



The proposed regulatory regime for 2011/12

Annex 4 - A response to the Postal Services Commission's
May 2010 consultation document

August 2010

S UMMARY

Royal Mail first raised concerns about the access regime and broader regulatory regime in response to Postcomm's interim review (2007). Royal Mail's response to the Independent Review of Postal Services (the Hooper Review) further described the onerous nature of the current licence and regulatory controls. The issues relating to the current controls were confirmed by the Hooper Report ("Modernise or Decline", 2008)

Since 2007/08, competition in the retail pre-sorted market has developed at pace such that, even according to Postcomm, Royal Mail now has about 40% share of the market. This has primarily arisen from the access headroom constraint that determines the minimum percentage difference between Royal Mail's retail and wholesale prices; and which has not changed since it was first set in 2006. The headroom is a blunt regulatory tool that has needed to be amended for some time. In addition, during this period competition in packets and parcels has intensified. However there has been no change to the regulatory controls.

In Annex 4 of its May 2010 consultation, Postcomm proposes limited changes to the operation of Condition 7 and 21 in the light of its market review. It proposes to reduce the period of publication from 3 months to 6 weeks under Condition 7 and changes to the headroom regime under Condition 21. In the process it also suggests the removal of above 750g, and prospectively above 500g, B2X packets from Condition 21. It proposes the market above 2kg has effective competition.

A change to the regulatory regime is now essential for April 2011. The high level changes that we propose for 2011/12 are only an incremental step towards a new regulatory regime for 2012 and beyond. They are as shown in the table.

- **Deregulation of services**
 - Removal of above 750g packets from Conditions 7 and 21
 - Removal of contracts for over 100k items, and prospectively all items, in 500-750g packets from Conditions 7 and 21
 - Removal of deferred premium packet services from Condition 7
- **Wholesale led control**
 - The move to a Wholesale led control in 2011 as under Postcomm's option (iv), subject to clarification of the licence modification and operation of the average headroom basket.
- **Headroom control**
 - Introduction of an average headroom basket for retail services where there are access equivalent services currently in Condition 21, with the average headroom for 2c letter format reduced to significantly below 3p per item to better reflect Royal Mail's upstream costs as provided to Postcomm.
- **Notification and publication of prices**
 - For services in markets where there is effective competition there should be no requirement for notification or publication
 - For Basket A and B services (other than where subject to effective competition, notification 3 months in advance with publication 4-6 weeks in advance
 - For services in the new headroom Basket (Basket C) and new services or variants, notification only 3 months in advance
- **Allowed revenue**
 - Amendment to the Condition 21 wording to extend the applicability of the volume adjuster to 2011/12 and then increase allowed revenues (recognising that the actual revenue likely to be achieved will be a significantly reduced figure because of substitution and switching)

Deregulation of services

Postcomm proposes, and Royal Mail concurs, that deregulation can occur where Royal Mail has no market power or even where it retains some limited market power, but the nature and extent of competition is such that certain forms of regulation are no longer needed (i.e. there is sufficient competition to protect the interests of users). 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 and this provides the strongest case for deregulation. Further, services could be removed from Condition 21 and 7, where competition is sufficiently developed but has not developed to the level of effective competition. Royal Mail has provided evidence that there is effective competition in several markets (see Annex 2). The finding of services operating in a market with effective competition goes beyond the requirement for deregulation from Conditions 7 and 21.

Postcomm also identifies the need for some further regulatory safeguards, primarily through the provision of information, for deregulation to occur. Primarily it identifies the need for cost transparency to be developed for 2011 and accounting separation from 2012.

In Postcomm's view the information needed for deregulation in 2011/12 is:

- to know the relevant market definition and assess market power;
- to assess potential cross subsidy from the non-competitive markets into the competitive markets;
- to assess whether the level of charges in the competitive market covers estimates of the long run incremental cost (LRAIC).

We do not concur that these elements are necessary in order for deregulation to take place, but in any event this information can be derived from already provided information and so there is no reason to delay deregulation until 2012.

In our response to Annex 2, Royal Mail sets out the evidence in support of Royal Mail having very limited market power or operating in a highly competitive market such that there is sufficient competition for deregulation in:

- deferred retail pre-sorted mail market,
- deferred unsorted high volume market (above 250 items per mailing)
- deferred packets market above 750g (and prospectively above 500g)
- deferred packets 500-750g (above 100k items per annum)
- deferred premium and express packets

Since the publication of Postcomm's consultation, the Government has reconfirmed its intention to introduce VAT on some postal services from 31 January 2011. It retains the current VAT exemption for services under Condition 2 (universal

services), Condition 9 (access services) and Condition 21 (price controlled services), but introduces VAT for all other services. Royal Mail's position for 2011/12 in respect of the price control is based on the fair assumption that the draft legislation will be passed. The introduction of VAT would have consequences for services removed from the price control. [X].

Wholesale led control

Postcomm proposes an option (iv) for the headroom control in 2011, whereby Royal Mail Wholesale would set prices before Royal Mail Letters. Royal Mail supports this in principle but has not seen any draft licence modifications to confirm Postcomm's proposals. The timescales to complete this are now very tight if Royal Mail Wholesale is to prepare prices for a tariff in April 2011 (which requires Royal Mail Wholesale to prepare prices in November 2010). If Postcomm does not confirm the arrangements soon the default position of option (ii) might occur and the opportunity to implement a step towards better regulation will be delayed yet further.

Headroom basket

Postcomm proposes that the headroom basket is set such that the average upstream price exceeds a price floor based on Fully Allocated Costs (FAC). It uses an estimate of level of the upstream FAC at 3p for the 2c letter format. The actual level of upstream FAC for the letter format is significantly below 3p, as provided to Postcomm, and this should be reflected in the setting of the average price floor. Royal Mail supports the move to an average basket in principle. However, this would require a number of technical points discussed later in this annex, including significantly lower minimum price floors than proposed by Postcomm, to be clarified and resolved immediately for implementation for April 2011.

Notification and publication

Royal Mail believes that Postcomm's requirements for notification and publication of prices (under Condition 7) can and should be developed to reflect the high level degree of competition now present. Nevertheless, for 2011/12, it recognises the need to inform the general public of prices and the regulator of information that will inform it about its ex ante headroom basket control.

Royal Mail proposes that there should be no regulatory obligation to notify or publish in relation to services where there is effective competition in the relevant market. Further, it proposes to notify 3 months in advance and publish 4-6 weeks¹ in advance for Baskets A and B, services and to notify only 3 months in advance (and not have an obligation to publish) for the headroom basket (Basket C) services and new services and variants. This would avoid double regulation of

¹ The timescale would be dependent on the time taken for Postcomm to review Royal Mail's proposed treatment of new services with respect to the baskets. For example if it takes Postcomm 1 month to confirm the allocations, it might take another month to finalise prices, complete and external audit and publish, leaving 4 weeks to implementation.

headroom basket services through both Condition 21 and Condition 7, when the market is already subject to sufficient competition for full deregulation in 2011/12.

Allowed revenue

Postcomm focuses on deregulation and the regulatory safeguards required for deregulation to occur and there is significantly less focus on the finances of Royal Mail. It does not propose any change to the level of allowed revenue, but does include the extension of the existing volume adjuster to 2011/12.

Royal Mail is working off a price control set five years ago, the drafting of which did not envisage the continuation of that control beyond 2010/11. In particular, the volume adjuster (G factor) mechanism is not provided for beyond 2010/11. As volumes have decreased significantly since the price control was set, it is vital that this drafting flaw is remedied. Royal Mail supports the extension of the volume adjuster to 2011/12 but also believes that it needs to be amended (or an separate amendment to allow for price increases needs to be made) to more adequately recompense Royal Mail with extra allowed revenue in the presence of the continued fall in volumes. Further discussion would be necessary to discuss the precise mechanism for bringing forward price increases and increase the allowed and earned revenues to safeguard the progress of on-going modernisation, the financial sustainability of Royal Mail and therefore the Universal Service.

1. INTRODUCTION

- 1.1 This document sets out Royal Mail Group's (RMG) position on the regulatory regime for 2011/12. It has been prepared in order to respond to the consultation questions raised by Postcomm in Annex 4 of its May 2010 Consultation Document. RMG is committed to working with the regulator to help ensure that a regulatory framework for 2011/12 is developed that is a positive move towards securing a vibrant and sustainable mails industry.
- 1.2 Postcomm's proposals recognise the change in the market and a need for changes to the regulatory regime for 2011/12 and beyond. These were confirmed in the Hooper report (2008), including the need to undertake a market review and revise the headroom regime. The May consultation discusses both market definition and the access headroom regime, with a view to changes to the control from April 2011. The consultation response does not address the price control for 2012/13 and beyond, but focuses on the regulatory regime for 2011/12.
- 1.3 Our response has been influenced by the Government's draft legislation on VAT. It would mean that Royal Mail's services under Conditions 2, 9 and 21 will remain VAT exempt. Given the tight timelines involved in amending systems to introduce the VAT changes from 31 January 2011, we are proceeding on the assumption that the legislation will be put into effect.
[X].
- 1.4 In the light of the VAT legislation, Royal Mail believes that it and Postcomm will need to look at the VAT effects for RML of services being taken out of Condition 21. Royal Mail believes that it would be appropriate to retain these services, as currently, under Condition 21 for a transition year in 2011/12 while this is considered further.
- 1.5 This Annex response discusses the principles for deregulation and is focused on the proposals for 2011/12. It takes information from the response to Annex 2, to comment on Postcomm's overall principles for deregulation. Section 2 discusses the overall approach to deregulation. The proposal to move to a headroom control is included in Section 3. Section 4 discusses the notification and publication requirements for retail services. The retail baskets are discussed in Section 5. Section 6 discusses the volume adjuster and allowed revenues,
- 1.6 Appendix 1 includes supplementary analysis of the change in allowed revenue arising from a change to the volume adjustment mechanism.

2. APPROACH TO DEREGULATION

Summary

Royal Mail believes its Licence is clear that deregulation should occur where competition in the relevant services is sufficiently developed to protect the interests of users. Where Royal Mail has no or limited market power, this provides clear evidence of there being sufficient competition, although as Postcomm acknowledge in their consultation document, this is not the only test for deregulation. In our response to Annex 2, Royal Mail sets out the evidence in support of Royal Mail having very limited market power or operating in a highly competitive market such that there is effective competition for:

- deferred retail pre-sorted mail market,
- deferred unsorted high volume market (above 1000 items per mailing)
- deferred packets market above 750g (and prospectively above 500g)
- deferred packets 500-750g (above 100k items per annum)
- deferred premium and express packets

Since the publication of Postcomm's consultation, Government has published legislation for introduction of VAT in January 2011. The proposal would have consequences for services removed from the price control. [X].

General approach

2.1 Postcomm states that "*We propose to reduce the amount of regulation where our market study has concluded either that Royal Mail has no market power, or even where it retains market power, where we consider that the nature and extent of competition is such that certain forms of regulation are no longer needed*".

2.2 Postcomm's principles for deregulation are summarised as follows:

Condition 11	-	Would not apply where a market has effective competition, but could apply where a development in the market changes the position.
Condition 7	-	Would not apply where Royal Mail has no market power, but would apply to all services (including bespoke and services provided under tenders) in a market where there is market power.
	-	Where Condition 11 applies, there is thought to be the potential need for notification under Condition 7 to assist in any enquiry or investigation.
	-	There would be 3 months notification to Postcomm and 6 weeks notification to the market, in recognition of the need for greater pricing flexibility for Royal Mail and limited occurrences of an investigation
Condition 21	-	Price controls would not apply where Royal Mail has no market power, and might also not apply where there is some market power and effective regulatory safeguards in place.
Universal services	-	Conditions 7&11 would apply to universal services whether or not there is market power.
	-	Condition 21 might also continue to apply to universal services

2.3 In Royal Mail's Licence there is provision for Royal Mail to apply for services to be removed from the price control where "*sufficient competition... has*

developed” to protect the interests of users. 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 or “exploit” customers is limited and the market has sufficient competition to protect the interests of users. Further, services could be removed from Condition 21 and 7, where competition is sufficiently developed but has not developed to the level of effective competition. Royal Mail has provided evidence that there is effective competition in several markets (see Annex 2). The finding of services operating in a market with effective competition goes beyond the requirement for deregulation from Conditions 7 and 21.

- 2.4 Most businesses have a degree of market power and this is not a universal detriment that requires regulation per se. For example, a corner shop charges a premium because it offers services of convenience to local residents – it has a degree of market power within an area but is not regulated. Therefore, Royal Mail does not believe the main criterion for full deregulation is Royal Mail having “no market power”. A criterion of Royal Mail has limited market power or operates in a highly competitive market should be more than sufficient for full deregulation to occur.
- 2.5 In Royal Mail’s Licence Condition 7 there is reference to a Postcomm direction for exemption from notification and publication of services, but no reference to a measure of competition to attain the exemption. In general, the prior publication of prices to the market by Royal Mail provides information to competitors as well as customers. In a market that has a sufficient level of competition already, this can lead competitors to have an advantage over Royal Mail, and remove Royal Mail from the provision of a service simply by offering a marginally lower price after the publication date for Royal Mail’s services. It would not be proportionate and targeted regulation to retain a requirement for Royal Mail to publish prices in such circumstances. Consequently, the removal of the requirement for Condition 7 to be published should not be dependent on there being effective competition. The criterion should be based on there being actual competition being present in the market.
- 2.6 In its assessment of market power, Royal Mail finds the distinction made by following two categories in Figure 2 of Postcomm’s Annex 4 are unnecessary:
- “Competition is developed to some extent but Royal Mail retains market power”; and
 - “Although Royal Mail retains market power, the competitive environment is such that we are considering changes to the regulation in 2011 to ensure that it is better targeted and proportionate”

In both instances, Royal Mail has limited market power or operates in a highly competitive market sufficient for full deregulation to occur.

2.7 Royal Mail believes its Licence is clear that deregulation should occur where competition in the relevant services is sufficiently developed to protect the interests of users. Where Royal Mail has no or limited market power this provides clear evidence of there being sufficient competition although as Postcomm acknowledges in their consultation document, not the only test for deregulation. In our response to Annex 2, Royal Mail sets out the evidence in support of Royal Mail having limited market power or operating in a highly competitive market such that there is effective competition for:

- deferred retail pre-sorted mail market,
- deferred unsorted high volume market (above 250 items per mailing)
- deferred packets market above 750g (and prospectively above 500g)
- deferred packets 500-750g (above 100k items per annum)
- deferred premium and express packets.

2.8 Since the publication of Postcomm's consultation, Government has published draft legislation for introduction of VAT from 31 January 2011. The proposal retains the current VAT exemption for services under Condition 2 (universal services), Condition 9 (access services) and Condition 21 (price controlled services), but introduces VAT for all other services. Royal Mail's position for 2011/12 in respect of the price control is based on the assumption that this comes into effect. [X].

Information for deregulation

2.9 Postcomm states the need for cost transparency for 2011 and accounting separation for 2012 as pre-requisites for deregulation. Postcomm expresses a concern that Royal Mail might use its market power in other markets to influence its behaviour in those competitive markets. For example, Postcomm suggests that the deregulation of the services provided by Royal Mail might enable Royal Mail:

- to benefit by unfairly cross subsidising its competitive activities from non-competitive activities; and
- to price below cost and foreclose the market for competitors
- to leverage market power from Royal Mail Wholesale to Royal Mail Letters services.

2.10 While Postcomm has set out cost transparency and accounting separation as the provision of information necessary for deregulation, Royal Mail believes that the requirements of ex post investigations should suffice alongside the existing information provisions in the Licence. These would focus on market

definition and the pricing relative to long run average incremental costs (LRAIC).

- 2.11 The economic basis for an assessment of cross subsidy is with respect to the relevant market revenues covering LRAIC and not exceeding stand alone costs – it is not made through comparison with fully allocated cost (FAC). The economic basis for an assessment of foreclosure is also centred about the recovery of LRAIC, though an assessment against average avoidable costs (AAC) can also be relevant. Royal Mail believes that it prices above LRAIC estimates in setting the overall level of prices in relevant markets.
- 2.12 A long run marginal cost (LRMC) estimate is formed in Royal Mail’s costing system and could be used, in most cases, to form an indication of the costs to be recovered by revenues for the relevant market. Indeed, this was used in the investigation by Postcomm on Mailsort Light (May 2010). Further, a costing manual is being developed to show in detail how Royal Mail’s costing system conforms to the agreed Guidelines and Methodological principles (see our response to Annex 3).
- 2.13 Consequently, we disagree with Postcomm that accounting separation is necessary for assessing the issue of cross subsidy and therefore with Postcomm’s statement that “*some from of access headroom will need to continue at least until there is market confidence in the results of separated accounts*”.² There is significant provision of information under the licence, including through Royal Mail’s Regulated Accounts.
- 2.14 Further, Postcomm’s Annexes 2 and 4 suggest that Royal Mail could leverage market power when setting its access and retail prices. Postcomm believes this could be the case through limiting access services, setting onerous non-price terms or setting its prices.
- 2.15 In practice the headroom basket under Postcomm’s preferred option (iv) would ascribe an existing access service to each retail service, and implicitly would recognise that access services are available to serve the market. Further, while there are non-price conditions in the access contracts, these contracts have led to significant take up and there can be no grounds for saying that they are unduly onerous. Finally, the scope for Royal Mail Wholesale to increase prices is constrained by the price control, as well as the threat of non-postal and bypass competition, and the scope for RML to reduce prices is constrained by competition law. Thus there are good grounds to deregulate in 2011/12 without further accounting separation.

² Paragraph 2.23 of Postcomm’s May consultation document Annex 4 (2010)

3. WHOLESALE LED CONTROL

Summary

Postcomm proposes an option (iv) for the headroom control in 2011, whereby Royal Mail Wholesale would set prices before Royal Mail Letters, Royal Mail supports the move to a Wholesale led control in 2011 as under Postcomm's option (iv) subject to clarification of the licence modification and operation of the average headroom basket. The timescales to complete this are now very tight if Royal Mail Wholesale is to prepare prices for November 2010 in order to achieve an April tariff change. If Postcomm does not confirm the arrangements soon the default position of option (ii) might occur and the opportunity to implement a step towards better regulation will be delayed yet further.

Regulatory timetable for April 2011

- 3.1 Postcomm describes four options for the access headroom, three involving Royal Mail Letters setting prices first and one involving Royal Mail Wholesale setting prices first. Postcomm's preferred option (iv) is for Royal Mail Wholesale to set its prices first, in November, and for Royal Mail Letters and its competitors to set prices subsequently.
- 3.2 Royal Mail supports the proposal for Royal Mail Wholesale to set prices first. However, the details of the operation and process for this option are not confirmed in Postcomm's consultation. Timescales to complete this are now very tight if Royal Mail Wholesale is to prepare prices for November 2010. If Postcomm does not confirm the arrangements soon the default position of option (ii) (of a reduction in the level of headroom in the current Licence framework) might occur and the opportunity to implement a step towards better regulation will be delayed yet further

Price setting timetable for April 2011

- 3.3 Postcomm's document outlines a timeline to April for the setting of prices by Royal Mail Wholesale and Royal Mail Letters. At present, the price setting process involves Royal Mail Letters setting price proposals in October, which are audited in November and published in December, with Royal Mail Wholesale prices then following in January (absent of any audit process).
- 3.4 Under Postcomm's preferred option, the timetable for the setting of the control is now challenging for April 2011, because it would:
 - reverse the order of the price setting between Royal Mail Letters and Royal Mail Wholesale;
 - require two audit process, one for Royal Mail Wholesale and another for Royal Mail Letters;
 - require Basket A prices to be set before the audit can take place.The challenge is recognised, at least in part, in Postcomm's proposals.

- 3.5 For Postcomm's preferred option, Royal Mail Wholesale price proposals would likely be set in October, audited in November and published in early December. Royal Mail Letters Basket A prices would likely be prepared in December-January, Basket B and headroom prices prepared in December-January and audited in early February for possible notification to customers or publication by the end of February. For 2011/12, Royal Mail Letters would likely need to set Basket A prices in December to allow for the 3 months processing required for stamps services to be implemented. This means that the Basket A prices would likely need to be determined by the end of December, with the audit process later in February.
- 3.6 In theory, the audit process could identify changes necessary to comply with Licence Condition 21(5) to undertake all reasonable endeavours to not over-recover in either Baskets A or B. If a change was required in Basket A, having set the prices 3 months in advance, Royal Mail would not be able to implement any changes for April 2011 and would both incur additional cost and confuse customers if changes were implemented at a late date. The need to amend the proposed prices is less likely if Basket A has a significant under-recovery (as is currently the case). However, consideration might need to be given to a circumstance where the audit process identified an over-recovery for Basket A. In our view, an over-recovery would lead to a penalty reduction in allowed revenues for the subsequent year and this should be sufficient incentive for Royal Mail Letters to decide whether or not to amend its prices in the light of the auditor's review.

Basket definition

- 3.7 Postcomm has not provided licence modifications to confirm precisely how the wholesale basket will operate. For example,
- the consultation refers to an average mark up of 2.5%³ or individual mark ups for letters, large letters and packets of 3%, 1% and -0.1% respectively⁴;
 - it is also unclear whether these factors will apply to mid-weight prices within a range for 2010/11, as is currently the case for the retail baskets, or for every price point.
- 3.8 Royal Mail believes that the average mark up of 2.5% should be applied to mid-weight prices within a range for 2010/11, as is currently the case for the retail baskets, or for every price point. This would be in line with the operation of the retail baskets. The overall level of the mark up should also take account of the level of allowed revenue, including the level of the volume adjuster and a share of the expected under-recovery from Basket B from 2010/11 (see Section 6).

³ Table 23 of Postcomm's May consultation document Annex 4 (2010)

⁴ Table 18 of Postcomm's May consultation document Annex 4 (2010).

3.9 In the period following publication of the consultation Royal Mail sought further clarification from Postcomm of the regulatory treatment of the Wholesale basket:

- the services in the Wholesale basket would be the same as those services currently listed as Controlled Services within Condition 21. It would exclude any access services introduced since March 2006 and currently regulated through Condition 21(5), such as Responsible Mail, Direct Mail Access and Access 70. Royal Mail believes that these services should be also considered as being in the Wholesale basket, because they are formed as discounts off the standard access services. However, it might be simplest to exclude any new services that might be introduced in 2011/12.
- of those services listed in the Wholesale basket, items weighing above 750g (and prospectively above 500g) would be excluded from the Wholesale basket. If the provision of these services remains under Condition 9, then they would continue to be VAT exempt; and, conversely, they would be VAT rated if their provision is removed from Condition 9. Royal Mail understands that Postcomm will consult on access later in the year.

3.10 More generally, Postcomm's consultation proposes that all new access services are to be excluded from the Wholesale basket. Royal Mail believes that Postcomm's market definition indicates that these services are all in a market where Royal Mail has considerable market power (other than for above 750g, and prospectively above 500g) and therefore believes that the revenues for these contract services could be brought within the Wholesale basket (excluding above 750g, and prospectively above 500g). The main benefit of doing so would be to clarify to customers that these services would remain VAT exempt beyond 2011/12.

3.11 Postcomm proposes that the basket has no price sub-caps and therefore provides the flexibility for Royal Mail Wholesale to rebalance access prices. In practice, more than a single price movement from one year to the next is precluded by the bilateral contracts. However, Royal Mail Wholesale intends to move access prices to be more cost reflective and welcomes the opportunity to do so.

3.12 In the event that the process defaults to option (ii), which would not be Royal Mail's preferred option, Royal Mail would expect the Wholesale prices to be able to increase up to the maximum sub-cap of the Basket B services.

4. RETAIL NOTIFICATION AND PUBLICATION

Summary

Royal Mail believes its requirements for notification and publication of prices (under Condition 7) can and should be developed to reflect the high level of competition now present. Nevertheless, for 2011/12 it recognises the need to inform the general public of prices and the regulator of information that will inform it about its ex ante headroom basket control.

Royal Mail proposes that there is neither notification nor publication obligations where there is effective competition. Further, for services in Baskets A and B, it proposes to notify 3 months in advance and publish 4-6 weeks⁵ in advance, and to notify 3 months in advance all remaining services (other than where there is effective competition). This will avoid double regulation of headroom basket services through both Condition 21 and Condition 7, [X].

- 4.1 Postcomm states that prices and terms need to be notified to Postcomm 3 months in advance and published 6 weeks in advance of implementation and that this is needed to facilitate it undertaking provisional investigations, when necessary, under Condition 11 where the service is not considered to be exposed to effective competition. Postcomm also confirms its policy to undertake a provisional investigation in 6 weeks.
- 4.2 For the transitional period of 2011/12, Postcomm proposes that it be notified of changes 3 months (presumably on some provisional basis for some services) and terms are published 6 weeks in advance of implementation for all markets under review (with or without effective competition).
- 4.3 Royal Mail considers that where it has limited market power or operates in a highly competitive market, the services in that market should be removed from Condition 7. This would be the case for services in markets that have effective competition. This should also apply where sufficient competition has developed in recognition that prior publication would put Royal Mail at a disadvantage and is not warranted.
- 4.4 Each regulated area needs to be considered separately with a view to ensuring that the regulation under Condition 7 is proportionate and targeted.
- 4.5 For services in markets where there is sufficient competition, and therefore effective competition, including deferred packets above 750g (and prospectively above 500g), deferred packets 500-750g high volume, deferred

⁵ The timescale would be dependent on the time taken for Postcomm to review Royal Mail's proposed treatment of new services with respect to the baskets. For example if it takes Postcomm 1 month to confirm the allocations, it might take another month to finalise prices, complete and external audit and publish, leaving 4 weeks to implementation.

unsorted high volume, premium deferred packets and express packets, there should be no requirement for either notification or publication under Condition 7.

- 4.6 For services in Baskets A and B, and miscellaneous services⁶, (other than deferred unsorted high volume), Royal Mail proposes to notify Postcomm of the direction of provisional price changes 3 months in advance and publish prices 4-6 weeks⁷ in advance to reflect the fact that these services are subject to increasing competition and to allow for the main annual setting of prices and audit process to take place by the end of February 2011. It also believes that it should be able to introduce add-on features and new options to existing services with 4 weeks notice.
- 4.7 For the remaining services of Royal Mail Letters in Basket C and for new services or variations of existing services (where there is not sufficient or effective competition), there would be notification only to Postcomm 3 months in advance (and no obligation to publish). In particular,
- For remaining services in Basket C (headroom basket) and new services or variations of existing services, Royal Mail would notify Postcomm of its provisional intentions and relevant market for the service 3 months in advance of implementation, with a view to Postcomm confirming the position ahead of final audit processed.
 - For other services outside of Baskets A, B and C (and Miscellaneous services), where there is already sufficient competition for the services to be outside of the price control (by definition), there should be no requirement to notify or publish because to do so would place Royal Mail Letters at a commercial disadvantage when competing in that market.
- 4.8 The purpose of the headroom basket is to provide a safeguard against undue discrimination regarding margin squeeze and as such it becomes unnecessary regulation for there to be a requirement to publish prices in advance in order to facilitate complaints under Condition 11. These services would still be subject to competition law and, where their respective markets are not deemed to have effective competition, to Condition 11. Royal Mail would continue to publish information relating to products and services in order to compete for business on a normal commercial basis.

⁶ Miscellaneous Services would be treated in the same way as those services in Basket A, consistent with the X being the same for both in Condition 21

⁷ The timescale would be dependent on the time taken for Postcomm to review Royal Mail's proposed treatment of new services with respect to the baskets. For example if it takes Postcomm 1 month to confirm the allocations, it might take another month to finalise prices, complete and external audit and publish, leaving 4 weeks to implementation.

- 4.9 Table 2 provides a summary table of the proposed regulatory treatment for 2011/12 regarding Conditions 7 and 21, of the five market areas identified in Annex 2 as having effective competition. Beyond this period further deregulation might be expected, but is outwith the focus of this discussion which is on 2011/12.

Table 2: Regulatory treatment of market areas identified as having effective competition

Market	Consequence 2011/12
Above average 750g, deferred packets	C7: Removed C21: Removed
Above average 500-750g, high volume deferred packets	C7: Removed C21: Removed
Below average 750g, premium deferred packets (inc Royal Mail Tracked)	C7: Removed C21: Not applied.
Pre-sorted upstream D+2	C7: 3 month notification only to Postcomm C21: Retained in headroom basket.
Unsorted upstream D+2, high volume	C7: Removed C21: Retained in Basket B.

5. RETAIL BASKETS

Summary

Postcomm proposes that the headroom basket is set such that the average upstream price exceeds a price floor based on Fully Allocated Costs (FAC). It uses an estimate of level of the upstream FAC at 3p for the 2c letter format. The actual level of upstream FAC for the letter format is significantly less than 3p, as provided to Postcomm, and this should be reflected in the setting of the average price floor. Royal Mail supports the move to an average basket in principle. However, this would require a number of technical points, including significantly lower minimum price floors than proposed by Postcomm, to be clarified and resolved for implementation by April 2011.

Headroom basket

5.1 For 2011/12, Postcomm proposes a headroom basket of controlled services, including Mailsort 2, Walksort 2 and Mailsort 3. Postcomm's proposed basket has several features:

- The forecast weighted average upstream prices is to exceed a weighted average upstream cost
- The level of costs is determined by Postcomm.
- There is to be a minimum floor price estimated at 60% of Postcomm's cost estimate;
- The reference access price is to be proposed by Royal Mail and confirmed by Postcomm;
- There are two headroom baskets, once for letters and large letters and the other for packets;
- The forecast is to be subject to an audit
- There is to be quarterly monitoring of outturn with potential need to amend prices subject to outturn

We look at each of these features in turn.

The forecast weighted average upstream prices is to exceed a weighted average upstream cost

- 5.2 Postcomm does not provided licence modifications to assess how this will operate in practice. Royal Mail supports the proposal to move to an average headroom basket, subject to clarification of several points of detail relating to its specific calculation and operation.
- 5.3 A key area is to define the volumes in a clear and auditable way. For Condition 21, volumes are not forecast for every price point and this level of detail would not be auditable given the number of price points involved. Under the current licence, revenues and prices are used to derive volumes. A similar approach could be applied to derive the volumes to apply to representative prices and unit costs.
- 5.4 As with the current operation of Condition 21, we would expect this calculation to use a representative price as our forecast revenues are based on the expected volume at a representative price, rather than for all prices. We would then expect the same volumes to be used to weight the average unit costs for the respective services. As such this would be a reasonably simple extension to the existing control.

The level of costs determined by Postcomm

- 5.5 Postcomm proposes that the average costs for the formats of Letter, Large Letter and Packet 2c services are 3p, 5.5p and 31p respectively and for 3c services are 2.3p, 2.3p and 17p.⁸ Postcomm estimate the 2c letter average cost of 3p on the basis from 2008/09 data as “*a conservatively high estimate for such product FAC costs may be 2.5p at this stage*”⁹ plus “*an uncertainty of +/- 0.5p is still likely at this stage*”.¹⁰ Postcomm also concludes that this “*may still require Royal Mail to price above other operator’s current pricing levels for a number of these customers.*”¹¹ Indeed Postcomm states “*We do not expect that a change of headroom for Mailsort 2 letters to a level in the region of 3 pence would have a substantial early impact on existing patters of competition, because the evidence we have is that most competition is currently at prices well below this level.*”¹²
- 5.6 Royal Mail agrees with Postcomm’s conclusion that the current headroom exceeds Royal Mail’s upstream FAC costs for the letter format, and that the reverse might be the case for large letters and packets. When setting the level of costs, Royal Mail believes that Postcomm needs to consider whether

⁸ Figure 18 of Postcomm’s May consultation document Annex 4 (2010).

⁹ Paragraph 6.27 of Postcomm’s May consultation document Annex 4 (2010).

¹⁰ Paragraph 6.45 of Postcomm’s May consultation document Annex 4 (2010).

¹¹ Paragraph 6.32 of Postcomm’s May consultation document Annex 4 (2010).

¹² Paragraph 6.52 of Postcomm’s May consultation document Annex 4 (2010).

the regulatory rules would lead the business to have to exit the market because it is not able to compete under those rules:

- We believe that this could be the case for Mailsort 1400 packets if the average upstream prices are required to cover the Postcomm’s proposed or actual FAC upstream costs, because the price increases would be expected to lead to significant switching out of Mailsort 1400. Indeed, in this instance Royal Mail would be required to continue to offer the 2c service as to fulfil its provision of the universal service, even though it is likely to be uncompetitive and costly to continue. A further reason to continue the service might arise if the FAC cost is seen to include inefficiency which, once removed, would enable it to be priced competitively (i.e. if the LRIC is significantly lower than current FACs).
- We also believe that the significant difference between A3 Packets and Packets, particularly if minimum floor prices upstream are to be formed from these costs, means that an A3 format needs to be defined.
- Royal Mail believes Postcomm’s level of 3p could be reset significantly below this level and corresponding adjustments should be made to the costs of the other formats. Postcomm builds a contingency of 0.5p built onto its estimate of FAC to form an estimate of 3p. The Revenue Derived Traffic (RDT) average cost is significantly below 3p in 2009/10 (see Table 2). The contingency is unwarranted; the additional costs incurred by competitors for upstream services through downstream access are minimal¹³. Even with Postcomm’s 0.5p contingency, Postcomm’s updated “relevant cost” would be below 3p. Royal Mail believes that competitors are pricing at levels that reflect upstream costs below 2p and that the headroom level should reflect this.

Table 2: Upstream FAC costs for Mailsort 1400 2c 2009/10 (p/item)

Weight	Letters	Large letters	A3 Packets	Packets
0-100g	[]	[]	[]	[]
101-250g		[]	[]	[]
251-500g		[]	[]	[]
501-750g		[]	[]	[]
Average	[]	[]	[]	[]

5.7 Further, where the average headroom basket is extended to include new services and variants that avoid elements of upstream costs Royal Mail believes it would be necessary to amend these costs accordingly. This would ensure that these incremental revenues are compared to the corresponding costs within the average headroom calculation.

¹³ These costs for the first time reflect the move to Pricing in Proportion (made in 2006). This was not taken into account in Postcomm’s previous analysis.

There is to be a minimum floor price estimated at 60% of Postcomm's cost estimate

- 5.8 Postcomm proposes that there is an upstream price floor under Condition 21 set at 60% of Postcomm's estimate of upstream "relevant costs", as a first approximation for a LRAIC estimate.
- 5.9 Royal Mail does not agree that there is a regulatory requirement to set a price floor. The introduction of a price floor as proposed by Postcomm would be an unjustified restriction on Royal Mail's commercial pricing flexibility in upstream markets where there is effective competition. The access headroom control itself is the mechanism that acts as a safeguard against margin squeeze and there is no case for additional measures.
- 5.10 Postcomm propose the price floors as a way of mitigating the "risk of potential anti-competitive flexing of prices in the basket." The price floors would place on Royal Mail a restriction that goes beyond the requirements of competition law; thus it would be possible to fail the type of price floor mechanism proposed by Postcomm and yet, under competition law, not be acting in an anti-competitive manner in any way. Royal Mail should not be prevented from undertaking fair price competition in this way. In this context general price floors on individual prices appear to be disproportionate and untargeted regulation.
- 5.11 Looking at the detail of Postcomm's proposed price floors, Royal Mail believes that individual price points should cover average avoidable costs (AAC), with prices overall in a market recovering LRAIC. Royal Mail does not have AAC estimates, but does derive LRMC estimates as, approximately, [X] % of FACs.
- 5.12 Taking the 2c letter format as an example, Postcomm's reference cost of 3p is a conservative average cost and is not the appropriate cost to apply 60% to and form an estimate of the minimum price floor for all price points for the following reasons:
- The estimate of 3p overstates the average FAC for the letter format
 - The estimate of 3p does not reflect cost variation arising from operational differences that are reflected in prices (e.g. volume related discounts, term discounts, OCR/CBC, bespoke services).
- 5.13 At current price levels some price points would be below the minimum price floors if they were set at 60% of FAC (e.g. maximum volume related discount on Mailsort 3 700). The percentage would need to reduce to 40% for the nearly all of the existing price points on standard services to meet the minimum floor price. However, it is in the setting of a minimum price floor for new or bespoke services, where there are some avoided upstream costs,

that the use of a blunt tool of like a multiplier on a standard FAC could be most distortionary.

5.14 If Postcomm's proposed upstream price floor is applied to individual price points at the levels currently proposed by Postcomm then some existing price points would be in breach of the ex ante rule, but still be cost reflective and legitimate under competition law (as referred to above). If Postcomm finds ex ante regulation to be necessary, then it must ensure that it is aligned to competition law. A requirement for every price point to be above a floor price set at 60% of an estimate of FAC would not be consistent with competition law, nor with proportionate and targeted regulation.

5.15 Royal Mail is also concerned as to how Postcomm's proposed price floor would be monitored. It would introduce additional administrative costs on top of the existing ex ante checks undertaken by Royal Mail.

5.16 The treatment of short terms discounts under the price control floors proposed by Postcomm is not clear in paragraph 5.140 of Annex 4. Royal Mail's position is that short term discounts or prices like the Royal Mail Sale and Tailor Made Initiatives (TMIs) should be excluded from any price floor (but be included in the average headroom).

5.17 Royal Mail believes that prices should be above a minimum price floor of AAC. In the absence of AAC, Postcomm's proposal to set price floors set on the basis of 60% of the actual average FAC in 2009/10 would lead to price floors that are too high for some price points because :

- the price floor is a measure of LRMC when it should be AAC
- the price floor is an average over a multiple price points that fails to allow for variability in costs; and
- applying a percentage to FAC to derive the price floor does not take account of where costs are avoided.

If there is to be a minimum price floor, and Royal Mail reiterates its strong objection to price floors that do not align to competition law, it could be based on the relevant actual FAC multiple by a percentage, where :

- the percentage is significantly lower at about 40%;
- the relevant FAC takes account of avoided upstream costs for the purposes of new or bespoke services;
- short term discounts or prices are excluded from minimum price floors.

The reference access price is to be proposed by Royal Mail and confirmed by Postcomm

5.18 Postcomm proposes that Royal Mail proposes the access reference price to apply to any service within the headroom basket or potentially subject to the headroom basket for Postcomm to confirm. In principle, Royal Mail supports this approach and believes that it would be compatible with a process under Condition 7 whereby Royal Mail notifies Postcomm of its intentions 3 months in advance.

5.19 There are three areas that need consideration:

- Cases might emerge which bring into question whether the service should be treated within Basket A, or B or within the headroom basket (Basket C)
- Cases might emerge which bring into question what access service should be applied in the headroom basket
- The length of time it will take for a decision to be made.

5.20 To assist in the turn-round time, it might be helpful to develop a set of guidelines to be applied. For example, we would expect any offers that are genuinely individually negotiated, and hence subject to VAT, would by definition be outside of Condition 21 and not part of any headroom calculation; otherwise there would not be a “genuine” negotiation between the relevant parties.

5.21 Royal Mail believes that short term offers and TMIs should be excluded from the minimum price floors and included in the average headroom. In extending the access headroom control to include Mailsort 3 and Sustainable Mail 3 for the first time Postcomm should exclude from the average headroom any short term promotions or prices (such as TMI's) for these services that came into effect on or before 31 March 2011. This is required as a transitional measure to ensure that short term promotions or prices for these services, notified under the current licence, are not adversely affected by any licence modifications that come into effect from April. Any short term promotion or prices for Mailsort 3 and Sustainable Mail that come into effect from April 2011 onwards would, of course, be subject to whatever licence modifications made and implemented for that time. [§<].

There are two headroom baskets, one for letters and large letters and the other for packets

5.22 Postcomm proposes to transfer Mailsort 2, Walksort 2 and Mailsort 3 services from current Basket B into headroom baskets on the basis of these services having sufficient competition to do so. More specifically, it proposes two headroom baskets: one for letters and large letters and the other for packets.

5.23 Royal Mail believes that Mailsort 2, Walksort 2 and Mailsort 3 services are in a market that has effective competition and therefore sufficient competition to remove the services from the Basket B. Royal Mail notes that the proposal to form two headroom baskets is consistent with the perspective of letters and large letters format services being in a separate market to packets.

Mailsort 2 and 3 in the same headroom basket

5.24 Postcomm proposes to include Mailsort 3 in the headroom basket alongside the 2c services. Royal Mail views the bringing in of Mailsort 3 services into the headroom basket as an increase in regulation because it imposes a new upstream headroom constraint on those services. However, Royal Mail recognises that Mailsort 2 and 3 are both services in the retail deferred presorted mail market and that there is a case therefore for both of them being in the headroom basket.

5.25 [✂].

The forecast is to be subject to an audit

5.26 Postcomm proposes that the forecast headroom basket is subject to an external validation. Aside of our views on the acceptability or otherwise of aspects of the proposals on the access headroom and price floors, Royal Mail has no issue with a requirement for the headroom baskets and minimum price floor tests to be subject to an external review ahead of implementation. It believes that these should suffice in providing the regulatory safeguards and reassurance on the pricing of these services.

5.27 Royal Mail would expect this to occur between 31 December, for the 3 month notification of the service to Postcomm (based on provisional prices), and 31 March for the potential publication of prices 4-6¹⁴ weeks ahead of implementation.

There is to be quarterly monitoring of outturn with potential need to amend prices subject to outturn

5.28 Postcomm proposes that the headroom is monitored on the basis of quarterly outturns. This would apply 12 months' volumes, and thereby require those volumes to be split by quarter in 2010/11. This would then be updated with revenues and volumes (derived from representative prices) each quarter.

5.29 Royal Mail believes that this might be manageable but would place and additional administrative burden on the business to prepare and review the

¹⁴ The timescale would be dependent on the time taken for Postcomm to review Royal Mail's proposed treatment of new services with respect to the baskets. For example if it takes Postcomm 1 month to confirm the allocations, it might take another month to finalise prices, complete and external audit and publish, leaving 4 weeks to implementation.

outturn on a quarterly basis. However, Royal Mail's main concern is what the consequence would be if the outturn differs from the forecast in a way that does not conform to the inequality of the headroom calculation. Given the presence of well established competitors in the pre-sorted mail market, it is increasingly difficult to assess whether customers would respond to price movements arising from the average headroom. As such, we believe that forecast volumes would be subject to significant uncertainty and therefore the movement between forecast and actual calculations could be considerable. Hence, greater clarity is needed as to what the consequences would be of such a situation.

5.30 Royal Mail does not believe that there should be any consequence if the outturn is contrary to the forecast position provided that :

- the forecast is compliant with applicable ex-ante tests;
- the forecast is made with best endeavours;
- the outturn against forecast is subject to external audit review;
- any audit recommendations are incorporate in future forecasts by Royal Mail.

5.31 The monitoring of outturns each quarter would inform Postcomm of subsequent developments in the market, and any need for further review, and ensure that this information is available for the subsequent year.

Treatment of specific services

5.32 Postcomm's consultation proved to be difficult to interpret in terms of the specific treatment of services. As a consequence, Royal Mail sought clarification on a number of points of detail.

5.33 Postcomm confirmed that the proposal was for no services currently outside of the price control (e.g. Royal Mail Tracked) to be brought into the price control. Royal Mail agrees with this conclusion, but in the case of Royal Mail Tracked reaffirms that below 750g this service is in a premium market that is distinct from the vanilla services, and as such should be fully deregulated.

5.34 Postcomm confirmed that metered services relating to SD 1pm meter services and above 750g metered STL would be removed from the price control. However, Postcomm also confirmed that these services would remain under Condition 2 of the licence (as part of the universal service). Consequently, meter STL above 750g services would remain VAT exempt. Royal Mail believes that PPI STL would also need to price controlled and remain VAT exempt, because PPI STL above 750g is a similar service in the same unsorted market to metered STL). Hence, even though unsorted high volume mail has effective competition (see Annex 2), these services should remain within Basket A of the price control.

- 5.35 Postcomm has not clarified the position with regard to Mailsort 1400 2c packets above 750g. This is a service currently within Condition 2 (universal service). Postcomm's consultation proposes that universal services would be subject to Condition 7 and 11, but does not propose one way or the other regarding Condition 21. Royal Mail believes that Mailsort 1400 2c is in the same market as Mailsort 1400 3c, and as such should be treated in the same way¹⁵. Mailsort 1400 2c above 750g (and prospectively 500g) should not form part of universal service and like Mailsort 1400 3c above 750g (and prospectively 500g) should be outside of Condition 21. This would also allow similar treatment of these two services under the new VAT legislation. The same should also apply to Mailsort 1400 1c above 750g (and prospectively 500g), which also currently forms part of the universal service under Condition 2.
- 5.36 Postcomm's proposals take forward changes to the prices of some PO boxes. The price of these services needs to be amended to reflect cost. Royal Mail welcomes Postcomm's recognition of the need for change to this service.

¹⁵ Mailsort 1400 1c is within the presorted D+1 market which would be in Basket B and subject to Condition 21.

6. VOLUME ADJUSTER AND ALLOWED REVENUE

Summary

Postcomm focuses on deregulation and the regulatory safeguards required for deregulation to occur and there is significantly less focus on the finances of Royal Mail. It does not propose any change to the level of allowed revenue, but does include the extension of the existing volume adjuster to 2011/12.

Royal Mail is working off a price control set five years ago, the drafting of which did not envisage the continuation of that control beyond 2010/11. In particular, the volume adjuster (G factor) mechanism is not provided for beyond 2010/11. As volumes have decreased significantly since the price control was set, it is vital that this drafting flaw is remedied. Royal Mail supports the extension of the volume adjuster to 2011/12 but also believes that it needs to be amended to more adequately recompense Royal Mail with extra allowed revenue in the presence of the continued fall in volumes. Further discussion would be necessary to discuss the precise mechanism for bringing forward price increases and increase the allowed and earned revenues to safeguard the progress of on-going modernisation, the financial sustainability of Royal Mail and therefore the Universal Service.

Context

- 6.1 The focus of Postcomm's May consultation is towards deregulation and the regulatory safeguards required for deregulation to occur. There is significantly less focus on the finances of Royal Mail and the need to safeguard the service of the universal service provider in the UK. Royal Mail faces the prospect of cash headroom reaching a level which could represent a risk to a business of this scale and with our cash outgoings and believes this needs further consideration.
- 6.2 While Postcomm may be interested in whether the non-competitive (regulated) markets cross subsidise the competitive (non-regulated) markets, there is no such anti-competitive cross subsidy currently as evidenced by the costing information provided to Postcomm through Royal Mail's Regulated Accounts and in response to ad hoc requests for information. This would be the case even with some increases to the allowed revenues of the Royal Mail services in non-competitive markets.
- 6.3 While Postcomm recognises the significant cash outflow of Royal Mail as the transformation plan is implemented and the cash gap relative to the price control set in 2006, the proposals do not appear to provide any additional revenue for services beyond that existing in the current licence, with the one exception of the proposed 1-year extension of the volume adjustment mechanism. Postcomm confirms "*the cash flow of the Letters business has been up to £800million weaker than we assumed it would be by 2010 when*

*setting the existing price control*¹⁶ but then concludes that the impact of their proposals “*will be an increase in allowed revenues of below 1%*”,¹⁷ and our review of the proposals has confirmed this. In the light of the weak financial position of the business this warrants further review.

- 6.4 Royal Mail believes that there is a need to review the scope for additional revenues to assist its financial position and make the urgent changes to the business that are now required. Postcomm does refer to some of the mechanisms that determine the allowed revenue. It also indicates that extra revenue allowances might also be considered for a looser price control for markets where competition is developing.¹⁸ Royal Mail’s review of allowances is made in this context.

Current volume adjustment mechanism

- 6.5 Postcomm recognises the importance of delivered volumes: “*increases in the volume of mail using Royal Mail’s network, including through access, will secure contributions to the costs of part of Royal Mail’s pipeline that are required to support the provision of the universal service*”¹⁹. Postcomm indicates that, for every 1 % reduction in volume the business is recompensed through additional allowed revenue by about an extra £10m (such that the 30% reduction in volume leads to a £300m allowance from the volume adjustment).
- 6.6 Royal Mail is working of a price control set five years ago, the drafting of which did not envisage the continuation of that control beyond 2010/11. In particular, the volume adjuster (G factor) mechanism is not provided for beyond 2010/11. As volumes have decreased significantly since the price control was set, it is vital that this drafting flaw is remedied.
- 6.7 Royal Mail believes that the volume adjustment mechanism does not adequately compensate for the financial effect of reduced volumes. While Postcomm might consider this to have given incentives for the business to address inefficiency during the 4 year price control, the current proposals now relate to an extension of the control for one year. This provides the opportunity to redress elements within the current volume adjustment mechanism.
- 6.8 While the current figure of around £300m from the volume adjustment mechanism might sound a significant amount, three factors need consideration.

¹⁶ Paragraph 5.85 of Postcomm’s May consultation document (2010).

¹⁷ Paragraph 5.87 of Postcomm’s May consultation document Annex 4 (2010).

¹⁸ Paragraph 3.21 of Postcomm’s May consultation document Annex 4 (2010).

¹⁹ Paragraph 3.10 of Postcomm’s May consultation document Annex 4 (2010).

- The volume adjuster undervalues the average cost of delivery because the average cost is based on access prices (which are below FAC and dominated by the letters format).
- The volume adjuster overstates the cost reduction arising from a volume reduction, and thereby under-compensates the business for a given reduction in volume.
- The additional revenue allowance from the volume adjuster overstates the amount of actual revenue that can be earned. As prices are increased to recover the additional allowance, the decline in volumes has the effect of reducing the total allowed revenue. Royal Mail estimates, for example, that an across-the-board increase in prices akin to an increase volume adjustment of £[X]m would lead to just over an increase in revenue of around £[X]m.

6.9 These factors, when combined with continued volume decline, mean that Royal Mail continues to be short-changed in its revenue allowance. This should be addressed in the extension to 2011/12.

Updating the volume adjustment mechanism

6.10 The current Licence states what the forecast volume growth is to 2009/10 to allow the volume adjuster to define an allowance for 2010/11. However, it does not do the same for 2010/11 or beyond and therefore the volume adjustment would be undefined without a licence modification. We agree with Postcomm's proposal to extend the volume adjuster for the additional year based on the forecast growth factor used by Postcomm at the time of setting the control of 102.46. The allocation of the volume adjuster should also be extended to the new Wholesale basket. This would ensure that there is no step reduction in allowed revenue in 2011/12.

6.11 This is only the first of several changes to the volume adjuster that are required.

- the extension provides an opportunity to correct for the average price used to scale the access volumes. Currently, the average price is formed by weighting access prices by access volumes. As these volumes have historically been skewed heavily towards lower weights (and in particular the letter format), the average price would be below that formed by weighting access prices by total delivered volumes. If this was corrected it would increase the total volume adjuster (GG) by about £[X]m (see Appendix 1).
- the factor of 0.4 applied to scale the volume adjustment within the licence, which is meant to reflect the marginal change in costs with

respect to a marginal change in volume, should be reviewed and increased in the light of falling volumes. Postcomm's consultation document recognises that the short run, marginality factor is less than 0.6, which would imply that factor of 0.4 in the licence should be increased for the one-year extension. A movement in the factor, for example, from 0.4 to [X] would increase the total volume adjuster (GG) by about [X]%.

- The factor of 0.4 applied to scale the volume adjustment within the licence should be divided by a further factor so that the allowed revenue converts into the same actual revenue. Royal Mail estimates that this divisor to be [X].
- The recovery rate of actual revenue from allowed revenue should be improved by allowing greater sub-cap flexibility. The allowance from the volume adjuster would adjust the sub-caps all by the same average level. If this sub-caps are lifted, for a given revenue allowance, it would improve the recovery of actual from allowed revenue, because price elasticities are not the same across all services. However, the improvement is relatively small because of the sensitivity to in the mails markets.

6.12 The above technical discussion needs to be placed in a broad market and regulatory context. In 2009/10 actual revenue was less than allowed revenue by about £[X]m in basket A (subject to the outcome of Industrial Action dispensation) and less than £[X]m in Basket B. This allowance is carried forward and could be recovered in 2010/11 and 2011/12. When combined with Postcomm's proposed volume adjustment for 2011/12, the average price increases would be about [X]% and [X]% in Basket A and B respectively. Hence the average price increases in the baskets, even without any additional revenue allowance (beyond the extension of the volume adjuster to 2011/12) would likely exceed inflation.

6.13 Given the market position of falling volumes and revenues, there is a risk that above inflation price increases will increase the rate at which mail volumes decline. Nevertheless, Royal Mail believes that this decision should be left to the business to make, in the light of its financial position and the short change it has received during the last price control period.

6.14 The above analysis assumes that the allowed revenues being applied through amendment to the volume adjustment. The additional revenue allowance could also be expressed and applied as a one year price change (Po) with accompanying sub-caps for 2011/12. Further discussion would be necessary to discuss the precise mechanism for bringing forward price increases and increase the allowed and earned revenues to safeguard the progress of on-

going modernisation, the financial sustainability of Royal Mail and therefore the Universal Service.

Pensions adjustment mechanism

6.15 Postcomm's consultation also makes reference to the potential for the allowed revenue to increase as a consequence of a higher pension deficit.

6.16 The pension deficit has increased and could lead to a higher revenue allowance. However, in the event that Royal Mail claims the additional allowance the licence requires that sum to be paid to the Pension Trustees irrespective of whether that sum is recovered through additional actual revenues. Royal Mail's licence would need to be amended to remove the risk of any financial harm to the business for this to be a more realistic proposition. However, even then, in the current market, there is considerable uncertainty as to whether the additional allowance could be recovered. As such, it remains very likely that Royal Mail will not seek to claim an additional revenue allowance in relation to the pension deficit for 2011/12. Nevertheless, the pension adjuster should be extended to 2011/12 and to the new Wholesale basket.

Adjustments for option (iv)

6.17 Postcomm's preferred option of a headroom basket, combined with above 750g packets (and prospectively above 500g) being in a market that has sufficient competition to remove them from Condition 21, would mean the removal of services from Baskets A and B. This affects the balance between allowed and actual revenues for the remaining services. There are two effects. First, the allowed revenue reduces more than the actual revenue which has the effect of increasing under-recovery. Second, the allocation of the volume adjustment into the basket reduces the allowed revenue and under-recovery. We believe an adjustment should be made to the allowed revenue so that the overall under-recovery position remains the same as it is prior to the removal of the service from the control. We currently estimate these adjustments to be increases in allowed revenue for baskets A and B to be £[X]m and £[X]m.²⁰

6.18 Postcomm also indicates its intention for options (ii)-(iv) to have similar implications for the access prices. Postcomm's indicates an average additional allowance of 2.5%²¹ which is de-averaged into 3%, 1% and -0.1% for letters, large letters and packets.²² Royal Mail has estimated the average subcap for Basket B under options (i)-(iii) to be [X]% for 2011/12; and therefore access letter prices could increase by this amount under options (i)-

²⁰ If meter and PPI above 750g was retained basket A then no adjustment to the allowance would be required (see Section 6).

²¹ Table 23 of Postcomm's May consultation document Annex 4 (2010)

²² Table 18 of Postcomm's May consultation document Annex 4 (2010)

(iii). This is currently [~~8~~] % above the level of increase for access letter prices in 2011/12 under option (iv). This is caused by Basket B taking account of an expected under-recovery in 2011/12 that is not picked up in setting the access price in option (iv). Royal Mail therefore believes that the factor of 2.5% should be supplemented by the percentage under-recovery in Basket B to make the options more closely aligned in terms of the access levels that can be achieved.

APPENDIX 1: AMENDMENT TO THE VOLUME ADJUSTER TO REFLECT THE DISTRIBUTION OF DELIVERED VOLUME IN CALCULATING THE AVERAGE PRICE IN THE VOLUME ADJUSTER

Historically, the distribution of Downstream Access (DSA) volumes have been weighted towards letter format. Royal Mail's current forecast for 2010/11 continues to expect this to continue.

In Licence Condition 21 the volume adjuster is valued by reference to the average price of access prices. However it is meant to be an adjustment to allowed revenue arising from a reduction of delivered volumes. This would suggest that the average price should be adjusted to be a weight the access prices by delivered volume (rather than just access volume).

This is undertaken in the Table 1. The current price is [x] (£/item). The amended price would be [x] (£/item) and represents a [x]% increase. The impact upon the volume adjuster GG_t of using the two AR_{t-1} terms is shown in Table 2 using the equation given by Licence Condition 21(14):

$$GG_t = AV_{t-1} * ((IFV_{t-1}/IAV_{t-1}) * (100-D/100)-1) * AR_{t-1} * R$$

The effect would be to increase in GG_t for 2011/12 by about £[x]m.

Table 1 – Average Unit revenue using delivered traffic distributions

	Total DSA Avg Unit prices (£)	% make up of delivered traffic	Avg DSA Unit Price * % make up of delivered traffic (£)
Letters	[x]	[x]	[x]
Large Letters	[x]	[x]	[x]
Packets	[x]	[x]	[x]
		AR_{t-1} =	[x]

Table 2 – Calculation of GG_t

	AV_{t-1}	IFV_{t-1}/IAV_{t-1}	$(100-D/100)-1$	AR_{t-1}	R	GG_t (£m)
Current calc	[x]	[x]	[x]	[x]	[x]	[x]
DSA Vol using RM weighting	[x]	[x]	[x]	[x]	[x]	[x]
Difference						[x]