royal Mail is much lower at weights below 750g. This of course is consistent with the Continental market share data set out previously, which showed a marked reduction in Royal Mail's market share for LTND services for weights above 750g[39]

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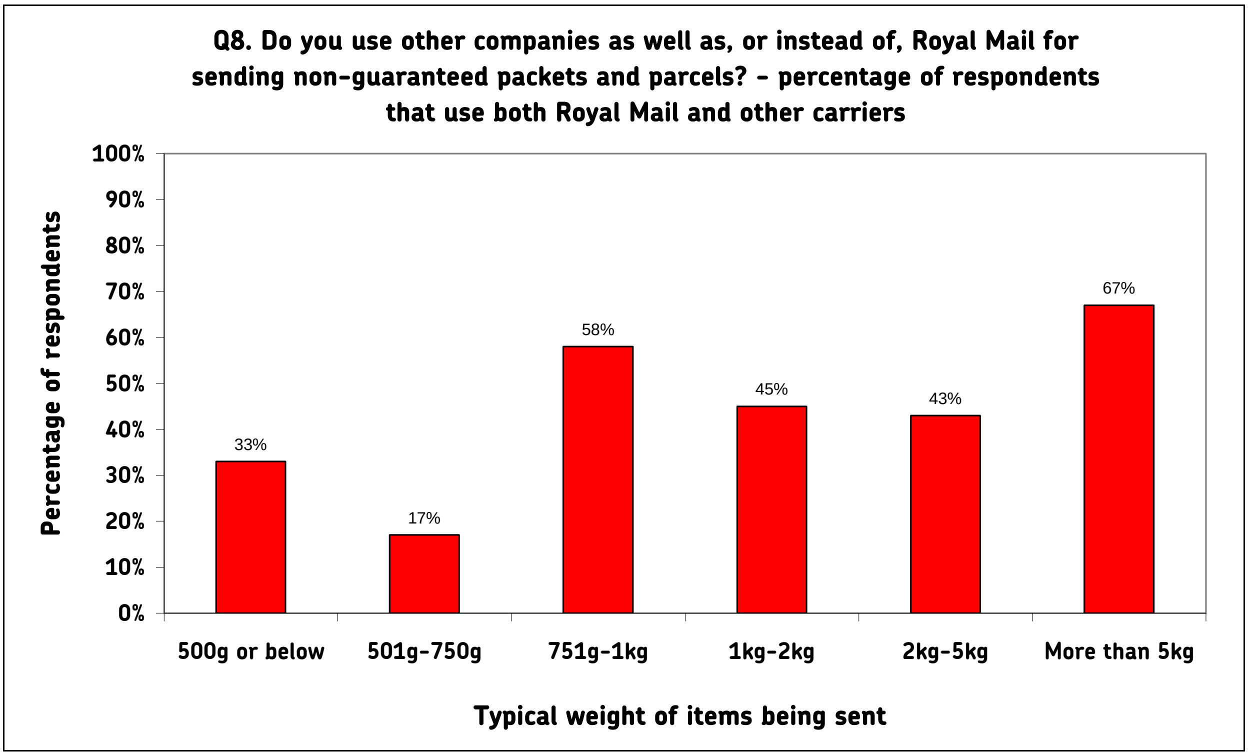
38 This therefore means that the overall sample base size for the data is 103.

39 Note that the responses to Q8 of the Accent survey (shown in the chart) cannot themselves be used to draw inferences about Royal Mail's market share. This is because they show the proportion of customers that use Royal Mail / other carriers rather than a percentage share of revenues or volumes.

Figure 9 Percentage of respondents that use both Royal Mail and other carriers – by weight

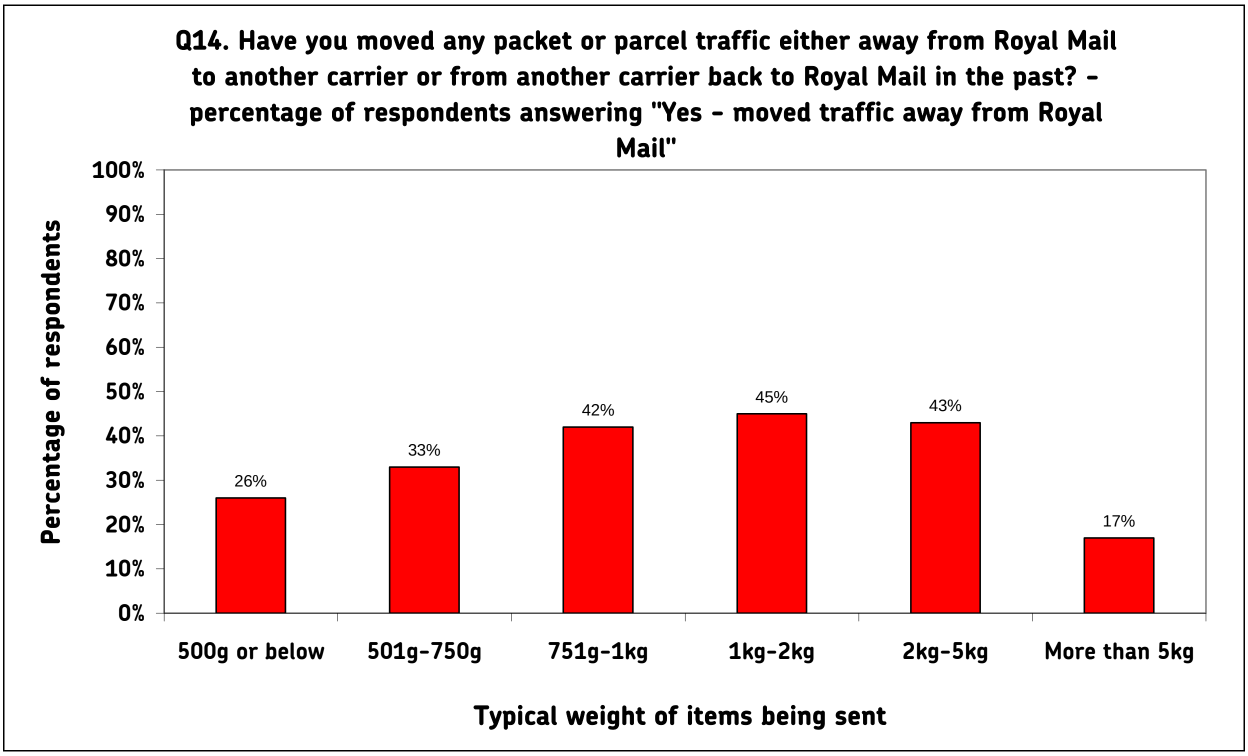


Source: Accent Research

79. Figure 10 below shows the proportion of respondents that have moved traffic away from Royal Mail to another carrier, segmented by typical item weight. The results are consistent with the previous chart in that they show that, at higher weights, a greater proportion of customers have moved traffic away from Royal Mail. In particular, at typical weights above 750g over 40% of respondents have moved traffic away from Royal Mail to another carrier. Further, it should be noted that even in the 500g-750g weight band, a third of all respondents have moved traffic away from Royal Mail to other carriers, indicating that there is clearly a good degree of competitive choice at these weights.[40]

40 The survey results indicate that the majority (73%) of this switching relates to volumes switched away from Royal Mail in the last 12 months.

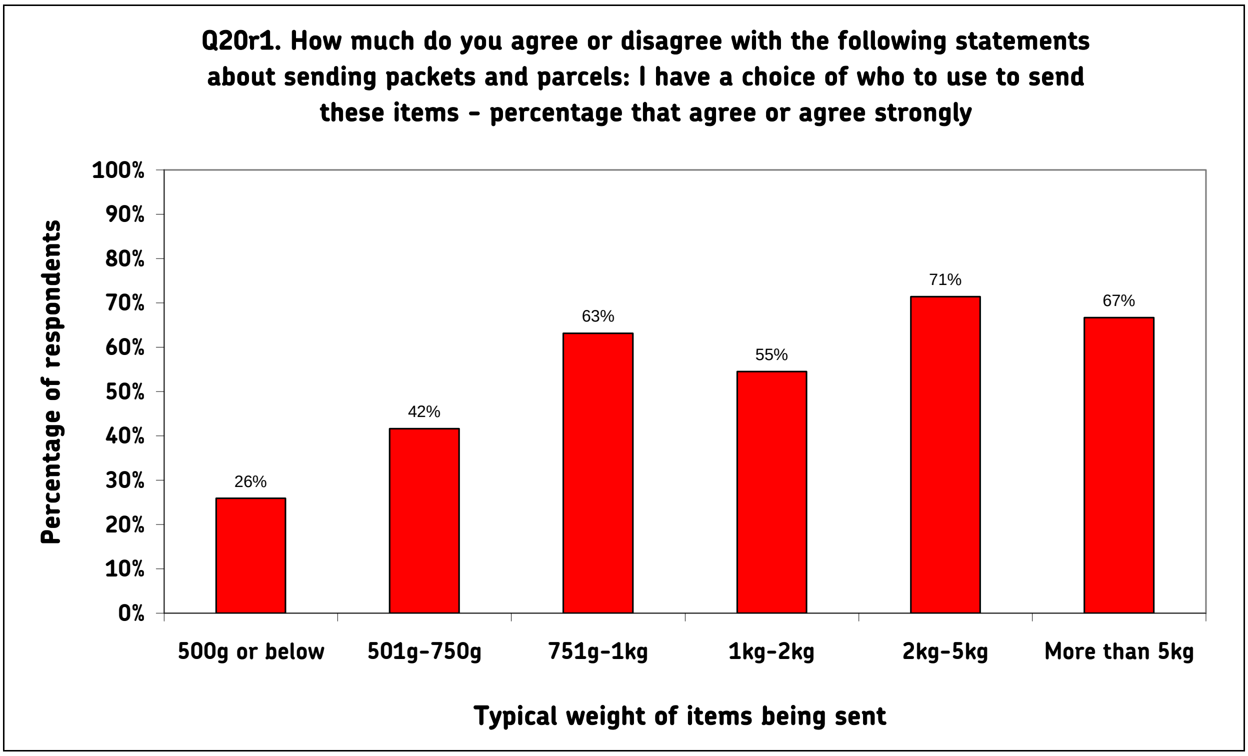
Figure 10 Percentage of respondents that have moved traffic away from Royal Mail – by weight



Source: Accent Research

80. Figure 11 shows the percentage of respondents who either agreed, or agreed strongly, with the statement: *"I have a choice of who to use to send these items."* The results indicate quite a sharp change in respondent's perception of choice at 750g. Specifically, of respondents with a typical weight of 750g-1kg, some 63% felt that they had a choice of supplier, compared to just 26% for respondents with a typical weight below 500g. This is consistent with there being a high degree of choice for items above 750g in weight. Interestingly, the data also shows that 42% of respondents with a typical weight of between 500g and 750g agreed that they had a choice of supplier. This might indicate there is a reasonable degree of choice down to a typical item weight of 500g.

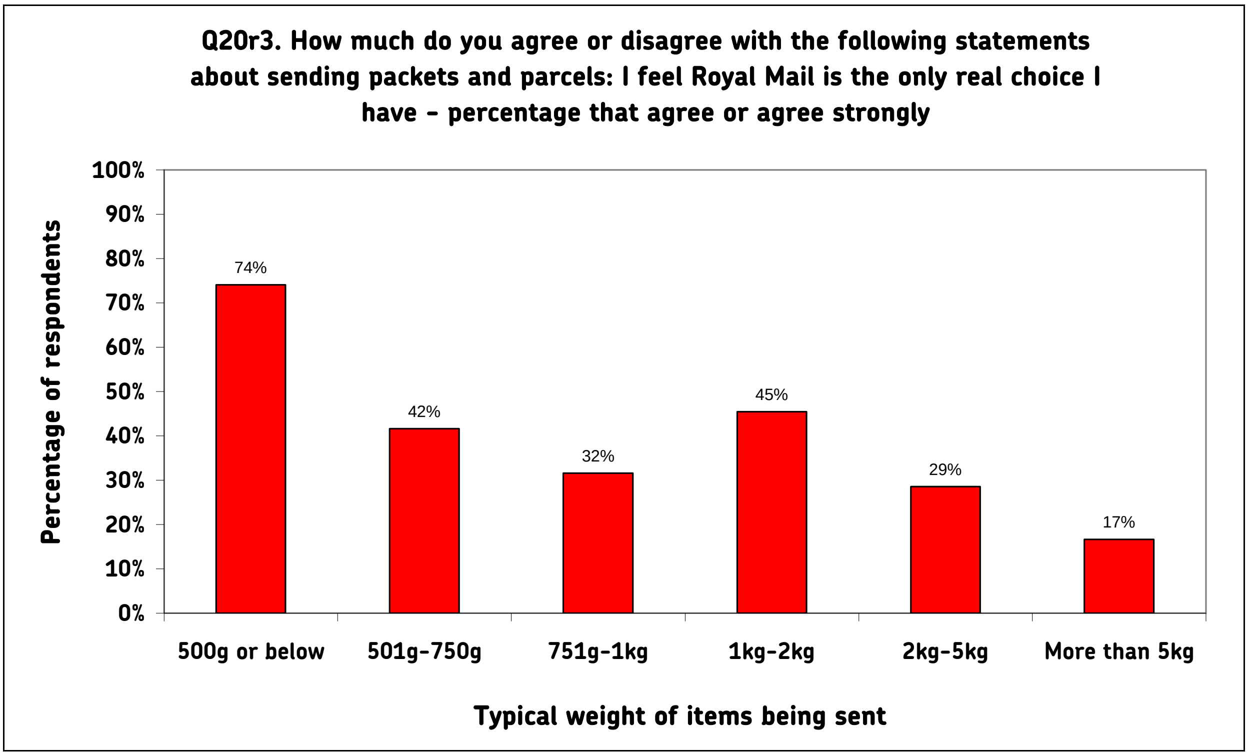
Figure 11 Percentage of respondents that agree they have a choice of supplier – by weight



Source: Accent Research

81. Figure 12 below shows the percentage of respondents who either agreed or agreed strongly with the statement: *"I feel Royal Mail is the only real choice I have"* by weight band. This shows that, below a typical item weight of 500g, the vast majority (74%) of respondents believe that Royal Mail is their only real choice of supplier. However, this figure falls sharply at typical weights above 500g, consistent with a change in competitive conditions. At a typical weight of 500g-750g, only 42% agreed or strongly agreed with the statement; and for a typical weight of 750g-1kg only 32% agreed or strongly agreed.

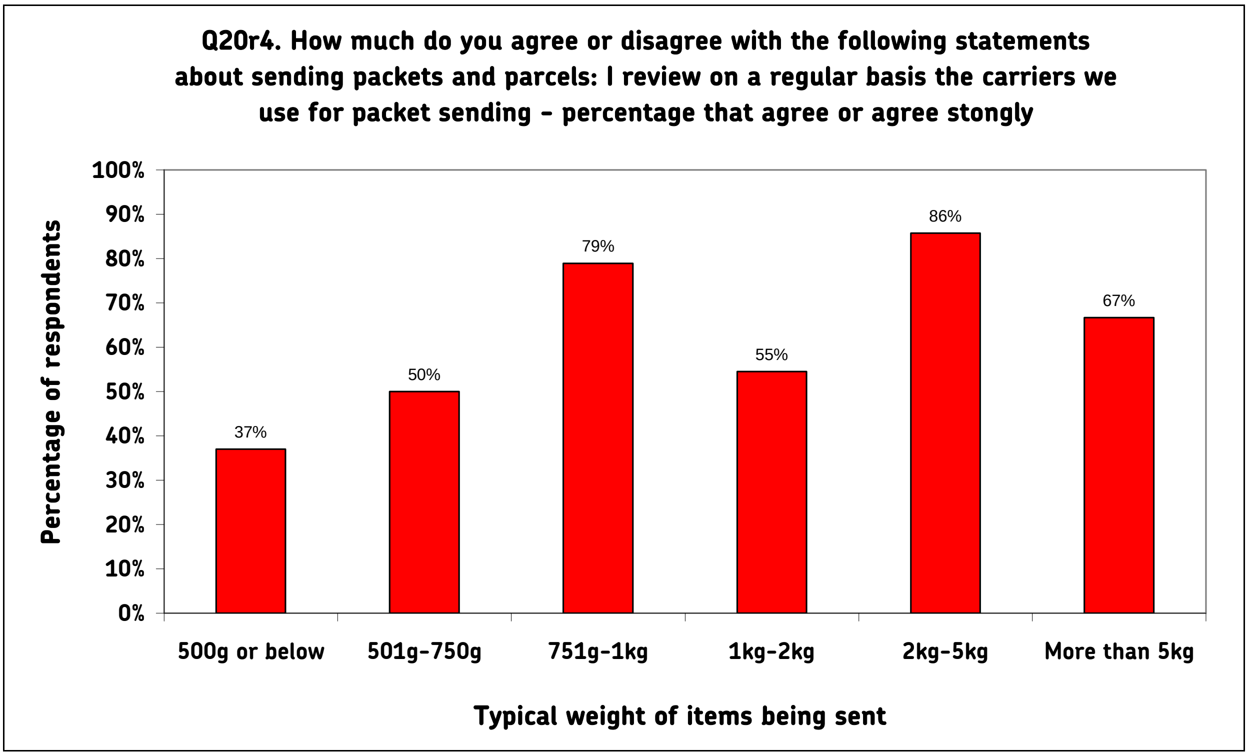
Figure 12 Percentage of respondents that believe Royal Mail is their only real choice of supplier – by weight



Source: Accent Research

82. Finally, with regard to the Accent Research, we show the proportion of respondents that agreed or strongly agreed with the statement: *"I review on a regular basis the carriers we use for packet sending."* The data (see Figure 13) shows a marked difference in the responses for weights above 750g. In particular, we find that for respondents with a typical weight of between 750g and 1kg, 79% regularly review their choice of supplier. However, for weights below 500g, the figure is just 37%. As it is both time-consuming and costly for firms to consider alternative suppliers, it is only rational to assume that firms would only do so in circumstances where they considered it likely that they faced effective choice in the market (which might enable them to receive a lower price or enhanced service). The fact therefore, that for typical weights of above 750g such a high proportion of customers regularly review their choice of supplier is consistent with customers facing effective choice in the market above this weight. Further, we note that down to a typical weight of 500g, 50% of respondents regularly review their supplier choice. This suggests that, even at weights down to 500g, there is a good degree of choice in the market.

Figure 13 Percentage of respondents that review their choice of supplier regularly – by weight



Source: Accent Research

83. In summary, RMG believes that the Accent Research has yielded a number of important insights with regard to how competitive conditions vary with weight for deferred services. Specifically, the results show:

- There is a marked increase in the proportion of customers using alternative carriers at weights above 750g; specifically above a typical item weight 750g, over half of respondents use alternative carriers in addition to Royal Mail.
- Customer switching away from Royal Mail is notably more prevalent for typical item weights above 750g; 42% of respondents with a typical weight of 750g-1kg have switched traffic away from Royal Mail to alternative carriers (33% for typical weights of 500g-750g).
- There is a clear increase in the amount of perceived choice in the market for weights above 750g, with 63% of respondents with a typical item weight of 750g-1kg agreeing that they have choice in the market (below 500g only 26% of respondents agree that there is choice).
- The evidence suggests that competition has developed in the 500g-750g space, where a material proportion of customers have been able to switch

traffic away from Royal Mail and where over half of all respondents believe they face choice beyond Royal Mail.[41]

- As we understand our rivals do not generally offer deferred vanilla services, the results of the Accent Research (which show a break in competitive conditions at 750g) are consistent with our deferred vanilla services being competitively constrained by deferred premium services above 750g. As discussed previously, this would indicate that at weights above 750g, deferred premium and deferred vanilla services are in the same market. The data is also consistent with:
  - that at weights below 500g, the constraint placed on deferred vanilla services by deferred premium services is low, indicating that they are in separate markets; and
  - that at weights between 500g and 750g, the extent of the competitive constraint placed on deferred vanilla services by deferred premium services is less clear and may depend on other factors (i.e. posting volumes).

Demand side: price elasticity estimates relevant to weight

84. As a further piece of evidence, own price elasticity estimates for RML products indicate that higher weight items are more price elastic than lower weight items. Specifically, Royal Mail asked IDEI Toulouse University to estimate price elasticities for the largest 500 customers (by 2008/09 revenue) of Packetpost and Packetsort; which could be regarded as deferred / vanilla products. To examine whether the price elasticity might vary by weight, IDEI split the sample based on average price (which, in Royal Mail's case, is a reasonable proxy for average weight). The results of this are shown, for packet format only, in the table below.

Table 5: Price elasticity estimates for Packetpost and Packetsort customers split by average unit revenue

[✂]

85. The results show that, for the sample as a whole, the price elasticity was [✂]. However, the elasticity was higher [✂] for the top 250 customers by average price and lower [✂] for the bottom 250 by average price. The average unit revenue (AUR / price) of the top 250 customers was [✂]. For the bottom 250, it was [✂]. This difference in AUR is likely to reflect the fact that the top 250 customers are sending higher weight traffic than the bottom 250 customers. Whilst the underlying data does not allow us to directly identify the weight of the traffic sent by these customers, the AURs for the dataset as a whole imply that the majority relates to customers with weights of up to 750g. Therefore, we suggest that the top 250

41 Specifically see the responses to the question 20r3, which showed that 42% of customers in the 500g-750g space agreed that Royal Mail was there only real choice of supplier.

customers by AUR are likely to be nearer the higher end of the 0-750g range, whereas the bottom 250 will clearly be nearer the lower end of that same weight spectrum.

86. The results are therefore, consistent with customers sending higher weight items being more price sensitive (elastic) than customers sending lower weight items (and therefore, are also consistent with markets being defined on the basis of weight). However, we note that it is difficult to make any strong inferences about specific weight break points for the purpose of defining markets based on this analysis. This is primarily because the underlying dataset itself contains few customers with an AUR that would imply they are sending higher weight items (i.e. items above 750g) with Royal Mail. This is unsurprising given that the market share data shown previously indicated that Royal Mail's share falls markedly around the 750g point (i.e. we have relatively few customers with an average weight over 750g). However, the fact that customers with an implied average weight nearer the higher end of the 0-750g range have an elasticity of [✂] (higher than for lower weight customers) allows us to infer that for customers with an average weight above 750g the elasticity is likely to be higher still.[42]

Demand side: evidence of price and volume trends by weight

87. Finally, we have examined whether there are any differences in key product trends (AURs and volumes) by weight. Whilst differences in such trends would not in itself prove that markets should be defined based on weight, they could indicate differences in demand conditions by weight. Figure 14 below shows the percentage change in Packetpost AURs by weight band from 2005/06 to 2009/10.

Figure 14 Change in Packetpost AURs by weight

[✂]

88. The data presented above indicates that Royal Mail has adopted quite different approaches to pricing strategy by weight in recent years for Packetpost. In particular, average unit revenues (AURs) have steadily increased for low weight items (0-500g) but have been reducing for higher weight items. One might interpret this as evidence that Royal Mail believes there are differences in competitive conditions by weight, which has led the business to conclude that it would be profitable to increase prices at low weights (up to 500g), but reduce them at high weights (above 500g). Similarly, the chart below shows the % change in volumes by weight step for Packetpost 1c from 2005/06 to 2009/10.

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42 Indeed, given that the Accent Research data indicates that there is a break in competitive conditions at 750g, one would expect this to be the case.

Figure 15 Change in Packetpost volumes by weight

[✂]

89. Consistent with the AUR data shown previously, the volume data shows quite different trends by weight band for Packetpost. Specifically, we find that, for weights above 350g, Royal Mail has experienced increasing volumes since 2005/06 but for weights below 350g, volumes have fallen. This may be for a combination of reasons and, in part, it is likely to reflect Royal Mail's pricing over time, which (as shown previously) has led to price increases at low weights but price reductions at high weights. However, given the evidence on price elasticities set out elsewhere (which indicates that Packetpost customers are less price elastic at lower weight) the data perhaps indicates that there are fundamental differences in demand conditions by weight. Whilst this does not prove that markets should be defined by weight, the presence of different demand conditions by weight band is consistent with a finding that markets could be defined by weight. To the extent that the data does indicate a difference in demand conditions, it appears to show that demand for light weight items (in the deferred vanilla product segment) may be in decline (as evidence shown elsewhere indicates that, at these weights, volumes are not primarily being lost to competitors).

Conclusions

90. With reference to the SSNIP test, we must consider whether separate markets could be defined by weight based on the evidence presented here. Firstly, it is clear that on a supply side, weight is likely to drive some operational activities and, therefore, costs. Secondly it is also clear that, given Royal Mail's historic pricing structure for its deferred vanilla services (under which prices follow weight) it is only to be expected that competition has developed around weight points (as reflected in the market share evidence). However, it is also clear that intuitively one would not expect weight to be particularly relevant to determining the extent of competition for express or deferred premium services.

91. The current evidence suggests that weight is a relevant factor to determining competition (and therefore market definition) for deferred vanilla packets and parcels. In particular, the change in market shares by weight, the results of the Accent research, elasticity evidence from Toulouse University and differences in Royal Mail's price and volume trends by weight are all consistent with a view that competition increases at higher weights for deferred vanilla products. Given the sharp reduction in our market share in the LTND segment at 750g (as shown by the Continental Research) and the change in competitive choice at 750g shown in the Accent Research, RMG's current view is that there is a separate deferred high weight market for items above 750g. We further conclude that this high weight market must include both deferred premium and deferred vanilla products, since our rivals

do not generally provide vanilla services (thus if our vanilla services are constrained above 750g, by definition they must be constrained by premium services). The evidence is also consistent with this deferred heavy weight market being effectively competitive.

92. At weights below 500g, RMG believes (as set out previously) that there are distinct deferred premium and deferred vanilla markets (when one starts with a deferred vanilla service as the focal product). However, for deferred premium services, we consider weight to be irrelevant to an assessment of competitive conditions; and that there is effective competition irrespective of weight for deferred premium services.

93. RMG believes that there is a deferred vanilla light weight market for items below 500g. For deferred vanilla services below 500g, RMG accepts that there is not currently effective competition.

94. With regard to weights of between 500g and 750g with respect to deferred vanilla services however, the evidence is less clear. In particular, the Accent Research indicates that a material proportion of customers do have choice in this space. Further, we note that Royal Mail has, in recent years, been actively reducing prices for deferred vanilla services above weights of 500g and has increased prices below 500g. This would seem to be consistent with a commercial view that Royal Mail's deferred vanilla services are competitively constrained above 500g. RMG's current view therefore, is that with respect to deferred vanilla services in the 500g-750g space, it is possible that other factors – and specifically posting volumes – are relevant to the determination of competitive constraints. We explore this question in the next section.

95. We note that in the Consultation Document, Postcomm raised the question as to whether it might be more appropriate to delineate regulatory boundaries based on price points rather than weight.[43] We generally believe that it is preferable that regulation reflects underlying supply and demand side conditions; and that further, it is for the regulator to identify relevant supply and demand side factors and set regulatory scope accordingly. Given the evidence presented above, RMG's current view is that, with respect to deferred vanilla services, weight is a relevant factor to determining competition and thus market definition. However, RMG would be open to discussing price point regulation with Postcomm; in particular to understand whether in practice this form of regulation could provide benefits to the industry and greater scope for regulatory freedom.

96. It should be noted that the above reflects RMG's current view of how markets should be defined by weight. We believe that these views are consistent with the currently

43 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.208.

available evidence and are robust. Nonetheless, over time it is possible that the specific weight points around which competition develops will change due to (i) changes in demand in the market; and (ii) the evolution of the operating models and commercial strategies of firms in the market. Indeed, RMG considers that, over time, it is likely that rivals will increasingly be able to compete with us for customers with lower item weights. Further, as we ourselves make changes to our pricing structure [✂] it is possible that the way in which competition functions will change.

Issue 5: Whether separate markets can be defined by posting volumes

Summary of Postcomm's and RMG's positions on posting volumes

Postcomm's position	RMG's position
• There is likely to be greater competition for higher volume customers but it is not currently possible to identify a break point. • There is unlikely to be competition below an absolute weight of 500g regardless of volume (with the exception of premium services). • Volume and weight are likely to jointly determine competitive choice – Postcomm's market definition diagram indicates that volume is considered relevant to competition for weights of between 1kg and 2kg.	• There is greater competition for higher volume customers. • However volume does not drive competition independently of weight because customers can multi-source their contracts. • Therefore volume and weight jointly determine competitive choice; and volume is most relevant to determining choice for deferred vanilla services weighing between 500g and 750g. • With regard to the 500g-750g segment of deferred services, customers with a posting volume of over 100k (for all deferred services) pa face effective choice.

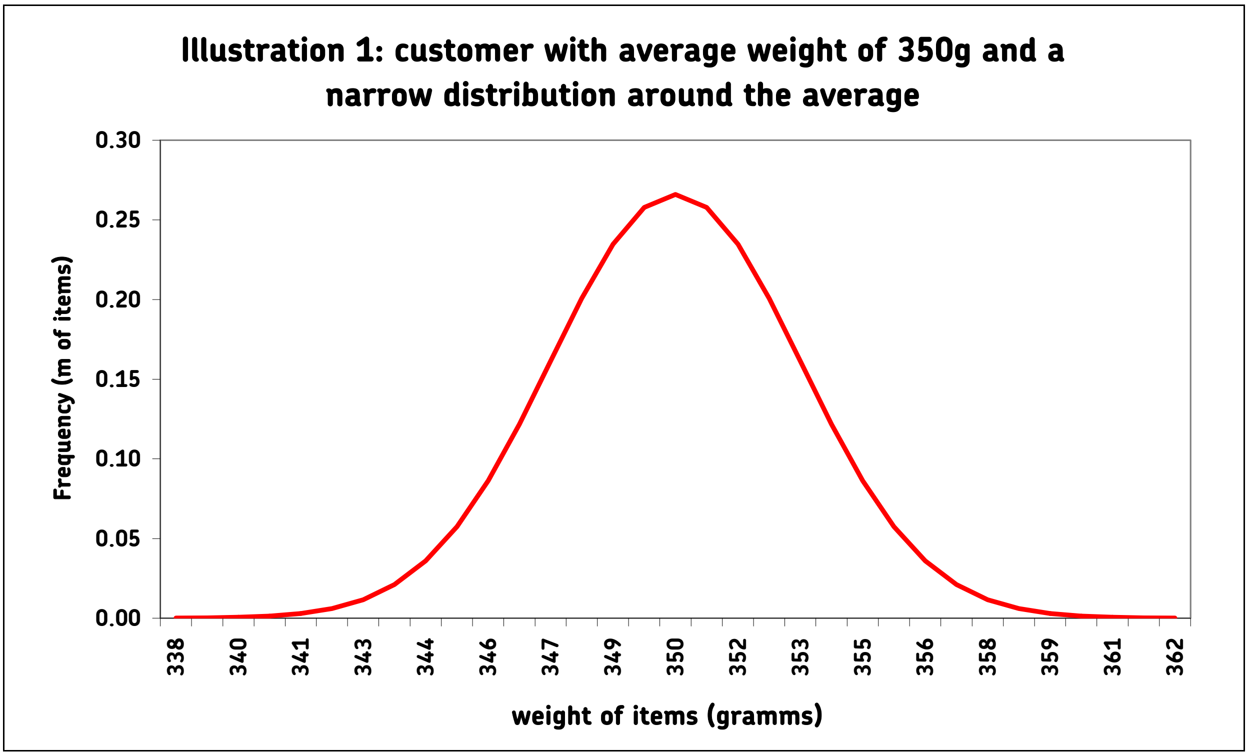
97. Volume is a key profitability driver in packets and parcels markets due to the fixed costs associated with networks. In particular, higher volumes are likely to result in lower collection costs per item. These factors are likely to lead firms to focus on higher volume customers, which could mean that competition is more intense for higher volume customers than for smaller customers. We are aware that some operators do in fact specifically target larger customers through minimum posting requirements. For example, Hermes uses a minimum volume acceptance for business customers, which is generally at 50,000 items per annum (unless the customer is located close to their central operating hub). In addition, one might also imagine that higher volume customers have more of an opportunity and incentive to shop around, further driving competition by volume. This then could be seen as consistent with defining markets on the basis of volume. However, it is not clear that one would expect (in all circumstances) posting volumes to drive competition independently of other factors; and in particular, weight.

Illustration of how volume could drive competitive choice for deferred services

98. Figure 16 below illustrates why average weight and the distribution of items by weight may remain relevant to determining choice in deferred vanilla markets for customers. The illustration shows a hypothetical distribution of packet and parcel items for a customer. The average weight is assumed to be 350g with a narrow

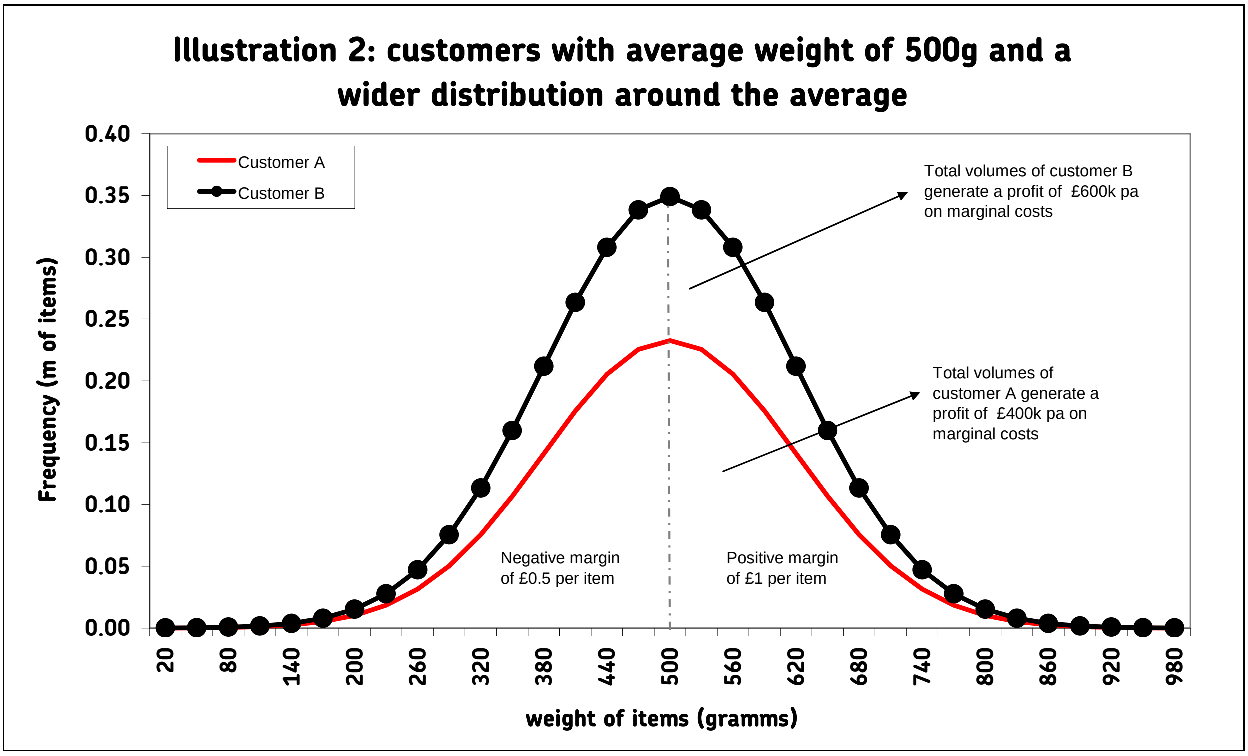
distribution around that, such that the customer has no items that are above circa 360g in weight. Now, if we suppose that, at weights below 400g there is perhaps only one firm able to offer competitive prices (in deferred vanilla markets), it becomes clear that volume does not increase the purchasing options of the customer. In other words, a customer with an identical profile of traffic but double the volume would not have any more choice in the market.

Figure 16 Hypothetical volume distribution example 1



99. The second illustrative example (see Figure 17 following) shows an alternative profile of traffic for two hypothetical customers: customer A; and customer B. The customers are assumed to have an identical profile of traffic, where the average weight is assumed to be 500g and there is a wider spread around that average (relative to the first example) such that the customers have some items weighing up to around 1kg. The only difference between the two customers is that customer B sends 50% more items than customer A. We also assume that, for one potential postal supplier, the volumes below 500g attract a negative margin (on a marginal cost basis) of -£0.5 per item. However, the volumes above 500g are assumed to attract a margin of £1 per item. In this case, we show why volume may well increase the amount of choice a customer has in the market, as illustrated in the following chart.

Figure 17 Hypothetical volume distribution example 2



100. Given the assumptions described above, if the postal operator were to supply all of customer A's volumes, it would earn a total profit of £400k. However, if we assume that this postal operator had to recover fixed costs of £500k from the contract, it is clear that it would not be profitable for it to supply customer A's volumes and thus the operator would not choose to bid. However, if that same postal operator were to supply customer B's volumes, it would earn a profit of £600k on a marginal cost basis, which would be sufficient to cover its fixed costs. Therefore, customer B, by virtue of having higher posting volumes, would have more choice in the market than customer A. In simple terms, the need to recover fixed costs in the postal industry can act as a mechanism by which competitive choice increases with volume. However, this example might not hold if the customer in question was able to multi-source its contracts, as this could result in the customer splitting its contract and placing the very low weight items with one carrier and the remaining items with other carriers.

101. The illustrations above demonstrate the intuition behind why volume may be a driver of competition and therefore, a relevant dimension for market definition. However, they also demonstrate that (i) volume may not drive competition independently of weight; and (ii) that the importance of volume as a driver is likely to depend on the degree to which customers can multi-source their contracts.

102. With regard to multi-sourcing, one view of this is that it enables customers to place their lower weight items with Royal Mail, whilst using other suppliers for higher weight items. To the extent that this multi sourcing occurs, one might imagine that it is somewhat easier for larger customers. This is because, for larger customers, the costs of multi sourcing (i.e. the costs of splitting out their mail and negotiating multiple contracts) are more likely to be offset by the benefits (i.e. lower prices on average). Therefore, there are some intuitive reasons to suppose that larger customers might be more able to place their lower weight items with Royal Mail. This issue must be kept in mind when assessing the evidence relating to posting volumes.

Market shares by customer size

103. Evidence on whether markets might be defined by volumes can be found from the Continental Research data described previously (a survey of 1,000 packets and parcels customers, which allows us to calculate revenue market shares). While the survey did not directly address customer size by reference to annual posting volumes, it did look at annual spend. The chart below provides a summary of Royal Mail revenue market shares for different customer spend levels for "All Services" and "Standard" services.[44] The results show that Royal Mail's market share decreases as customer spend levels increase and at spend levels above £50,000 per annum, Royal Mail's share is below 30% on all measures. To the extent that spend levels are likely to be closely correlated with posting volumes, this data is consistent with Royal Mail having a lower market share for larger customers.[45]

Figure 18 RM market shares by spend

[✄]

Demand side: evidence of customer switching and choice by posting volumes

104. In addition to the market share estimates from Continental, the Accent study (referred to previously in the assessment of whether markets can be defined on the basis of weight) can also yield some insights into how competitive constraints (for deferred services) might differ by posting volumes. Figure 19 below shows the proportion of respondents that use another carrier in addition to Royal Mail segmented by posting volume.[46] This shows that higher volume customers are more likely to use other carriers (as well as Royal Mail) than smaller customers. This is intuitively sensible because (as described previously) for larger customers, the

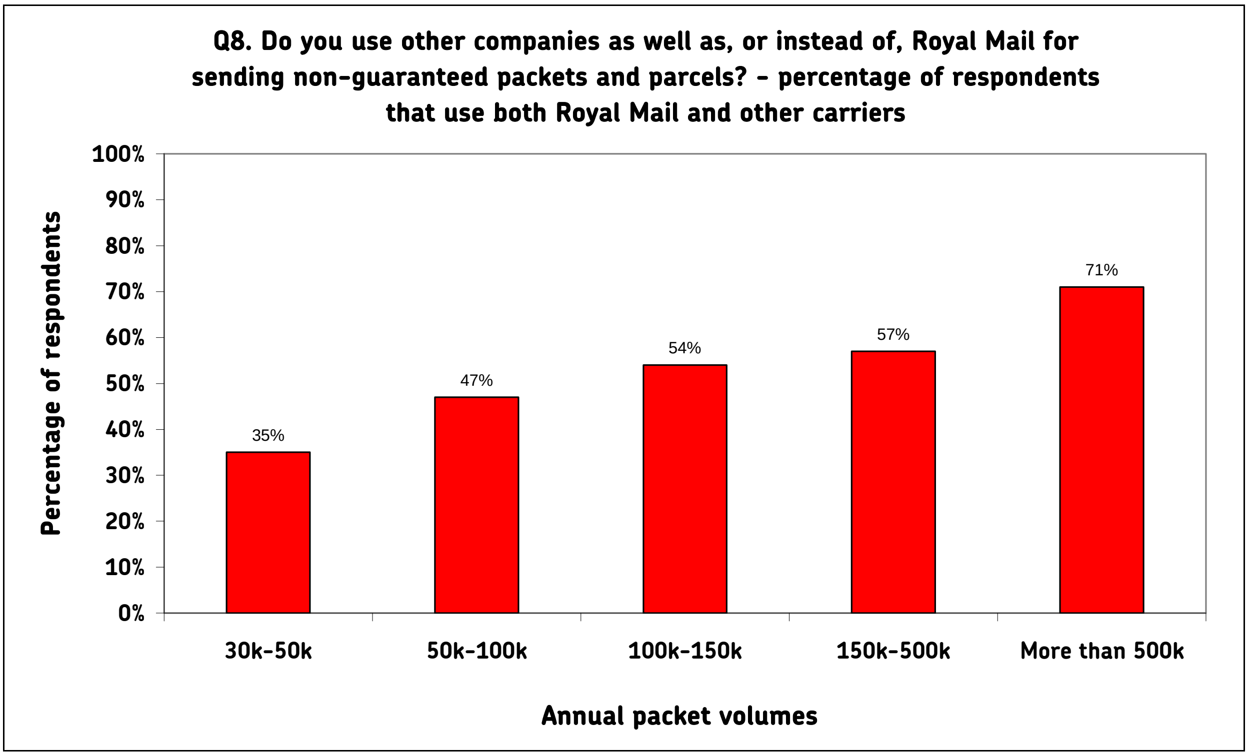
44 There is not sufficient data to enable this to be done for LTND

45 RMG notes that the data shown does not specifically relate to deferred vanilla markets, where we believe posting volumes are most likely to be relevant to determining competitive conditions.

46 Note that of the 103 respondents included in the survey, 101 were able to classify their volume. Therefore the base sample for the following data is 101 unless stated otherwise.

costs of splitting out their mail and contracting with multiple suppliers are more likely to be offset by the benefits. Given the results of the Accent survey by weight (shown earlier) it would be reasonable to infer that customers multi-source their contracts by weight bands in order to receive the best prices.[47] Also of note is that, although the degree of multi-sourcing increases with posting volumes, there does not appear to be a clear cut off point (as there was with weight). Rather, the data is more consistent with there being a continuum of competition with larger mailers being more likely to use multiple providers. However, we note that for respondents with a posting volume of over 100k items pa, more than half use alternative providers in addition to Royal Mail.

Figure 19 Percentage of respondents that use both Royal Mail and other carriers – by volume

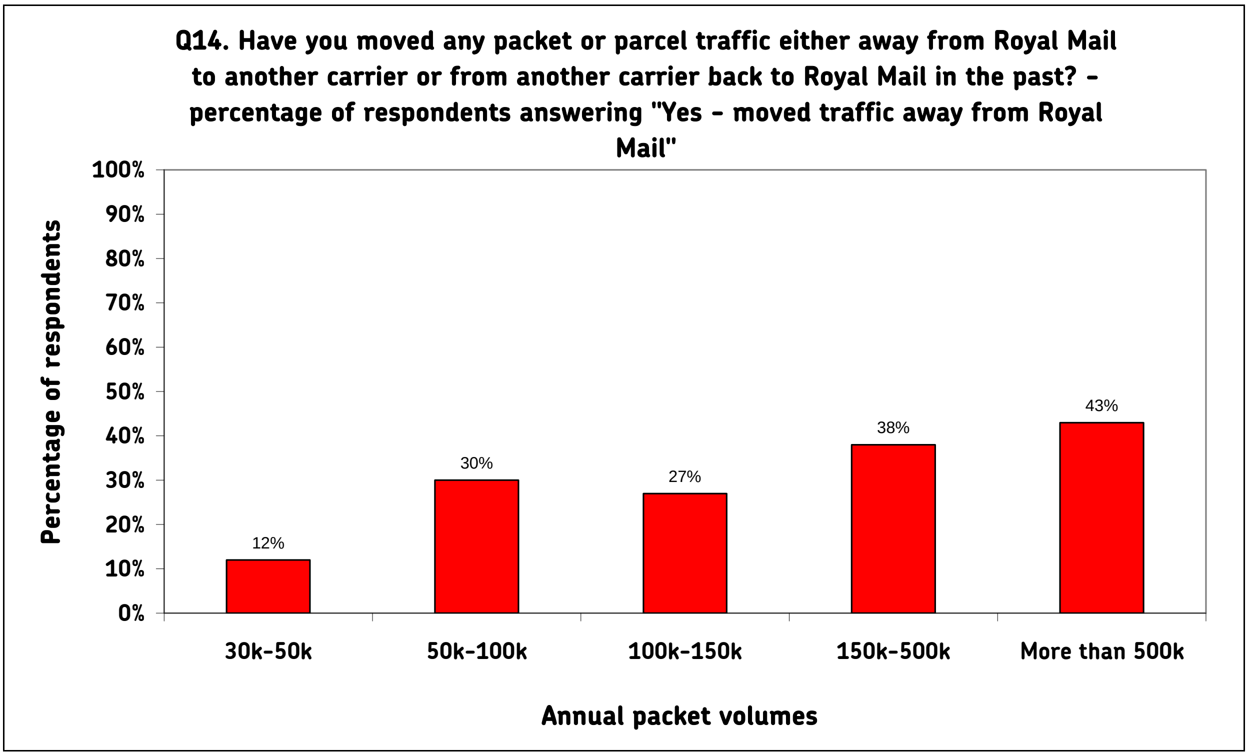


Source: Accent Research

47 Because the Accent data relates to customers using alternative suppliers *in addition* to Royal Mail – and shows that the prevalence of this differs considerably by weight.

105. Figure 20 below shows the proportion of customers that have switched traffic away from Royal Mail to alternative providers segmented by posting volumes. Consistent with the previous chart, the results seem to show that larger customers are more likely to have switched volumes away from Royal Mail. Again there generally appears to be a continuum in how responses vary by volume, although there is a marked increase in the proportion of customers switching away at 50k items pa.

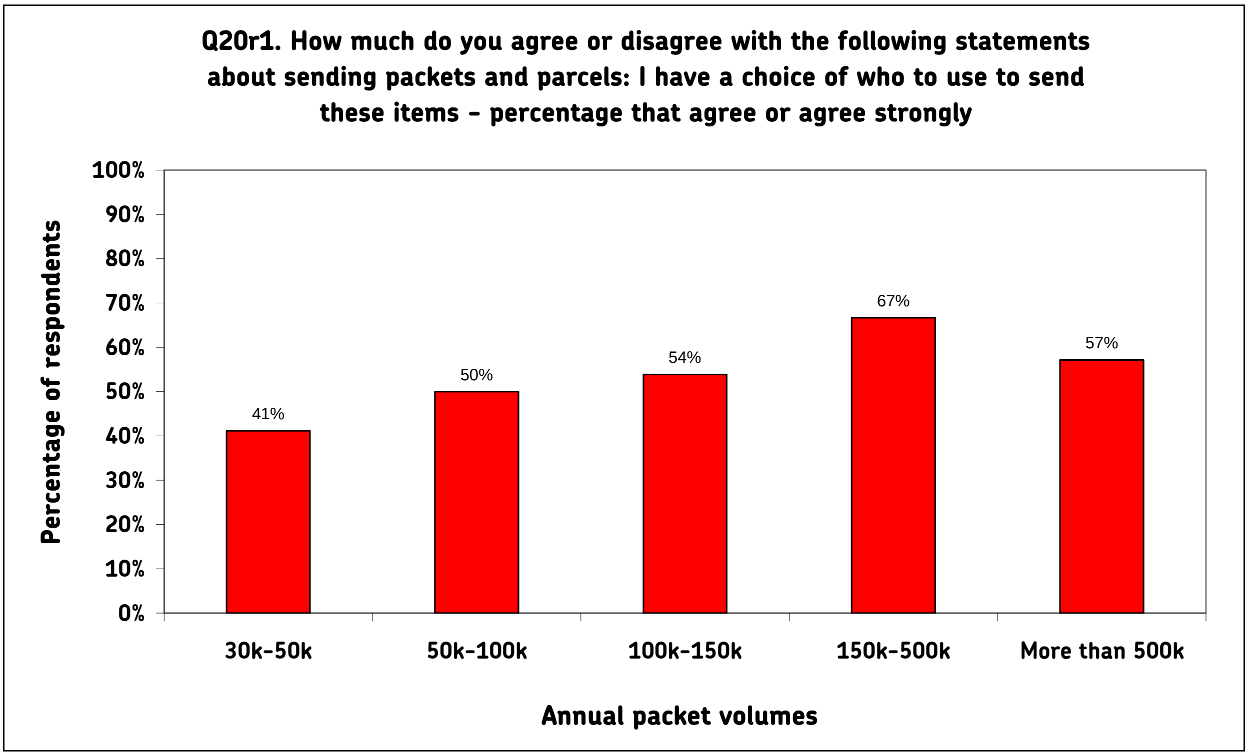
Figure 20 Percentage of respondents that have moved traffic away from Royal Mail – by volume



Source: Accent Research

106. Figure 21 shows the proportion of respondents that agreed or strongly agreed with the statement*: "I have a choice of who to use to send these items"* segmented by annual posting volumes. The results show that larger volume customers are more likely to believe that they have a choice in the market. At a volume of 100k items pa and over, more than half of all respondents agreed that they had choice.

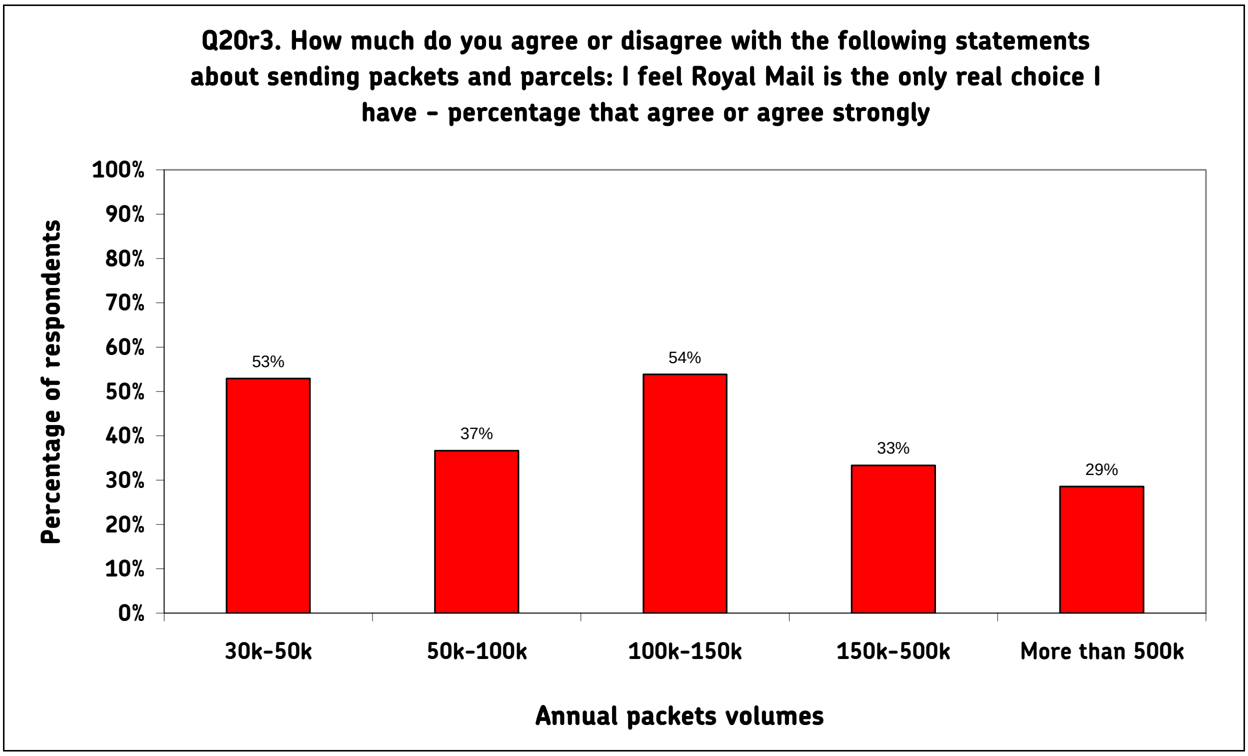
Figure 21 Percentage of respondents that agree they have a choice of supplier – by volume



Source: Accent Research

107. The following chart (Figure 22) shows the percentage of respondents that agreed or strongly agreed with the statement: *"I feel Royal Mail is the only real choice I have"* by posting volumes. The responses to this are quite varied and it is not clear that there is any particular pattern by posting volume. This contrasts with the responses to this question segmented by weight (shown previously) which showed clear differences in responses by weight. However, we note that above volumes of 150k pa, only a minority of customers agree that Royal Mail is their only choice of supplier.

Figure 22 Percentage of respondents that believe Royal Mail is their only real choice of supplier – by volume

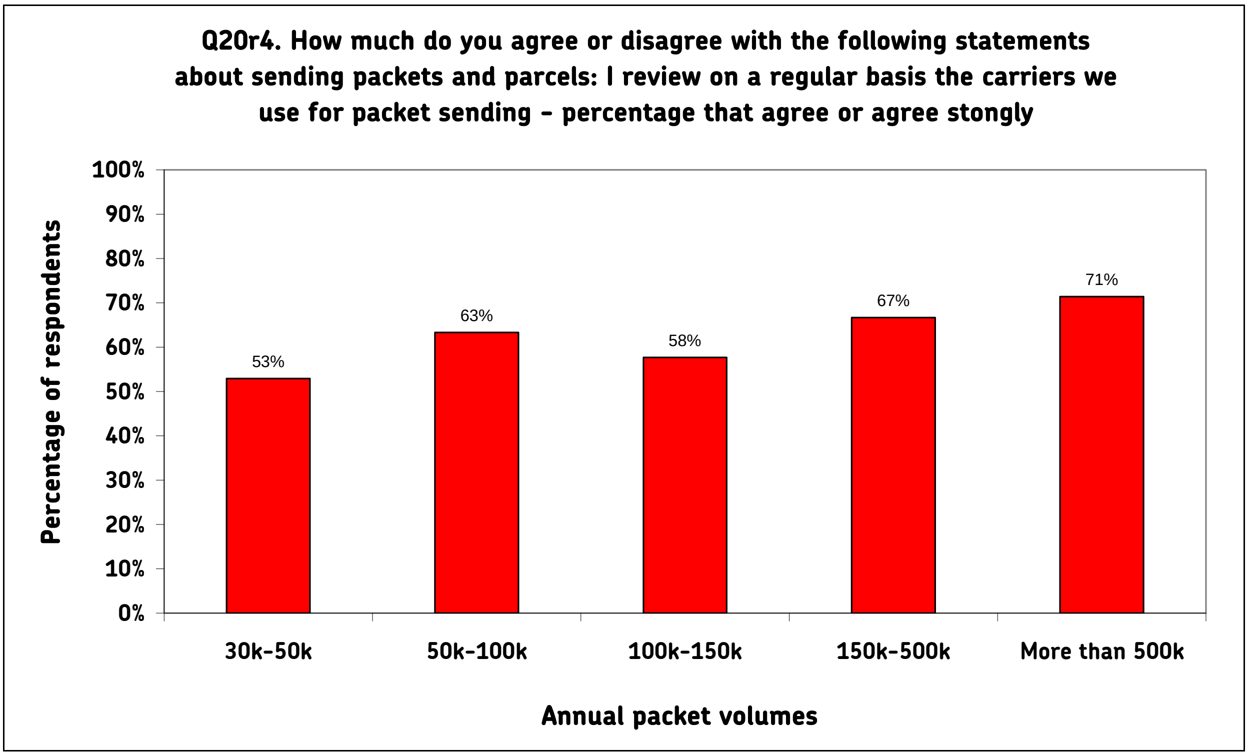


Source: Accent Research

The final chart from the Accent research (see

108. Figure 23 below) shows the proportion of respondents that agreed or strongly agreed with the statement: *"I review on a regular basis the carriers we use for packet sending."* The results are broadly consistent with those shown above in that they indicate that larger customers face increased choice in the market. Whilst the data does not appear to identify a clear break point by volumes, at all volumes the majority of customers review their choice of supplier.

Figure 23 Percentage of respondents that review their choice of supplier regularly – by volume



Source: Accent Research

109. In summary, RMG suggests that the Accent Research data shows the following with regard to posting volumes:

- That the proportion of customers using alternative carriers (in addition to Royal Mail) increases with posting volumes – intuitively this might suggest that it is easier for larger customers to split their contracts and multi-source suppliers in order to receive the best possible prices
- Generally it appears that larger customers do have more competitive choice in the market than smaller customers, although we accept that this is not as clear as it is with respect to weight
- Given the Accent Research results for weight, it would seem that the data is most consistent with larger customers multi-sourcing their contracts and

choosing to manage those contracts around weight points. In other words, posting volumes do not drive competition independently of weight

- Although there is not a clear break point by volume, at a posting volume of above 100k items pa (for all deferred items including both premium and vanilla products), most metrics could be seen as being consistent with there being effective competition:
  - the majority of customers use alternative providers;
  - a material proportion have been able to switch traffic away from Royal Mail; and
  - the majority of customers have choice in the market.

Demand side: previously submitted evidence on customer switching by volume

110. The results of the Accent Research, which show a correlation between posting volumes and customer choice, are generally consistent with evidence previously provided by RMG to Postcomm on this issue. In March 2010, Royal Mail submitted a paper,[48] which included the results of a survey of our account managers regarding customer switching. This internal survey asked account managers a number of questions, which sought to identify whether revenue reductions in Royal Mail packet and parcel products related to switching away from Royal Mail or other factors not directly related to competition. It should be noted that the survey was not just restricted to Royal Mail's deferred/vanilla products. Consequently, the results of that survey are less directly relevant to the issue of market definition than those in the Accent Research. Nonetheless, the results of the survey are consistent with a view that higher volume customers are more likely to switch away from Royal Mail;[49] and thus are supportive of the new evidence provided here.

Demand side: evidence of contracts lost for higher volume customers at lower weights

111. The evidence presented in the previous section of this paper (see: *'Issue 4: whether separate markets can be defined by weight'*) shows that there is a clear break in competitive conditions in the deferred market at a weight of 750g (and that above this weight the deferred market is effectively competitive). However, the evidence also shows that competition is materially developing in the 500g to 750g space, indicating that competition is developing at lower weights for deferred vanilla services (noting that we consider weight to be irrelevant to an assessment of competitive conditions for deferred premium and express services). Given that the Accent Research data showed that there is a clear correlation between posting

48 A position paper by Royal Mail on the fulfilment market (March 2010). Full details of the methodology used in the survey were provided in Annex 3.

49 For example, of the records included in the survey that related to end-to-end switching away from Royal Mail, we found that they tended to be higher volume customers compared to the sample as a whole.

volumes and customer choice, RMG believes that larger customers are likely to face effective choice in the market at weights below 750g. This view is consistent with our own experience of customer behaviour in recent years. For example, in 2009 RMG submitted a number of examples to Postcomm of larger value/volume contracts tendered for and lost.[50] These examples included:

- [✂]

112. In 2010, RMG has seen competition in the deferred market continue to develop further. The following are some examples of actual losses for our higher value/volume deferred packet contracts during 2010:

- [✂]

113. These examples clearly illustrate that a number of our larger customers have been able to switch traffic away from us at low weights (below 750g) in deferred packets and parcels markets.

Conclusions

114. In conclusion, RMG suggests that on examining the evidence in the round, it seems likely that volume does not drive competition independently of weight in deferred vanilla markets. Rather, we consider that volume is more likely to be a determining factor of competitive constraints within particular weight bands of deferred vanilla markets, where we have previously identified that the evidence on the extent of competition is not clear cut (specifically the 500g-750g space). Therefore, RMG's current view is that, within the 500g-750g segment of the deferred market, customers who annually post more than 100k deferred items (including both premium and vanilla) face effective choice. With reference to the previous discussion of whether markets can be defined on the basis of there being premium and vanilla services therefore, we would infer that for these high volume customers, deferred premium and deferred vanilla services are in the same market.

115. We note that in the Consultation Document, Postcomm provisionally suggested that there could be, on the supply side, separate wholesale markets for deferred heavy (above 1kg) and deferred light (below 1kg) packets and parcels.[51] Consistent with the evidence presented in this document on whether markets can be defined on: premium/vanilla, weight, and volume grounds, RMG's view is as follows. At weights above 750g, there is effective end to end competition for all packet and parcel

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50 The Competitive Environment for Packets – Royal Mail Group Response to Postcomm's Discussion Document, 2009, Page 19

51 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 2.287.

services; and thus there is no requirement to define a separate wholesale market. At weights below 750g, we accept that there would be a need to define a wholesale market for deferred vanilla packets and parcels.

Issue 6: Whether separate markets can be defined by format

Summary of Postcomm's and RMG's positions on format

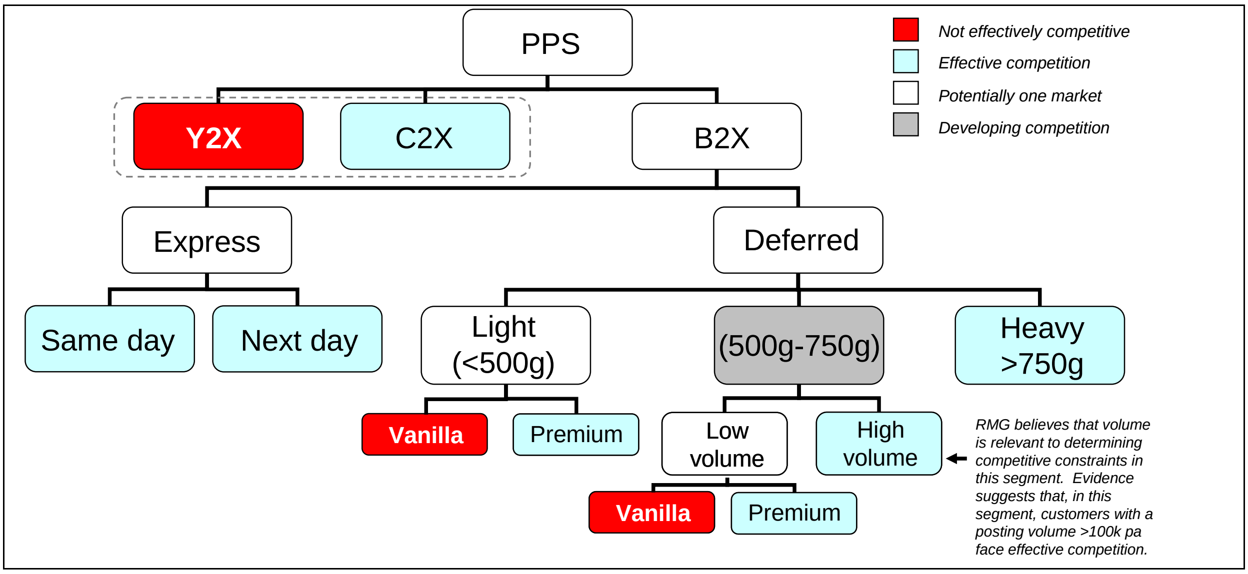
Postcomm's position	RMG's position
• There are separate markets for: packet/parcel format products and letter/large letter format products.	• There are separate markets for: packet/parcel format products and letter/large letter format products.

116. It is also necessary to assess whether it is appropriate to define markets by format and, specifically, whether Royal Mail's large letter products should be considered to be in either the parcels or letters markets. On the supply side, an important distinction may be whether an item can be machine sorted. In this regard, the evidence might suggest that large letters should be included within the letters market, as they can (in common with letters) be machine sorted up to a certain thickness. It could also be the case that the format of mail drives wider operational handling costs. From a handling perspective, letters and large letters tend to be handled in a fairly similar way, which is somewhat different from the way in which packets are handled. A more detailed description of the operational differences between processing letters/large letters and packets is set out in the subsequent assessment of market definition for letters products. On balance, an assessment of supply side factors (see subsequent section) would tend to indicate that letters and large letters should be considered to be in the same market.

Summary of RMG's current views on market definition for packets and parcels

117. Based on the evidence set out in the preceding sections, RMG's views on market definition for packets and parcels products are set out in Figure 24 below.

Figure 24 RMG's current views on relevant markets for packets and parcels



118. RMG would like to stress that the above reflects our current views on market definition with regard to packets and parcels. We note however, that the markets we operate in are dynamic and moving rapidly over time. Consequently, we believe that over time, it is possible that rivals will be increasingly able to compete with us for customers with lower item weights and lower posting volumes. Indeed, as we ourselves make changes to our pricing structure [✂] it is possible that the way in which competition functions will change. RMG believes that this perspective has important implications for future decisions regarding regulatory scope. These are set out subsequently in annex 4.

Assessment of market definition for letters and large letters

119. In this section, we set out RMG's current views on market definition for letters and large letters. We have structured this around a number of issues, which we believe are key to assessing market definition. These issues are shown in the table below. In the following passages, we present the available evidence relevant to each issue and then assess that evidence with reference to the SSNIP test framework.

Table 6: Key market definition issues for letters

Key issue to be considered	Predominantly demand or supply side issue
What vertical market definitions can currently be supported by evidence	Supply side
Whether letters markets can be defined based on speed of delivery	Demand side
Whether the evidence suggests that the 'format' of mail (sortation level, volume or format) delineates separate markets	Both supply and demand side
Whether markets can be defined on a UK wide basis	Supply side
Whether markets can currently be defined by application	Demand side

120. Postcomm will be aware that Royal Mail has structured its retail business units on the basis of applications (which refer to the use to which mail is put). This reflects our view that there are differences in demand conditions by application, which are important to understand from a commercial perspective. However, due to the fact that currently RMG's products do not fully align to applications, we accept that the application of the SSNIP test framework would not generally be supportive of defining markets by applications at this time. The following analysis should therefore, be viewed in this context.

Issue 1: What vertical market definitions can currently be supported by the evidence

Summary of Postcomm's and RMG's positions on vertical markets

Postcomm's position	RMG's position
• The postal supply chain comprises of the following activities – Collection, Outward sortation and Trunking (which represent upstream activities) and inward sortation and Delivery (which represent downstream activities. • Royal Mail has market power in both the D+1 and D+2 (and later) downstream markets. • Royal Mail has market power in all upstream D+1 and all unsorted low volume markets. • Royal Mail has market power albeit facing increasing competition in the D+2 (and later) presorted and high volume unsorted upstream markets.	• RMG agrees with Postcomm's explanation of the postal supply chain and apportionment of upstream and downstream activities. • RMG accepts that effective competition has not yet developed in the D+1 and D+2 (and later) downstream markets. • RMG accepts that effective competition has not yet developed in the upstream D+1 and D+2 (and later) unsorted low volume markets. • RMG believes that effective competition has developed in both the D+2 (and later) unsorted high volume and the D+2 (and later) pre-sorted upstream markets.

121. Any operator wishing to provide mail services to end customers will have to undertake themselves (or be able to buy access to) the five key activities that form the constituent parts of providing a basic end-to-end postal service. These are:

- collections;
- outward sortation;
- trunking;
- inward sortation; and
- delivery.

122. Different customer groups may demand products that make different use of these various activities and providers can choose to enter at different parts of the pipeline to serve their needs accordingly. For example, small retail customers may demand products which provide all the activities (end-to-end) whereas large customers may be willing to undertake some of the outward sortation activities themselves. To date, in order to offer end-to-end postal services to customers, operators have developed business models that rely on obtaining access to the final delivery segment of Royal Mail's network.

Supply side: description of operational differences between upstream and downstream

123. The activities of inward sortation, local distribution and delivery form the downstream (or wholesale) segment of the market. The key drivers of cost in delivery are volume per delivery point and delivery point density. Therefore, downstream costs decline with increased volume due to economies of scale and increased delivery point density (i.e. reduced distance and time between delivery points). This indicates that some level of scale is required to provide the downstream activities of delivery, thus making it harder for operators to enter this part of the postal pipeline.[52] Conversely, the upstream or retail activities of collection, outward sortation and trunking do not seem to exhibit these characteristics to the same degree.

124. In fact, the supply side characteristics of downstream and upstream activities are quite different. Undertaking the upstream activities predominantly includes purchasing or leasing vans for collections and trunking; and sorting machines for outward sortation. Downstream activities on the other hand, would require firms to obtain access to additional capabilities and facilities (such as delivery offices, additional staff and potentially, additional machinery) which could entail further investment.[53] Therefore, from a supply side, these differences in operational requirements between the upstream and downstream components of the supply chain are likely to limit short-term supply side substitutability between them.[54] These supply side differences between upstream and downstream activities are also consistent with the way in which entry into letters markets has occurred in the UK in recent years. Specifically, firms have predominantly tended to focus only the upstream markets when entering.

125. With regard to the upstream components, collection activities are associated with economies of scale, which will impact the unit costs of firms providing upstream services. This means that, with regard to collection activities, there may be a minimum volume level required for a business to be viable (and thus for entry to occur). Analysis using Royal Mail's Entry Pricing Model (EPM) implies that entrants should be able to offer competitive upstream prices above a collection volume of somewhere between 250-4,000 items per collection. Since most, if not all, pre-sorted mail would fall into this volume banding, it can be inferred that there are very few barriers to entering the bulk upstream segment of the market. This is

52 Clearly competitive conditions can change over time and, as rival firms build volumes upstream, entry into downstream activities may become more likely.

53 Although there are likely to be multiple potential models of entry into downstream services; and variable cost / opex based models, which entail low capex, may be possible.

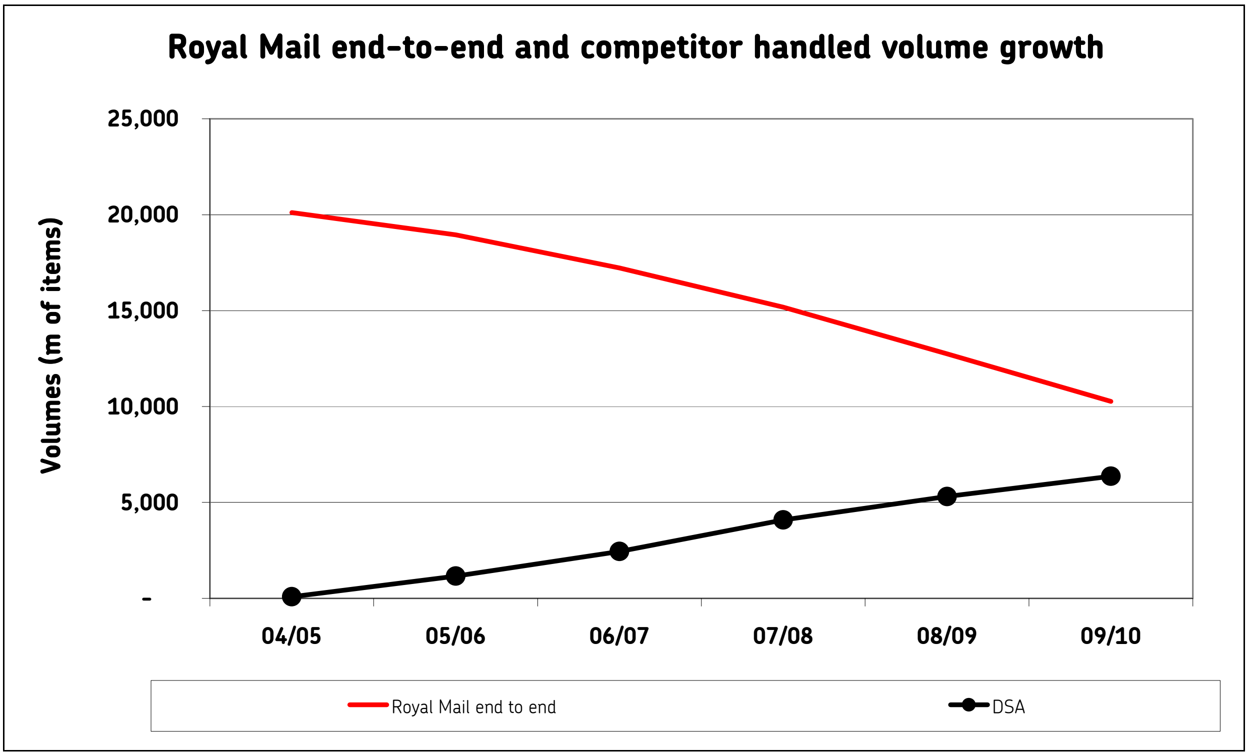
54 Even under a variable cost entry model it may take time for firms to develop a downstream presence.

consistent with the high degree of upstream competition now observable in the market.

Evidence of how upstream competition has developed

126. A view that there are low entry barriers into upstream markets is very much consistent with the rapid increase in access volumes that we have witnessed since the liberalisation of the postal market in 2004. Indeed, as demonstrated in Figure 25 below, DSA volumes have grown significantly and now make up nearly 40% of total mail volumes.

Figure 25 the total UK addressable mail market



Source: RMG

127. The significant growth in DSA volumes (as shown above) illustrates the rapid pace at which market entry has occurred in recent years. This entry has been characterised by firms choosing to focus on the upstream elements of the supply chain and we note that, to date, bypass competition (i.e. entry into the downstream market) is relatively undeveloped. Further evidence of the rate at which competition in upstream markets has developed can be found by observing the number of licenses Postcomm has granted to operators. In fact, since liberalisation of the postal market, 53 Postal Services Act licences have been awarded, which we have set out in the table below. As the table shows, the number of entrants awarded a Licence

increased significantly in 2009. Further, in 2010 alone, fifteen Licences have already been awarded.

Table 7: Number of licenses granted by Postcomm

	2005	2006	2007	2008	2009	2010
Number of Licences Issued	9[55]	9[56]	1	5	14	15[57]

128. In our response to Postcomm's Market Review Questionnaire,[58] we provided a range of evidence that demonstrated that entry barriers to upstream markets were low. RMG specifically provided a view on the level of investment required by a DSA entrant to enter upstream markets. Using UK Mail as an example, the analysis set out the volumes and revenues UK Mail achieved as a result of its investment and ultimately the profits generated. Full details of the analysis can be found by referring back to our response but the key points were:

- that between 2004/05 and 2008/09 capex by UK Mail was relatively low (and relatively flat) and did not exceed £5m in any one year;
- yet during this time, it achieved rapid volume growth, with mail volumes in 2008/09 of 2.3bn up from just 71m in 2004/05;
- this volume growth also translated to significant revenue growth of some 1,500% over the same time period (revenues in 08/09 were £165m compared to just £10m in 2004/05); and
- the mail business was profitable almost immediately, with a profit before tax (PBT) figure of £3.2m in 2005/06, which had risen to £11.6m by 2008/09. [59]

129. RMG considers that there is a range of evidence that indicates that there are no material entry barriers in upstream letters markets. RMG notes that this is highly consistent with the way in which competition has developed in these markets (i.e. that entry has predominantly been in upstream markets and this entry has been rapid).

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55 Two have since been revoked.

56 Two have since been revoked.

57 One has since been revoked.

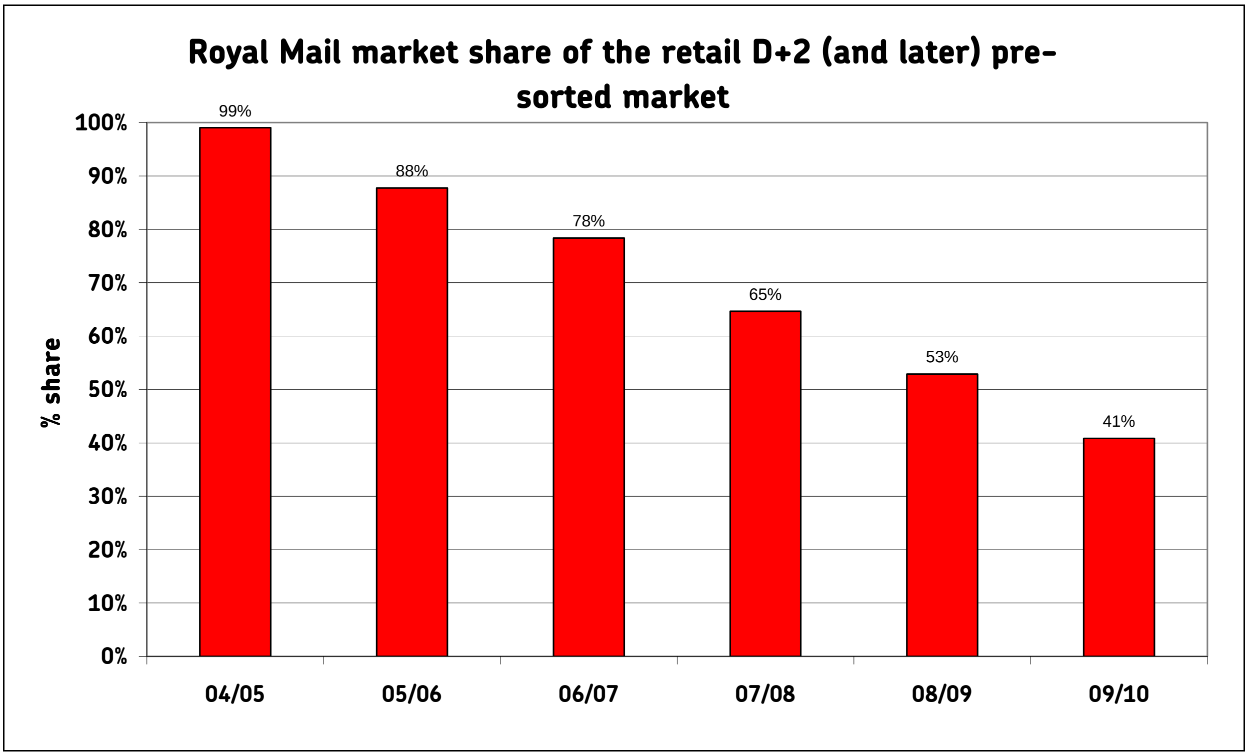
58 Royal Mails response of 15th February 2010 to Condition 17 Request to Furnish Information: Market Review Questionnaire – RM Letters (January 2010).

59 All data taken from the Business Post Annual report & accounts from 2005/06 through to 2008/09. Segment analysis in notes to accounts contains details of UK Mail financials.

Royal Mail's market share in upstream markets

130. A more disaggregated assessment of markets and an analysis of market power within them adds further weight to the view that upstream competition is significant and continuing to grow. Specifically, we note that Royal Mail has lost significant volumes to competitors in the retail D+2 (and later) pre-sorted mail market over the past few years; and our market share is continuing to decline. In 2009/10, as indicted in Figure 26, our market share is now approximately 40% of all pre-sorted end-to-end volumes, which would indicate that we no longer have significant market power within this upstream market (note, a discussion of RMG's view of whether letters markets can be defined by speed of delivery and by sortation is provided subsequently).

Figure 26 Royal Mail share of retail D+2 (and later) pre-sorted market[60]



Source: RMG

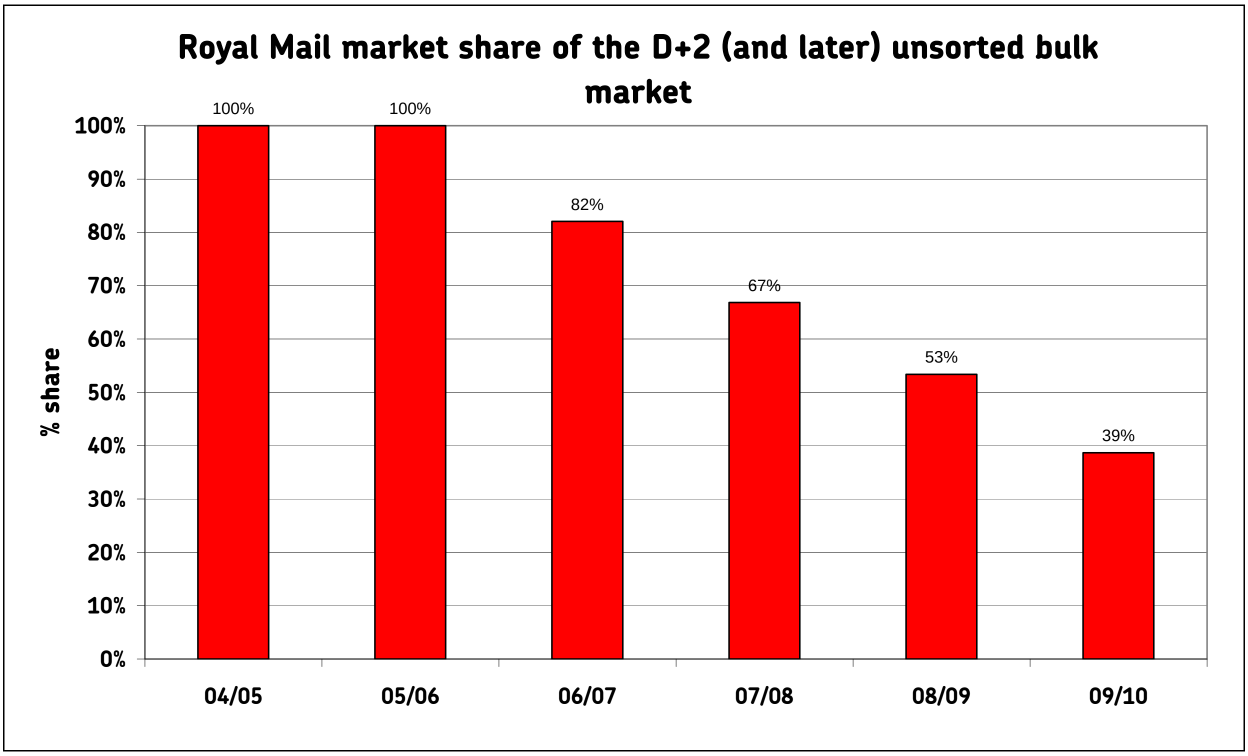
131. We would suggest that the current level of our share, and the sharp downward trend in that share, is highly consistent with there being effective competition and that Royal Mail, contrary to Postcomm's conclusion in the Consultation Document, no longer has market power in the D+2 and later retail (upstream) pre-sorted mail market.

60 Products included are: Mailsort 2 and 3, Walksort 2, Presstream 2, and Mailmedia.

132. In the early stages of access competition developing, RMG experienced sharp declines in our pre-sorted (e.g. Mailsort 2) volumes, as customers switched into DSA (as reflected in the market share chart for pre-sorted volumes shown above). More recently however, we have started to experience similar declines in our unsorted 2nd class volumes, consistent with these now moving at pace into DSA. This experience is reflected by our internal estimates of our market share in the unsorted high volume upstream market, where RMG would also argue that we no longer have market power (contrary to the position taken by Postcomm).

133. We would argue that, based on a definition of D+2 high volume (bulk) mail (which is discussed subsequently), no meter or PPI <250 items per posting should be included in this calculation. If these volumes were to be excluded, Royal Mail estimates that its own market share for unsorted high volume is much lower than that suggested by Postcomm, and in fact, is just under 40%, indicating that this too is an upstream market that is effectively competitive. This is shown below in Figure 27.

Figure 27 Royal Mail share of retail D+2 (and later) unsorted bulk market[61]



Source: RMG

134. Postcomm quoted a market share (for high volume unsorted) of over 80% for 2008/09, which we can only replicate by including: all of Cleanmail, PPI and Meter

61 Products included are: Cleanmail, PPI (over 250 items per posting) and Meter (over 250 items per posting).

volumes. On including these products, RMG calculated a market share in 2008/09 of 77%, which is broadly consistent with that reported by Postcomm. However, we believe that this is not the appropriate measure to use, as it would seem to include postings of under 250 items (i.e. mailings that would fall outside of the definition of bulk mail). RMG therefore believes that the market shares that we have reported in the figure above are accurate.

135. In order to estimate upstream market shares separately for pre-sorted and unsorted services (as shown above), RMG has used its Entry Pricing Model (EPM). RMG uses the EPM to model competitive entry, primarily into upstream mail markets, based on prevailing market prices. The EPM has been developed based on a series of underlying switching functions for each product type, split by format. The model also includes phasing assumptions to capture the possible timepath required for entrants to develop networks and thus win volumes. The EPM therefore, implicitly includes assumptions about the proportion of DSA volumes that have switched out of our pre-sorted and unsorted products. These assumptions are embedded in the product switching functions that underpin the EPM and reflect RMG's best commercial view of where volumes switch from and to. To ensure that the modelled outcomes of the EPM are likely to reflect reality, RMG calibrates the results to outturns. Specifically, the EPM has been calibrated for 2009/10 such that running the model for that year generates volumes and revenues which are consistent with observed outturns in that year. RMG also uses the Inland Letter Traffic Model (ILTM) to provide broad estimates of the market drivers for mail demand, which is also used to help calibrate the accuracy of the EPM. For example, Mailsort 2 volumes declined by around 35% in 2009/10. Of this decline, the ILTM model allows us to attribute a proportion to changing conditions in the mail sector; but some proportion can also be attributed to switching into DSA.

136. RMG would acknowledge that competition has not developed to such a great extent in the D+1 retail markets, or in either of the wholesale markets proposed by Postcomm.

137. RMG does not consider demand side issues to be particularly relevant to an assessment of vertical markets and so we have not discussed them in any detail here. This is primarily due to the fact that customers generally want to purchase an end-to-end service and would not want to purchase separate upstream and downstream services. The exception to this would be the very large customers, who may undertake some of the upstream activities themselves (e.g. sortation).

Conclusions

138. In conclusion, with regard to the SSNIP test, RMG believes that the current evidence is consistent with there being separate retail and wholesale markets covering the activities of collections, outward sortation, trunking (retail) and inward sortation and delivery (wholesale) respectively. This is primarily due to there being material differences in the operational requirements of providing upstream and downstream services, which restricts the extent to which firms could switch supply between them at short notice. Therefore, a 5% to 10% price increase in downstream (wholesale) products is unlikely to lead to sufficient supply side substitution from upstream to downstream services to render that price increase unprofitable.[62]

62 However, RMG notes that it is possible that more substantial increases in wholesale prices could trigger bypass competition.

Issue 2: Whether letters can be defined on speed of delivery

Summary of Postcomm's and RMG's positions on speed of delivery

Postcomm's position	RMG's position
• There are separate D+1 and D+2 (and later) markets for both upstream and downstream activities.	• There are separate D+1 and D+2 (and later) markets for both upstream and downstream activities.

Demand side: evidence regarding speed of delivery

139. From a demand side perspective there will always be some customers who are particularly time sensitive, and need to get mail to the end recipient quickly. For these customers there are unlikely to be any substitutes for a 1^{st} class service. For example, 1^{st} class services are often seen as a "distress purchase" used as a last resort when a letter needs to arrive the next day; and the usual 2^{nd} class service will not get to the customer in time. For these customers, if the price of the relevant 1^{st} class service were to rise by say 5-10%, it is unlikely that the 2^{nd} class equivalent would act as a sufficient constraint to make this unprofitable. This would signify separate markets for 1^{st} and 2^{nd} class.

140. However, for less time-sensitive items, cost plays a much bigger part in the decision of what speed of service to use. In these cases, it is plausible that even customers currently using a 1^{st} class service would consider trading down to a 2^{nd} class service. Therefore, in principle there are circumstances under which 1^{st} and 2^{nd} class products could be viewed as substitutable on the demand side. It is therefore necessary to examine the evidence on the extent of the demand side constraints between 1^{st} and 2^{nd} class services.

141. An analysis of cross-price elasticities can be used to help inform us on this issue, since it provides a measure of the rate at which demand for a product (e.g. 2^{nd} class) changes when the price of another (e.g. 1^{st} class) changes. A study by Accent Rand[63] provided estimates for these cross-price elasticities. The results indicated that there is some degree of up trading and down trading between 1^{st} and 2^{nd} class products. For example, PPI 2 had an own price elasticity of [✂] of which [✂] up traded to PPI 1. On the other hand, Cleanmail 1 had an own price elasticity of [✂], of which [✂] down traded to Cleanmail 2. However, whilst supportive of some substitutability around the edges, the cross price elasticities are sufficiently low to imply that 1^{st} class is in a separate market to 2^{nd} class from the demand side.

63 Accent: Modelling customer choices when mail price differentials change (October 2008)

Supply side: evidence regarding speed of delivery

142. On the supply side, the question of whether 1st and 2nd class products should be considered to be in the same market depends on the operational requirements of providing those services. Specifically, it depends on whether the services are sufficiently similar from an operational perspective such that short term supply side substitutability between them would be possible. To date, entry into letters markets has (as described previously) predominantly been focused in the upstream part of the supply chain, whereby firms rely on downstream access (DSA) to Royal Mail's delivery network to provide services. Currently few firms are choosing to use anything other than the standard access arrangements, which means (at present) many firms cannot readily substitute into the provision of 1st class letters services, indicating that they should be considered to be in a separate market to 2nd class services. Over time, competition could develop in a way that enables firms to offer a 1st class service, which in turn might lead to supply side substitutability between 1st and 2nd class services. However, this might require firms to develop significant downstream networks to support a 5 day / next day delivery service.

Conclusions

143. In conclusion, we suggest that a SSNIP test analysis would indicate that 1st and 2nd class services are in separate markets. On the demand side, the importance of speed to customers coupled with low cross price elasticities between 1st and 2nd class products indicates that 1st class prices could be increased by 5-10% without there being sufficient substitution to 2nd class services to render that price increase unprofitable. On the supply side, material operational differences (and the fact that entry has occurred via DSA) means that there is also limited scope for substitution between 1st and 2nd class. RMG therefore concludes that there are separate markets for D+1 and D+2 and later letters products.

Issue 3: Whether the evidence suggests that the 'format' of mail delineates separate markets

Summary of Postcomm's and RMG's positions on 'format' of mail

Postcomm's position	RMG's position
• Letters and Large letters are in the same market. • There are separate unsorted and pre-sorted markets.	• Letters and Large letters are in the same market. • There are separate unsorted and pre-sorted markets.

144. Here we consider whether markets can be defined based on "format" (where by "format" we refer to: whether the item is in letter or large letter format; whether the item is unsorted or pre-sorted; and the posting volume).

Format of mail – letter and large letter

145. From the supply side, one of the key operational considerations is the use of sorting machines for the sortation parts of the supply chain. Mail items that can be sorted by machine include all items in letter format as well as the majority of large letter formats. Whilst large letters may require larger sorting machines, if a provider has already invested in these machines it would be straightforward for them to provide products in both letter and large letter format (and furthermore, suppliers with such machines could easily switch into the provision of large letter format services from letter format services). Whilst some large letters do have to be manually sorted (a similarity with packet formats), the majority of large letters up to 10mm can easily be sorted by machine. Thus in sortation, the operational requirements for letter and large letter formats are very similar (but are different from packets).

146. The other supply side consideration with regard to format is the impact of mail size on handling costs. A large letter (up to 25mm) is similar to a letter format in that it can fit through a letterbox. This is very different to larger items (packet format) which would incur additional operational costs in ringing the doorbell, leaving a calling card and taking the item back to the local delivery office for re-delivery or customer collection. On the whole therefore, RMG suggests that the operational requirements of providing letter and large letter formats are sufficiently similar that it would tend to suggest that they should be considered to be in the same market.

147. We also note that, in practice, the major operators in these markets, such as TNT and UK Mail offer both letter and large letter format services to customers using DSA, whereas to date, the extent of packets services offered using DSA has been limited. This would seem to be consistent with there being a high degree of operational similarity between letter and large letter formats (but there being operational differences for packets).

148. From a demand side perspective, it seems logical to suppose that customers would require firms to provide letter and large letter format products. Indeed, Postcomm noted this point in their Consultation Document: "*…customers would be reluctant to separate unsorted letter and large letter items and expect a single operator to provide upstream services for both these formats.*" [64] Consequently, consistent with the supply side, RMG suggests that the demand side evidence is also supportive of letter and large letter format products being in the same market.

Unsorted and pre-sorted

149. We now turn to look at the issues of volume and level of sortation (pre-sort or unsorted) which are both intrinsically linked. Pre-sorted services require that customers present mail that has been sorted (typically to either delivery office or mail centre level). The sortation can be undertaken by the customer themselves, or can be outsourced to a mailing house. By presenting the mail already sorted, customers pay a lower price per item relative to unsorted products.

150. From a supply side, the question becomes whether it is possible for an existing provider of pre-sorted mail services to readily switch into the supply of unsorted bulk (high volume) services. As acknowledged by Postcomm, a firm moving into unsorted (high volume) would need to collect from more locations and with a lower volume per customer, which is likely to lead to high per unit collection costs.[65] To undertake this, a firm is likely to need access to additional vehicles and labour, which may entail a degree of investment. Similarly, an operator currently providing only pre-sorted services would not need sorting machines, but these would be required if that operator were to provide an unsorted service. The need to acquire access to sorting machines may well entail a degree of investment, although as noted by Postcomm, the extent of that investment is unclear and will depend on the network configuration of the firm in question.[66] Postcomm indicated that, on the assumption that an entrant into unsorted mail might need to acquire 10 sorting machines, this would translate to a capital outlay in the region of £10m. This kind of capital outlay would, Postcomm suggest, be sufficient to indicate that on the supply side, pre-sorted and unsorted mail could be considered to be in separate markets.[67] RMG does not have any further evidence to add to this.

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64 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 3.92

65 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 3.100

66 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 3.102

67 See Postcomm May 2010 Consultation Document, 'Laying the Foundations for a Sustainable Postal Service.', Annex 2 'Analysis of Markets' para 3.104

151. It should be noted (as Postcomm did) that firms could access sorting machines on a leasehold basis, which would mitigate the need for investment, thus increasing supply side substitutability between unsorted and pre-sorted products. RMG would agree with this, although we note that, were a firm to choose a lease model for supplying unsorted mail, this would result in there being higher opex in unsorted relative to pre-sorted services. In turn we would expect this to lead to there being price differentials between unsorted and pre-sorted services, which could lead to there being separate markets on the demand side.

152. On the demand side, the differing volume thresholds between the unsorted and pre-sorted product range will limit, so some degree, the extent to which customers can switch between them. To be eligible for Royal Mail's pre-sorted products (Mailsort 1400 and Mailsort 120) a customer must post a minimum of 4,000 items per mailing.[68] With regard to Royal Mail's unsorted bulk products, PPI has no minimum requirement and Cleanmail has a minimum requirement of 1,000 items per mailing.[69] Consequently, customers using unsorted products but posting below the pre-sorted threshold (4,000 items per mailing) cannot choose to substitute to pre-sorted products.

153. We have examined whether other operators apply a similar volume threshold to Royal Mail for pre-sorted products. This is relevant because, if other operators applied differing thresholds (and in particular materially lower pre-sorted thresholds) it might enable increased substitution between unsorted and pre-sorted products (because it would give customers with lower posting volumes an opportunity to access pre-sorted products via downstream access). TNT's pre-sorted products (TNT Premier 120, 700 and 1400) have minimum posting volumes of 4,000, 10,000 and 4,000 respectively.[70] These thresholds are all equal to or greater than those of Royal Mail's pre-sorted products. Therefore, TNT's pre-sorted offers do not seem to increase the potential number of marginal customers, whom could substitute from unsorted to pre-sorted products.

154. For any customer that meets the pre-sorted volume threshold, the purchase decision must be based on whether any costs they might incur in taking the pre-sorted product would be offset by the benefit of receiving a lower pre-sort price.

155. In practice, customers purchasing pre-sorted products typically do so through mailing houses. In order to gain access to pre-sorted products, mailing houses use software[71] to maintain the correct ordering of mail throughout the production

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68 Royal Mail Product A-Z and published price guides for 2010/11. Note that for MS 1400, the minimum requirement falls to 2,000 per mailing for items being sent within the same post code.

69 Royal Mail Product A-Z and published price guides for 2010/11.

70 As published on TNT's website: http://www.tntpost.co.uk/Mail/01Mail_Solutions--Premier.html

71 For example, see: http://www.capscan.co.uk/sortcode.aspx

process. For example BTB Mailflight (a large mailing house) state on their website: *"Sophisticated software and data processing capabilities are necessary to sort the records into mailsort order, to produce all the printed reports, produce the Royal Mail bag labels and to maintain sortation throughout the job."*[72]

156. To further our understanding of pre-sorted purchasing decisions, RMG spoke to a leading mailing house. The mailing house told us that, in general, the decision to purchase pre-sorted mail is made primarily on volume grounds, as customers with a volume in excess of the pre-sorted volume threshold (4,000 items) would almost always benefit from the discounted pre-sort price. The mailing house told us that, from a customer's perspective, the costs associated with taking a pre-sorted product are minimal. Often customers already provide data to the mailing house in a format ready for pre-sortation. Where this is not the case, the mailing house can provide the data services for a charge that is relatively small compared to the overall posting cost. Consequently, the mailing house's view was that customers using pre-sorted products would not substitute to unsorted products even if the pre-sorted price was increased from current levels. This would most likely be the case for as long as there was any discount for the pre-sorted product (due to the small costs associated with accessing the pre-sorted product).

157. The mailing house also said that its charging structure for providing the data services required to access pre-sorted products (for customers that did not provide data in a format already suitable for pre-sortation) gave lower prices to larger customers. This reflected the fact that the mailing house incurred some fixed costs in providing the services, which it had to recover.[73]

158. The mailing house informed us that, for any mailing, there might always be a proportion of mail that had to be sent unsorted. This could be due to errors in the customer's underlying database, or due to mailing volumes in a particular region not meeting the minimum pre-sorted requirement. In either case, it would clearly not be possible for these unsorted volumes to switch to pre-sorted. In summary, the mailing house told us that there was (i) no scope for unsorted mail to substitute to pre-sorted; and (ii) very limited scope for pre-sorted mail to substitute to unsorted for so long as there was any pre-sort discount.

159. Given the above description of customer purchasing decisions, RMG believes that the demand side constraints between pre-sorted and unsorted services are asymmetric (where pre-sorted prices are constrained by unsorted prices, but not vice versa). This is because, given the existing pre-sorted discounts (and relatively low costs associated with accessing pre-sorted services through a mailing house), those larger customers for whom it is currently commercially rational to take a

72 http://www.btbmf.co.uk/mailsort_mailing_houses.htm

73 For example, software and overheads.

cheaper pre-sorted product will already be doing so. Therefore, a 5% to 10% increase in the price of unsorted products is unlikely to lead to switching into pre-sorted products. However, the opposite would not necessarily be true. This is because if pre-sorted prices are increased such that the differential between pre-sorted and unsorted is eroded completely (or sufficiently reduced such that the price differential is less than the cost differential from a customer's perspective) then clearly it would be rational for customers to switch from pre-sorted services into unsorted services.

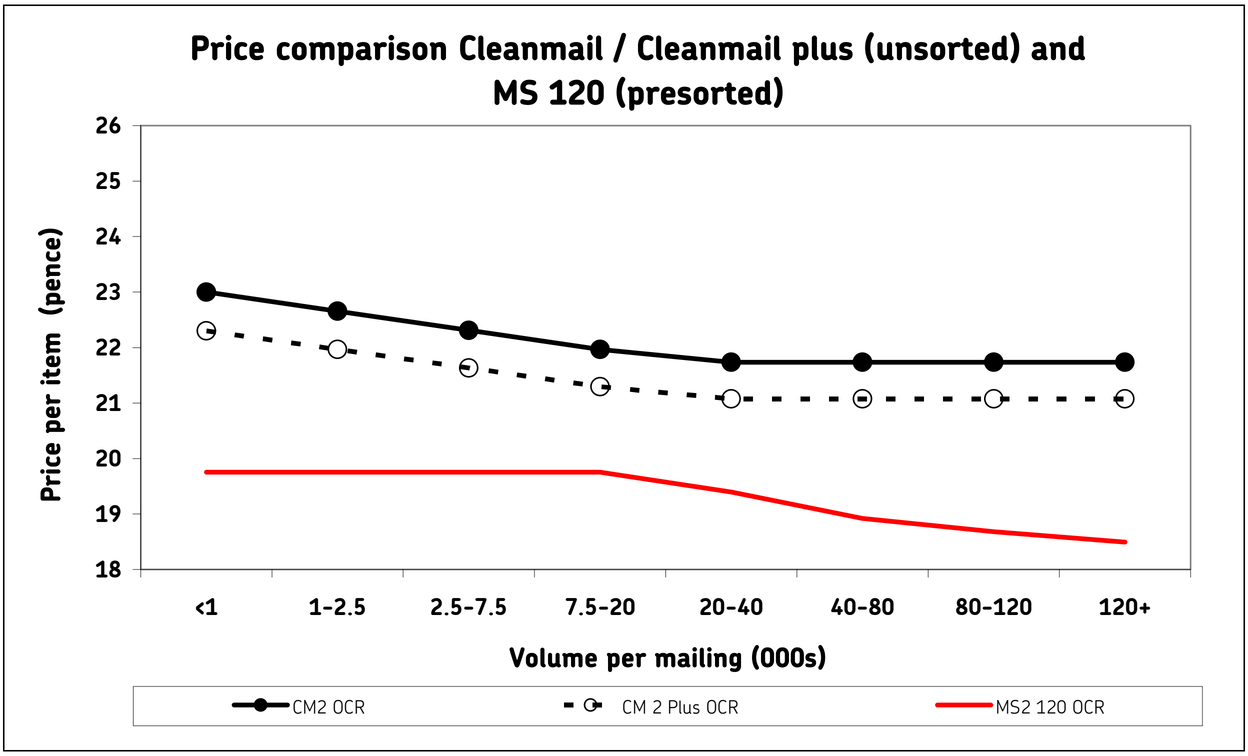
160. Following the above, we need to consider whether a 5% to 10% price increase in the price of pre-sorted products would lead to significant switching into unsorted products. To consider this issue it is appropriate to examine price differentials between pre-sorted and unsorted products. The table below shows the AURs for RMG's key unsorted and pre-sorted products in 2009/10. It indicates that where the level of machineability (OCR/CBC) is the same, the AUR (price) for the unsorted version is up to [✂] more expensive than the pre-sorted equivalent.

Table 8: AUR comparison for unsorted and pre-sorted products

[✂]

161. Clearly an AUR comparison, as shown above, is not entirely informative of price differentials. This is because effective prices are also driven by volume discounts and therefore, differences in AURs can arise due to there being differences in the size of customers across the products. It is thus, also necessary to undertake a comparison of list prices for hypothetical customers of similar volume levels. To this end, a comparison of prices for unsorted (Cleanmail 2C and Cleanmail Plus 2C OCR) and pre-sorted (MS 2C 120 OCR) customers of different sizes (for machineable products) is shown below. The price differential ranges from 8-18%, depending on the volume the customer is sending.

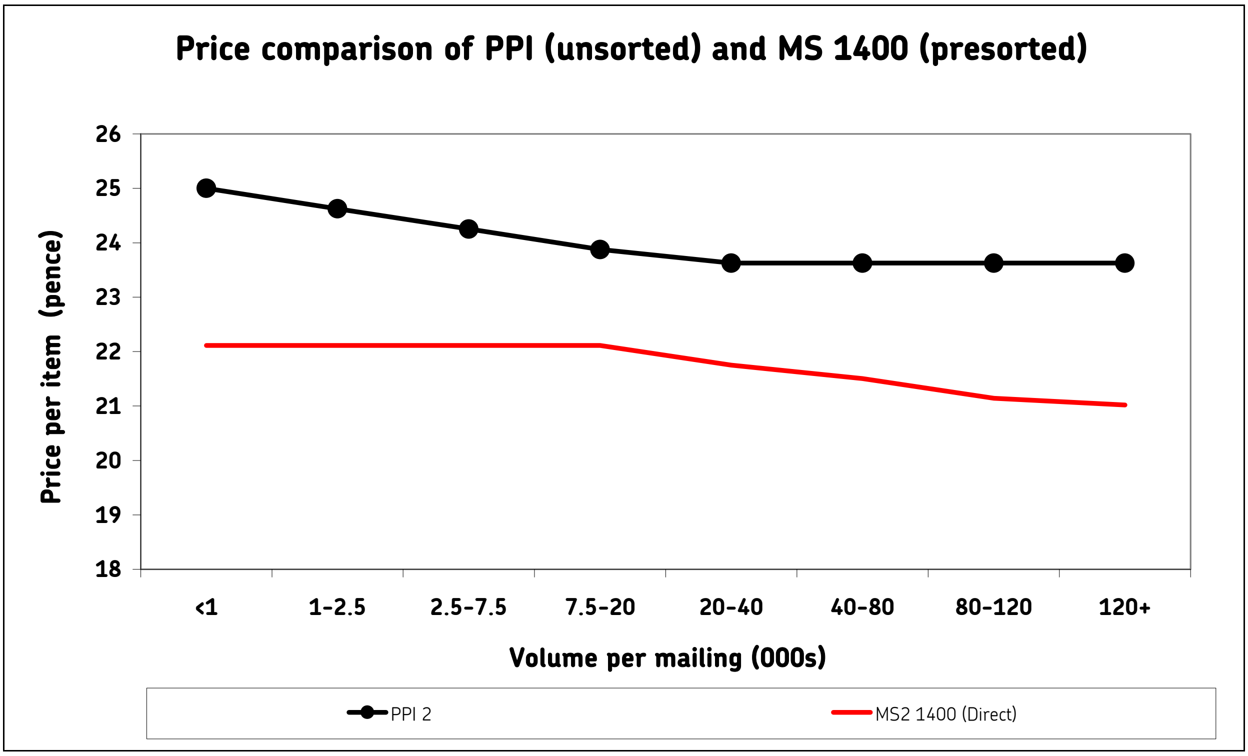
Figure 28 Cleanmail 2nd class and MS2 120 OCR prices by volume



Source: Royal Mail Tariff Guides

162. A comparison of prices for unsorted (PPI) and pre-sorted (MS1400) customers of different sizes for non-machineable (non OCR/CBC) products is also shown below. The price differential ranges from 8-13%.

Figure 29 PPI 2 and MS2 1400 (Direct) prices by volume



Source: Royal Mail Tariff Guides

163. With regard to the question of whether a 5% to 10% price increase in pre-sorted prices would lead to substantial substitution into unsorted products, the data suggests that, on balance, this would not be the case. This is because, for customers over the minimum pre-sorted posting threshold, it is likely to be commercially rational to remain on the pre-sorted product for so long as there is any price differential between pre-sorted and unsorted (due to the low costs associated with accessing the pre-sorted product).

164. As the analysis above shows, if pre-sorted prices were to rise by 5% we may assume that no customers would move to an unsorted product, since a price differential still persists, whereas for a 10% increase, the price differentials indicate that some customers may choose to do so. However, whether or not this would be profitable would depend on whether there was sufficient substitution from pre-sorted into unsorted. Given the spread of customer postings across all volume bandings, this is unlikely.

165. Further evidence on the demand side can be found in Royal Mail's estimates of cross price elasticities. Our internal analysis shows that the cross price elasticity between Cleanmail 2nd class and Mailsort 2nd class is low.[74] This is consistent with there

[74] Based on Royal Mail Group models and consistent with evidence previously provided to Postcomm as part of the BPQ in September 2008 (PCR4, 3.0.1 – SD3 price elasticity note).

being little demand side substitution between our pre-sorted and unsorted products, implying that they are in separate markets.

166. With regard to the SSNIP test, RMG suggests that, a 5% to 10% increase in the price of unsorted services would not lead to sufficient switching into pre-sorted services to render that price increase unprofitable. On the demand side, this view reflects the fact that larger customers, for whom it is currently rational to purchase a pre-sorted product, will already be doing so. Therefore further price increases in unsorted prices will not lead to material switching. However, a price increase of 5% to 10% in pre-sorted prices is likely to lead to some customers switching into unsorted services – at least where this 5% to 10% price increase erodes any price differential between the two products.

167. On the supply side, RMG notes that some investment may be required to provide unsorted services, although we have no further evidence to add to that set out by Postcomm. On balance, we suggest that the evidence currently indicates that pre-sorted and unsorted services are in separate markets.

Posting volumes

168. Supply side issues are particularly important when considering the high volume (or bulk) and low volume (non-bulk) distinction. The minimum posting requirement for most operators in the market is believed to be around 250 items per mailing, but this could be lower depending upon location of customer. For example, if a small business is located on a business park next to a very large sender of mail, then the additional collection costs associated with that customer will be minimal and therefore, more providers will be prepared to offer services to that customer and they will therefore have a greater choice of provider open to them. On the other hand, a small customer, with no other businesses in the vicinity in a rural area will face a more restricted choice. Further relevant evidence on this issue is contained in RMG's Entry Pricing Model (EPM)[75] which we use to model potential entrant prices. This model also allows us to examine potential cost-volume relationships for entrants by pipeline segment (as this is an element of the entrant's price). The EPM implies that entrants should be able to offer competitive upstream prices above a collection range somewhere between 250-4,000 items, adding further support a view that a collection size somewhere in the region of 250 items could be an appropriate definition for high volume or bulk mail.

169. This figure is also given further weight in that it is the minimum posting level quoted by TNT and UK Mail on their websites[76] for customers wishing to purchase their

75 Description contained in "PCR4 3.0.1 Volumes & Revenues Supporting Documents.zip" (RM Volume and Revenue Supplement PCR4 3.01 Supporting Documents)

76 UK Mail is actually 200 items per posting

services, indicating that customers posting above these volumes do have alternatives to Royal Mail.

170. There is also evidence to suggest that, whilst competition has initially focused on larger customers, over time the average size of customers being supplied by providers other than Royal Mail is declining. Figure 30 below shows the 12 month average number of customers and average spend of STL PPI account customers from April 2006 to Jan 2010. The data shows that the 12 month rolling average number of customers has increased by about [✂] over the period; but that the average spend of those customers has reduced by about two-fifths [✂]. The inference therefore, is that customers with above average STL mailings have progressively left STL. We also note that the reduction in total spend in STL PPI account is [✂].

Figure 30 Rolling 12 month STL customer analysis

[✂]

171. Figure 31 shows the 12 month average number of Cleanmail customers and the average spend of those customers from April 2006 to Jan 2010. It shows that the 12 month rolling average number of customers increased to four times the 2006 level by the end of the period [✂]. However, the average spend of those customers more than halved [✂]. The inference is that more customers have moved into Cleanmail, who were smaller in size than the average at the start of the period, and that these are likely to include some STL customers. The increase in total spend in Cleanmail is about [✂]. Hence STL PPI account customers have not just moved into Cleanmail.

Figure 31 Rolling 12 month Cleanmail customer analysis

[✂]

172. RMG would infer from the data that customers with above average STL PPI mailings have progressively switched away from Royal Mail over time. This is consistent with alternative postal providers focusing initially on the larger customers and then progressively seeking to attract smaller customers. Furthermore, RMG is beginning to observe reductions in the number of metered machines, as larger customers have started to transfer their volumes to alternative providers.

173. With reference to the SSNIP test framework, we consider that, following a 5% to 10% increase in the price of non-bulk products, customers would not switch into bulk services as (being non-bulk customers) they would not meet the bulk volume requirements. Therefore, the price increase on non-bulk would be profitable.

Similarly, a 5% to 10% price increase in bulk services is unlikely to lead to material switching of bulk customers back to non-bulk. Thus a demand–side analysis would indicate separate bulk and non-bulk markets, although the exact definition of what volume constitutes bulk is a grey area, depending upon location of the customer among other considerations. Whilst a minimum posting of 250 items is supported by a number of pieces of evidence, RMG understands from its Royal Mail Wholesale (RMW) business that this cut off could be as low as 100 items per posting for some customers. It is certainly likely that as other providers build scale, they will target ever smaller customers and the minimum posting requirement will therefore tend to get smaller.

174. In conclusion, RMG therefore finds that the evidence currently supports separate unsorted and pre-sorted markets and that unsorted can be further split by volumes into bulk and non-bulk, where non-bulk is defined as somewhere between 100-250 items per collection.

Issue 4: Whether markets can be defined on a UK wide basis

175. Royal Mail currently offers its access services and competes for customers on a national basis so we would agree with Postcomm that a national UK wide market is an appropriate definition for both wholesale and retail services.

Issue 5: Whether markets can currently be defined by application

Summary of Postcomm's and RMG's positions on applications markets

Postcomm's position	RMG's position
• Have not yet looked at this from a demand perspective (will form part of the November consultation). However, do not agree that from a supply-side the evidence is supportive of applications markets.	• RMG agrees that current evidence is not supportive of applications as markets. • On the supply side, operational activities do not vary by application; and thus this is not consistent with separate markets by application. • However, RMG believes that demand conditions do vary by application.

176. Royal Mail has, for commercial purposes, organised its business around applications (which refer to the use to which mail is put). These are: fulfilment, advertising, transactional, publishing and social. However, at present RMG's products do not fully align to applications, but rather, the products we provide tend to cut across the applications. For example, the same letter products could be used for direct mail (the advertising application) or for sending bank statements (the transactional application). However, we do have a Presstream product for publishers and an advertising product for wholesale customers. Due to the need to define markets in terms of products, RMG therefore accepts that at present, an application of the SSNIP test framework would not be supportive of defining markets on the basis of applications.

177. We note that from a supply side perspective, the operational activities of providing postal services are unlikely to vary depending on the application. This is because the applications in essence refer to the content of mail, which is largely independent of costs. Therefore, from a supply side perspective, there is no basis to believe that a firm would choose to supply letters products purely for one application rather than several. However, this could clearly change if firms (including RMG) were able to develop products by application, which had characteristics that led to there being differences in operational requirements.

178. On the demand side however, RMG believes there are material differences in competitive constraints by application (and we have previously provided Postcomm with a range of evidence to support this point).[77] In particular, RMG believes that advertising mail is especially constrained by wider media.

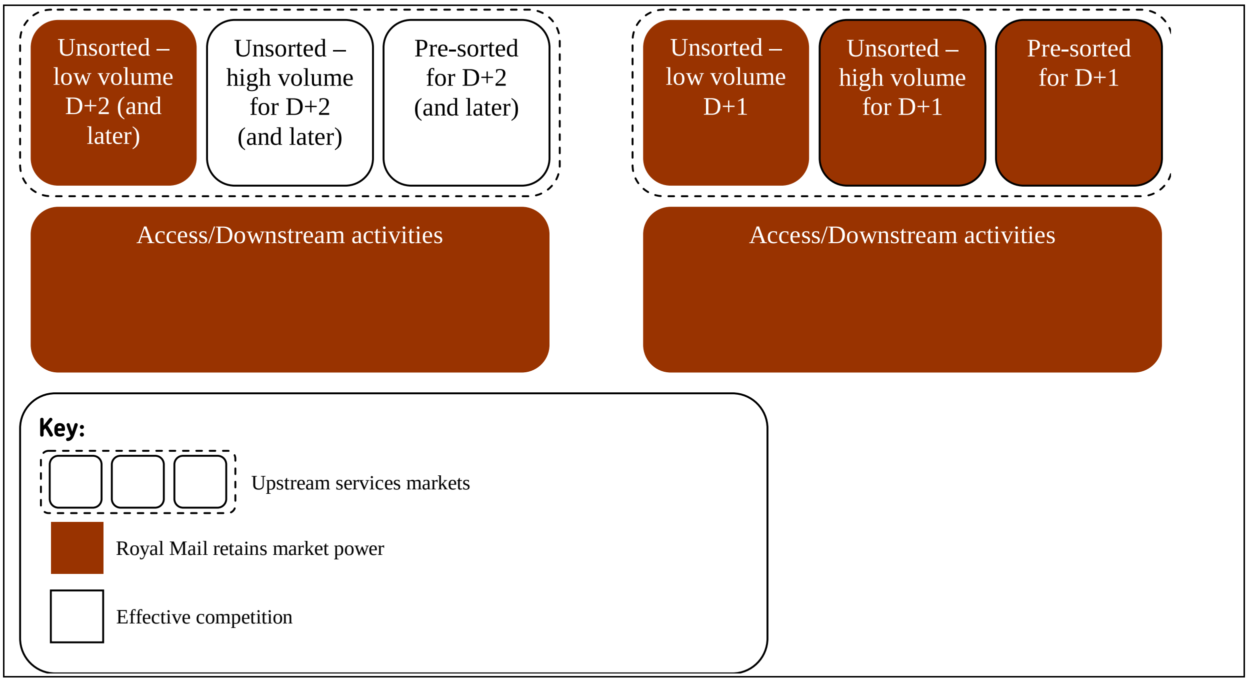
77 For example, see 'Advertising mail competitive dynamics' (January 2010) paper

179. More generally, RMG believes that differences in demand conditions across customer segments could mean that, over time, separate markets develop within mail at both the upstream and downstream level.

Summary of RMG's current views on market definition for letters products

180. Based on the evidence set out in the preceding sections, RMG believes that letters markets can currently be defined as shown Figure 32 below.

Figure 32 RMG's current views on relevant markets for letters



Conclusions and implications for regulation

181. In this section we set out, in headline terms, the key implications for regulatory scope that follow from our views on market definition as described in this paper. However, for a detailed description of our proposed amendments to the current regulatory framework, please refer to our response to Annex 4 of the Consultation Document.

182. Royal Mail agrees with Postcomm that deregulation can occur where Royal Mail has no market power, or even where it retains some market power. If Royal Mail has limited market power, or operates in a highly competitive market, then its ability to independently influence the market is limited and the market has effective competition. Royal Mail has provided evidence that this is the case in several markets (see detailed evidence contained in this Annex). However, services could be removed from Condition 21 and 7, where competition is sufficiently developed but has not developed to the level of effective competition. Consequently, the finding of services operating in a market with effective competition goes beyond the requirement for deregulation from Conditions 7 and 21.

Key conclusions for regulatory scope in packets and parcels markets

183. With regard to regulatory scope in packets and parcels markets, RMG believes that the detailed evidence set out in this document is consistent with the following.

- All RMG products that sit in the Express market should be free from regulation at all weights, as is currently the case.
- RMG believes there is a separate deferred high weight market for all items above 750g (including both deferred premium and deferred vanilla services) and that this market is effectively competitive. RMG therefore suggests that it would be appropriate for all deferred services to be deregulated above 750g.
- All RMG services in deferred premium markets should also be free from regulation at all weights. As we believe that tracking is a key distinguishing feature between the premium and vanilla markets (within deferred) by implication RM Tracked should be unregulated at all weights. This would further imply that it would be inappropriate to regulate any future products developed by RMG within deferred premium markets.

- Within the deferred market, RMG's current view is that there is a separate light weight vanilla market below 500g. With regard to the deferred <500g vanilla market, RMG accepts that effective competition has not yet developed. We therefore conclude that it would be appropriate for this market to remain regulated.
- The evidence currently suggests that, in the deferred market, there is effective competition for high volume customers (posting over 100k deferred items annually) in the 500g-750g segment.
- With regard to customers posting under 100k items pa in the 500g-750g segment of the deferred market, there is a separate deferred vanilla market. RMG accepts that effective competition has not yet developed in this space.

184. The table below summarises RMG's current views on the appropriate regulatory scope for packets and parcels markets. For further details please see our response to Annex 4 of the Consultation Document.

Table 9: RMG's views on regulatory scope in packets and parcels for 2011/12 and beyond

Market	Direct regulation of prices (Condition 21)	Pre-notification of prices, restrictions on product changes (Conditions 7)
Express	NO	NO
Deferred heavy (>750g)	NO	NO
Deferred premium services (all weights)	NO	NO
Deferred (500g-750g) high volume customers *(sending over 100k items pa)*	NO	NO
Deferred (500g-750g) vanilla services – low volume customers *(sending under 100k items pa)*	YES	YES – but modified*
Deferred light (<500g) vanilla services	YES	YES – but modified*

** RMG is proposing modifications to our notification periods. For details see our response to Annex 4.*

185. Whilst the current evidence on markets is consistent with the regulatory scope indicated in the above table, RMG would urge Postcomm to take a forward-looking perspective when making any decisions regarding regulatory safeguards and the scope for deregulation. We would therefore specifically ask Postcomm to consider, when making any deregulatory decisions regarding deferred vanilla packets, to go as far as it can beyond 750g; towards and potentially below 500g.

Key conclusions for letters markets and implications for regulatory scope

- RMG accepts that retail (upstream) and wholesale (downstream) are separate markets; but we believe that the evidence indicates that the retail D+2 pre-sorted market is effectively competitive and consequently, could be deregulated.
- RMG also believes that the evidence is consistent with the high volume D+2 unsorted retail market being effectively competitive; which could therefore, also be deregulated.
- RMG accepts that effective competition has not yet developed within: wholesale markets, D+2 (and later) unsorted low volume retail markets; and D+1 retail markets. We note however, that Postcomm are concerned that RMG could leverage market power in these areas into other retail markets. We refute this finding by Postcomm and the basis on which it has been reached. We discuss this further in our response to Annex 4 of the Consultation Document.

186. The table below summarises RMG's current views on the appropriate regulatory scope for letters markets (both in 2011/12 and beyond). Postcomm will note that our proposed regulatory scope for 2011/12 does not fully reflect our current views on letters markets and the extent of competition in those markets. [✂]. Certainly, beyond 2011/12, we would expect (given the evidence on letters markets set out here) there to be no regulation of deferred bulk mail retail markets.

Table 10 RMG's views on regulatory scope in letters for 2011/12 and beyond

Market	2011/12		Beyond 2011/12	
	Direct regulation of prices (Condition 21)	notification of prices, restrictions on product changes (Conditions 7)	Direct regulation of prices (Condition 21)	notification of prices, restrictions on product changes (Conditions 7)
Pre-sorted D+1	YES	YES – but modified*	YES	YES – but modified*
Pre-sorted D+2 (and later)	YES	YES – but modified*	NO	NO
Unsorted high volume D+1	YES	YES – but modified*	YES	YES – but modified*
Unsorted high volume D+2 (and later)	YES	NO	NO	NO
Unsorted low volume D+1	YES	YES – but modified*	YES	YES – but modified*
Unsorted low volume D+2 (and later)	YES	YES – but modified*	YES	YES – but modified*

** RMG is proposing modifications to our notification periods. For details see our response to Annex 4.*

187. Generally. RMG's aspiration is to ensure that we move towards a regulatory framework that allows us develop a range of products and services that meet the differing needs and requirements of our customers; and which reflects underlying differences in demand side conditions by application.