2006 ROYAL MAIL PRICE AND SERVICE QUALITY REVIEW:

ROYAL MAIL'S RESPONSE

December 2004

Royal Mail is a trading name of Royal Mail Group plc. Registered number 4138203.

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FOREWORD

1. This response is provided by Royal Mail to the consultation paper issued by Postcomm entitled "*2006 Royal Mail Price and Service Quality Review: consultation on principles*", September 2004.

2. Although Royal Mail's detailed response to the points raised in the document are set out in the executive summary and main body of the submission, there are a number of key observations that may help frame our view of the priorities for the coming price control period.

3. Royal Mail believes that:

   (a) under the Renewal Plan, we have made important changes to our business to improve quality and reduce costs but we have only begun the fundamental transformation necessary to ensure that Royal Mail flourishes in the coming competitive postal market;

   (b) particularly given Postcomm's market opening proposals, the period to 2011 will be one of very rapid change for the industry, requiring Royal Mail to provide its shareholder with commercially attractive returns in an open, competitive market, while continuing to be the sole provider of the one-price-goes-anywhere universal service throughout the UK;

   (c) competing effectively will require a fundamental transformation of Royal Mail's business to provide the high quality, dependable products and services our customers want, and this will only be achieved through engaging our people in new ways of working and through substantial investment in automation;

   (d) crucially, we will not be able to compete effectively and deliver commercially attractive returns to our shareholder unless prices can be fundamentally rebalanced to remove historic cross-subsidies early in the period of the next price control;

   (e) in addition to price rebalancing, the level of prices needs to be set to allow Royal Mail to recover all operating costs we efficiently incur, to generate a fair return on prudent new investment and to provide our shareholder with profits and cash flow consistent with the value that has been created by Royal Mail as it has built the industry and its own brand over many years;

   (f) in particular, prices must be set to allow Royal Mail to fund ongoing contributions to its pension fund and to fully fund its pension deficit in line with trustees' requirements;

   (g) the service target regime needs to be rethought fundamentally, with any licence targets and compensation schemes related to market requirements.

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EXECUTIVE SUMMARY

Introduction and Objectives

1. We welcome the opportunity to set out our views on the principles that should govern the next price control, which will be critical in shaping the development of the UK postal market over the next five years – including the viability of the universal service, quality of service to customers and the landscape of competition in what will be the most open postal market in the world.

2. Royal Mail has achieved much during the current price control period. We have restructured our cost base through the Renewal Plan – including implementing single daily delivery across the country. While quality of service dipped due to industrial action and transitional difficulties, it has now recovered with recent months showing a performance much more consistent with targets for most products including first class stamped and metered mail. We have negotiated downstream access agreements and as a result vigorous competition is developing. And we have started achieving a greater level of colleague engagement – with appropriate increases in financial rewards for our people – reflected in, this year, the lowest number of days lost to strikes for a decade.

3. However, we continue to face a number of challenges. The market outlook is uncertain with technological substitution beginning to impact volumes and fierce competition emerging from Europe's leading postal operators. Our network is suffering from years of underinvestment and cannot guarantee the consistent levels of quality of service our customers require. Our prices are fundamentally misaligned with costs so sending the wrong signals to customers and distorting the pattern of competitive entry. At the same time, despite recent improvements, we still face ongoing industrial relations issues, while the scale of our pension deficit is undermining the financial viability of the business.

4. In response to these challenges we have developed a five-year plan to transform the quality of our service to customers through automation, changes to working practices and colleague engagement. Delivering this plan requires substantial investment in our people and our operations, and a fundamental change in our products and prices to ensure cost reflectivity and a fair and level competitive playing field. We therefore require a price control that allows flexibility in pricing and encourages product innovation while providing sufficient funds to support the ongoing turnaround of the business, and deliver a commercial return to the shareholder.

5. *Postcomm's document sets out objectives for the price control including ensuring the universal service at a uniform price, promoting effective competition where possible, regulating through incentive regulation where necessary and transparency and objectivity.* We support these objectives, although we would also like to see Postcomm recognise the need for a price control that supports our shareholder's objective of owning a commercially viable and attractive business in the long term. This requires that we earn a reasonable commercial return and maintain a satisfactory credit rating.

Improving quality of service

6. *Postcomm believes that a stronger incentive framework is required to ensure that Royal Mail meets the existing quality of service targets and seeks consistently to improve quality of service.* We share Postcomm's view that improving quality of service is critical, although it is also important to recognise that our service quality has improved significantly in recent months and compares favourably with that of overseas operators. We are already taking every possible step to continue to improve quality of service and are highly incentivised to do this given that we face 28 targets and penalty regimes worth up to around £200 million per annum in addition to fines and individual compensation payments – even before taking into account the competitive threat we face. Consequently we do not believe that a more punitive incentive framework is required, nor would it help our customers.

7. *Postcomm asks for views on the appropriate quality of service targets.* Royal Mail will be responding in more detail to the Postwatch consultation on quality of service. In summary, we strongly believe that licence targets should apply only to USO products, although performance should still be measured, tracked and published for all major operators for non-USO products. For USO products the current range of targets should be rationalised. Furthermore, the incentive regime should be linked to ranges of performance rather than simple pass-fail targets and good performance should be rewarded in addition to penalties for poor performance. We also believe that our existing arrangements for loss and damage compensation are sufficient and that the bulk compensation scheme is being correctly applied.

Coverage

8. *Postcomm proposes five criteria to assess the intensity of competition – barriers to entry, scale and nature of competition, customer awareness and behaviour, Royal Mail's behaviour and effectiveness of competition – and applies these criteria to determine which products should fall within the price control.* These criteria strike us as being reasonable with the exception of the test relating to Royal Mail's behaviour in a competitive market. The approach should be consistent with that adopted by the Office of Fair Trading, including the definition of relevant market. The market will in many cases be broad – for example the relevant market for direct mail might include other substitutable forms of advertising. Postcomm has not demonstrated that it has done the analysis required to determine the extent of competition for Royal Mail's products. In particular we disagree with Postcomm's application of its own criteria in certain cases: Group 1 (non-competitive products) should contain only stamped mail and not meter and PPI which should be moved to Group 2 (prospectively competitive); and Special Delivery Next Day should be removed from price control (i.e., put into Group 4) since it already competes directly with established express services.

9. *Postcomm proposes to bring downstream access products within the price control, and asks how new products should be treated*. Access services are rapidly developing through bilateral and commercial contracts under Condition 9, with these contracts stipulating prices and operational terms. Accordingly there is no need for further regulatory intervention at this stage, and access products should remain outside the price control. Finally, new products should remain outside the price control for at least the period of the review, else innovation will be stifled.

Form and duration

10. *Postcomm proposes retaining an "RPI-X" form of control together with the current price control reopening mechanism.* We fully support the "RPI-X" approach, which provides superior incentives for cost reduction and innovation than the alternative "rate of return" approach. However, we believe that the current reopening mechanism is inadequate and needs to be augmented with clear rules based on objective and predetermined criteria to deal with specific material uncertainties primarily outside of Royal Mail's control – such as cost shocks or major volume reductions.

Structure

11. *Postcomm believes that there is merit in separate controls for 'captive' and 'non-captive' customers, noting that separate controls would prevent any rebalancing of prices between each control. Postcomm also states in its proposals for a revised market opening timetable that "as the postal sector becomes more competitive Royal Mail should be allowed an appropriate amount of flexibility to respond to competitive developments and to act in a more commercial manner…Postcomm supports the principle of more cost reflective pricing".* We welcome Postcomm's endorsement of the principle of cost reflectivity and of permitting commercial pricing flexibility. For historical reasons and because of our extensive universal service obligation, our pricing is fundamentally misaligned with costs so sending the wrong signals to customers and distorting the pattern of competitive entry. Accordingly it is critical that our prices be moved rapidly toward cost reflectivity, which will inevitably require substantial increases in stamp prices combined with decreases in business mail prices.

12. *Postcomm continues to favour the use of tight thresholds to limit our ability to rebalance prices.* We believe that the current thresholds on rebalancing are insufficient to allow us to move prices towards costs in a timely manner. Furthermore we are concerned that introducing separate controls for 'captive' and 'non-captive' customers will limit our flexibility to rebalance across social and business mail in a cost reflective manner, unless Postcomm is willing to allow a substantial initial rebalancing at the start of the price control period. We strongly believe, therefore, that the current single tariff basket should be retained for inland end-to-end mail, since a single basket allows for rebalancing across social and business mail while at the same time (rightly) placing limits on the average price increase.

13. *Postcomm refers to the application by Royal Mail in August 2003 to implement Size Based Pricing for many of its inland services – a process that has already taken 16 months with no timetable for completion.* Royal Mail expects to introduce zonal or geographic pricing on non-USO products within the next price control period, as well as significant changes to its range of services to better meet the needs of its customers. Royal Mail would like to work with Postcomm to ensure that the next price control facilitates such innovation through efficient, clear and transparent processes and with as many changes as possible introduced at the start of the next control period.

Approach to financing

14. *Postcomm has indicated its preference to retain a "cashflow approach" under which allowed revenues are set to cover projected cash expenditures over the*

price control period. We regard the cashflow approach as highly unsatisfactory because it does not support a commercially and financially viable Royal Mail, required by our shareholder and necessary for an efficient competitive market. In particular, Postcomm's proposed cashflow approach does not ascribe any value to the investment that the shareholder has made in Royal Mail to create a business which collects and delivers around 80 million items every day, everywhere in the country. By providing no return on historical investment in (tangible and intangible) assets and implicitly rewarding future investments at the cost of capital and no more, the cashflow approach effectively values our business at or close to zero. In practical terms, this would imply that our shareholder should be willing to give the business away to an entrant for nothing which is clearly nonsensical, not least since in reality an entrant would incur substantial investment costs to build a network that could provide our current service and volumes. In addition, the cashflow approach does not provide appropriate incentives to manage and deploy capital efficiently. Perhaps not surprisingly, the cashflow approach is not used by any other UK regulator.

15. We believe that an approach based around allowing Royal Mail to generate a fair and commercial return for its shareholder on its investment will address many of these issues and is, in addition, consistent with the approach taken to other regulated industries in both the UK and other jurisdictions. This approach recognises that the current value of invested capital provided by the shareholder and debt holders in our business should be expected to generate a fair return which compensates for the risk that such investors accept and creates the right incentives for further efficient investment. The initial value of invested capital in our business, or in other words the enterprise value of our regulated business, can be estimated through a number of different approaches (as recently applied by the Scottish Water Commissioner) including a 'top down' approach based on applying market comparables or a 'bottom up' basis that reflects the full shareholder value of Royal Mail including not just the replacement costs of the assets but also the intangible value of the Royal Mail brand. Finally, the shareholder should be allowed a return that compensates for the risk inherent in our business, especially given the very high operational leverage driven by our universal service network.

Setting the level

16. *Postcomm does not propose to 'claw back' any Royal Mail outperformance due to differences in outturn volumes from forecast in the current price control. Postcomm asks for views on what approach should be taken to setting the level of the price control, including operating and capital expenditure, the treatment of pension costs and the balance between upfront price adjustments ("P0") and ongoing price adjustments ("X" factor).* We agree with Postcomm that benefit to our profitability from exceeding projections made at the onset of the current price control should not be 'clawed back' in subsequent controls as this would be contrary to the basis on which we accepted the control and obstruct the incentive-based mechanism of an RPI-X control. We believe that the allowed revenues should explicitly include all operating costs reasonably and efficiently incurred by Royal Mail. We also believe that all pension contributions – both for ongoing funding and the funding of the pension deficit – should be funded through allowed revenues, which will require price increases. Prices have been lower as a result of Royal Mail taking pension holidays in the past, and there is emerging regulatory precedent for including allowance for pension deficits in the allowed revenue (for example Ofgem and Ofwat). Pensions also form a key part of employees' benefits and remains one of the key enablers for the continued

engagement of the workforce in the transformation of the business. Therefore, to maintain the momentum of change Royal Mail cannot overemphasise the need to have a basis for fully funding all of our pensions obligations.

17. *Postcomm's document refers to the efficiency review currently being undertaken by LECG.* We believe that this is an important piece of work and would appreciate Postcomm setting out a timetable that allows us to see an early draft to review and comment on in early 2005 and well ahead of our final price control submissions.

18. Finally, we recognise that setting a price control in the current market uncertainty is not straightforward. This is why we did not submit a disapplication to end the existing price control on 31 March 2006. This means that the existing price control could be extended for a short period beyond March 2006 on a similar basis to the current control. This would also enable the issues to be addressed in a timely way following some delays in the presentation of information to Postcomm arising from the sheer weight of issues involved in preparing detailed plans amidst the uncertainty of the developing market.

19. The table below summarises Postcomm's initial proposals as set out in its consultation paper (paragraph S.14) together with a summary of our own views on the principles that should govern the next price control.

SUMMARY OF ROYAL MAIL'S POSITION ON THE PRICE CONTROL AND SERVICE QUALITY REVIEW

Chapter	Postcomm's proposal	Royal Mail's position
Objectives Chapter 3	• Stated objectives – Ensuring USO at an affordable geographically uniform tariff – Promoting effective competition where possible – Regulating through incentive regulation where necessary – Transparency and objectivity • While it is reasonable to conclude that RM is responsive to financial incentives, there is a risk that this could be to a lesser extent than might be expected from a publicly listed company with Government as sole shareholder – Less pressure to outperform given absence of capital markets discipline – Potentially alternative objective function to profit maximization	• RM agrees broadly with Postcomm's stated objectives, with the reservation that Postcomm must ensure that the primacy of the universal service provision is not adversely affected by other objectives. • RM's business objective is to transform the quality and dependability of our service to customers through automation and colleague engagement and to deliver incremental profit growth for its shareholder so building a foundation for a commercially viable and sustainable business in the long term. • Government, as sole shareholder of RM, has taken significant steps to ensure that RM operates on clear commercial grounds and is responsive to financial incentives and, in particular, Government expects Royal Mail to generate commercially attractive returns in a liberalising market.
Improving quality of service Chapter 4	• Develop a stronger incentive framework to ensure RM meets targets set, and seeks to consistently improve QoS to further postal users' interests • Postwatch and RM will try and agree appropriate QoS targets • Other relevant issues: – What does market research of customers' needs say in relation to QoS? – What type of incentives should be within the control to improve QoS? – Should there be changes to the "C" factor and the compensation schemes?	• RM is already heavily incentivised on quality of service with 28 targets and penalty regimes worth up to around £200m p.a. in addition to fines and individual compensation payments – Targets are interrelated as most products go through the same processes, so problems affecting one target will likely affect others – Relative to other postal regimes, RM is more heavily targeted and has lower prices, despite having good 1C quality and high 2C quality • RM believes that a different incentive regime is required to improve or maintain QoS in a more competitive environment • Licence targets should only apply to USO products, although performance should still be measured, tracked and published by all major operators for non-USO products • For USO products the current range of targets should be rationalised – Incentive regime should be linked to ranges of performance rather than simple pass-fail targets – Good performance should be rewarded in addition to penalties for poor performance • Other relevant issues: – RM disagrees that current test on meeting Licence targets is insufficiently demanding, and opposes a higher proportion of allowed revenue being dependent on QoS by extending the C-factor to bulk mail – RM's existing arrangements for loss and damage compensation are sufficient and its bulk compensation scheme is being correctly applied – Moving bulk compensation scheme payments to an automatic penalty under the price control is neither necessary nor appropriate at this stage

Chapter	Postcomm's proposal	Royal Mail's position
Coverage Chapter 5	• Postcomm will use the five criteria from its November 2003 consultation to assess competition (Barriers to entry, scale and nature of competition, customer awareness and behaviour, RM's behaviour, Effectiveness of competition) • Proposes bringing access products within price control • Proposes process and timetable for considering how products should be removed from price control after it is set • Other issues – Are Frontier Economics' criteria for assessing competitive intensity of markets appropriate? – How should "new products" be regulated so that genuinely new products would remain outside price control?	• RM has several concerns with the approach and recommendations of Postcomm's consultant and the conclusions that Postcomm has drawn including – The consultants report takes into account only consideration of competitiveness when assessing and recommending the appropriate structure for the control. No account is taken of other duties of Postcomm and the fundamental requirement to rebalance and restructure Royal Mail's prices. – The consultants report is not based on a sufficiently evidenced approach. It does not apply the standard approach to the definition of relevant markets used in cases by for example, the Office of Fair Trading and is more qualitative than quantitative. • On the basis of the distinction drawn between residential and business senders of mail in the report by Postcomm's consultant, Standard Tariff Letter meter and PPI mail should be in Group 2 and Groups 2 and 3 are not distinguishable. Special Delivery Next Day should be removed from price control since it already competes directly with established express services • Access products (at least for next control period) are developing rapidly through bilateral contracts under Condition 9 and therefore there is no requirement to include these products in the price control • New products (and new services introduced in the control that are not established) should remain outside the price control for at least the period of the review, else innovation will be stifled
Form and duration Chapter 6	• Proposes to retain an "RPI-X" form of control • Duration should be between 3 and 5 years, with Postcomm's preference at 5 years (provided information underpinning control is sufficiently robust) • Proposes to retain the current price control reopening mechanism • Other relevant issues – Should PC continue to use RPI as measure of inflation or move to CPI? – Should operating and capital expenditure savings be retained for a fixed time period?	• RM supports RPI-X over rate-of-return since RPI-X provides better incentives for cost reduction and innovation. • RM believes that RPI is a more appropriate index than CPI for the current operation of the control. A further refinement would be to adopt RPI+bW-X as an index, where W is the national average wage inflation index relative to the RPI and b is the proportion of allowed revenue relating to labour costs. • RM believes that the price control needs to identify and address the risks that are primarily outside of the control for RM in a direct and satisfactory manner. This is consistent with good regulatory practice.

Chapter	Postcomm's proposal	Royal Mail's position
Structure Chapter 7	• Believes there is merit in separate controls for 'captive' and 'non-captive' customers • Proposes to retain a form of tariff basket structure of control, though raises question of whether the current ex post tariff basket approach (based on outturn volumes) should be replaced by an ex ante tariff basket (based on actual volumes) • Expects to retain a correction factor ("k") for under/over recovery of revenue in any one year • Does not propose to introduce a specific mechanism to mitigate the risk of actual volumes being different from forecast • Other relevant issues – Should access products have a separate tariff basket – What rebalancing flexibility should RM have to adjust individual prices within the control? – How should the "C" factor be treated under the proposed structure of control?	• RM's prices are fundamentally misaligned with costs so sending wrong signals to customers and distorting the pattern of competitive entry. RM expects to rebalance and restructure of its prices significantly in the next price control to become more cost reflective. • RM therefore seeks to rebalance its prices toward cost reflectivity and believes that this is best achieved through a single tariff basket for inland services (the existing arrangement). • Access products (at least for next control period) are developing rapidly through bilateral contracts under Condition 9 and therefore there is no requirement to include these products in the price control • RM believes that any thresholds should be applied to facilitate significantly higher price changes than is the case under the current control to reduce market distortions, create a more stable market environment and allow for price rebalancing. • It may be appropriate to put International controlled services into a separate basket given changes to the charging arrangements for delivery in other countries and the need to fundamentally change the pricing structure. • RM believes that the current price control has operated well. RM believes that further consideration could be given to whether the control should use historic or forecast volumes (and adjustments), or a variant of the forecast volumes and historic adjustments. • RM believes further consideration should be given on how to address the risk to Royal Mail's finances in the presence of volume uncertainty and potential cost shocks as a means towards ensuring the continued provision of the universal service. RM sets out a relatively simple way that volume adjustments could be incorporated into Licence Condition 19.
Approach to financing. Chapter 8	• Initial preference is to retain a "cashflow" approach for assessing RM's ability to finance its licensed activities • Other relevant issues – Are there any compelling circumstances where an alternative to "cashflow" approach, such as a "regulatory value" approach, might be appropriate? – Should any additional allowance for risk be made if the cash approach is adopted?	• An efficient regulatory framework for determining allowed revenues should satisfy the following objectives – Safeguard USO – Enable RM to finance its mails business and provide an adequate return to the shareholder – Promote efficient entry into potentially competitive areas – Support equitable consumer pricing – Provide efficient investment incentives – Incentivise efficiency gains • Postcomm's application of "cash" approach as it currently stands does not satisfy these criteria, primarily because it does not allow for a commercially and financially viable Royal Mail. It – does not value the investment that the shareholder has made in RM. The proposed price control effectively values the Royal Mail at zero, since the shareholder is not allowed to earn any return on prior investment nor return on new investment. – does not provide efficient investment incentives or support equitable consumer pricing. • RM believes a "regulatory asset value" is appropriate to allow the shareholder a reasonable, commercial return on market value of the business and solve many of these issues (above), while, in addition, being consistent with the approach taken for other regulated industries in both the UK and other jurisdictions. • RM believes the 'enterprise value' of its regulated businesses can be established through a number of different approaches including – adopting a top down approach to estimating the enterprise value of RM through applying market comparables – calculating the enterprise value on a 'bottom up' basis, reflecting the full shareholder value of the

Chapter	Postcomm's proposal	Royal Mail's position
		assets of the business. • RM believes it should be allowed a return that compensates it for the risk inherent in its business, especially given the very high operational leverage driven by the requirement to provide the high cost USO network
Setting the level In Chapter 9	• Does not propose to 'claw back' any RM outperformance due to differences in outturn volumes from forecast in the current price control • Will take the latest volume data as the starting point for forecasting volume for the next price control period • Other relevant issues – What approach should Postcomm take to setting the level of price control, including operating and capital expenditure? – Are additional incentives required for RM to invest in efficient, good quality and well planned capex? – What principles should govern the assessment of pension costs? – What should the balance be between upfront price adjustments ("Po") and ongoing price adjustments ("X" factor)?	• RM believes the allowed revenues should explicitly include all operating costs reasonably and efficiently incurred by Royal Mail • RM believes that all its pension obligations should be funded through increased revenue allowances and price increases. These should include: – ongoing pension contributions; and – funding the pension deficit as Royal Mail's customers have benefited from past pension holidays through lower prices • RM notes that other regulators, faced with pension deficits in other regulated business, have included the provision for the payment of pension deficits when setting the allowed revenue. • RM agrees with Postcomm that the benefit to its profitability from exceeding the expectations of the current price control should not be 'clawed back' in subsequent controls, as this would be contrary to the basis on which it accepted the control and obstruct the incentive-based mechanism of an RPI-X control • Supplementary to the "regulatory value approach", RM believes cover ratios and other financial performance indicators resulting from the WACC and market-based value should be cross-checked to ensure that the mails business is financially robust and able to finance its activities and adequately fund its pension deficit.

CHAPTER 1: INTRODUCTION

Context of the response

1.1 This document sets out Royal Mail's response to Postcomm's document "*2006 Royal Mail Price and Service Quality Review: consultation on principles*" (September 2004). This is subsequently referred to in this response as "Postcomm's document". On the same day Postcomm also published papers relating to Market Opening and Competitive Market Review, to which Royal Mail is responding separately. In addition, Postcomm's document itself refers to a paper by one of its consultants, Frontier Economics, on the "*Scope of the Control*" (published on Postcomm's Website in November 2004 and subsequently referred to as FE's document). Royal Mail considers all of these documents to be interrelated and relevant to the price control review. The issues raised in "Postcomm's document" to which this document responds relate directly to the modification of the licence for the next price control while, the other documents set out some of the context and background thinking of Postcomm for the development of the market going forward into the price control period.

1.2 In addition to these responses, Royal Mail is providing information to Postcomm on its forward-looking plans to 2010/11. Royal Mail is also providing information to Postcomm's consultants, LECG, for their efficiency review.

1.3 For ease of reference, the subjects of the subsequent chapters of this document mirror the corresponding chapters in Postcomm's document (Chapters 2 to 9) as follows:

Chapter 2: Royal Mail's performance under the current control
Chapter 3: Objectives for the review
Chapter 4: Quality of Service
Chapter 5: Coverage
Chapter 6: Duration and form
Chapter 7: Structure
Chapter 8: Finance
Chapter 9: Setting the level.

Also for ease of reference, Royal Mail quotes the question and reference made in Postcomm's document prior to its response.

1.4 The main purpose of this response is to comment on the principles and key areas that Royal Mail believes should be considered by Postcomm as part of its review for the next price control. This is undertaken on the understanding that further details will be developed and form part of Postcomm's next consultation. In this regard, Royal Mail's responses to Postcomm's other papers are also relevant.

CHAPTER 2: ROYAL MAIL'S PERFORMANCE UNDER THE CURRENT PRICE CONTROL

SUMMARY

2.1 At the time that the price control was set, Royal Mail's costs were spiralling and competition was looming. There was a need to control costs and drive towards efficiency in preparation for the opening up of the postal market in the UK. At the same time, there was a need to introduce a new price control, to enable the Renewal Plan to be taken forward together with price rebalancing and restructuring.

2.2 Postcomm's document reviews the progress made in the first year of the new control (2003/04). Royal Mail believes that the story so far is largely positive. Royal Mail has stopped costs spiralling and has driven out cost. It has implemented some very significant changes to its operations including a move to a single daily delivery. It has maintained volume growth and implemented very necessary and long overdue price changes allowed under the new control. It has also developed terms for businesses to access its network downstream to add further choice to customers. This is all something that the regulatory bodies, shareholder and the business should take pride in.

2.3 Nevertheless, there remains much to do. In the short term, the implementation of operational changes has had consequences on the service quality that were not foreseen ahead of their implementation, largely because of the sheer scale of the changes involved. While quality of service dipped due to industrial action and transitional difficulties, it has now recovered with recent months showing a performance much more consistent with targets for most products including first class stamped and metered mail. And Royal Mail has started achieving a greater level of colleague engagement – with appropriate increases in financial rewards for our people – reflected in, this year, the lowest number of days lost to strikes for a decade. In the longer term, and for the next control, there is a need to maintain the momentum of change within Royal Mail in striving to be more efficient and customer focused.

Royal Mail's financial performance

2.4 Some of the specific details presented in Chapter 2 of Postcomm's document are discussed in further detail below.

2.5 Postcomm's document sets out figures for 2002/03 and 2003/04 and compares these with figures that it used to set the price control. Following Postcomm's decision document (February 2003), Royal Mail took the control formulae and figures from the modified licence condition to establish what they meant for the business. Insufficient information was provided at the time by Postcomm to validate or otherwise the figures presented in that document and represented in Table 2.2 of its September 2004 document. Consequently, Royal Mail cannot comment in detail on these figures and their comparability.

2.6 Royal Mail is better positioned to comment on its 2002/03 and 2003/04 outturn figures which Postcomm has sought to convert to 2000/01 prices to aid its comparison. Royal Mail wishes to make two observations regarding these figures:

(a) the 2003/04 financial figures may be understated by too high a deflator in converting the actual figures into 2000/01 prices;

(b) the figures relate to the union of both price controlled and universal service products. While this is done to facilitate comparison with figures reported by Postcomm in setting the control, potentially different figures and results would arise if the comparison was made for just the price controlled services.

As a consequence the figures appear to understate 2003/04 revenues and costs, and thereby overstate the savings for 2003/04.

2.7 Furthermore, Postcomm's document refers to Postcomm having given an additional allowance within its cash costs of £354m for 2003/04 for implementation of the Renewal Plan (paragraph 2.14). Postcomm's document does not draw the possible conclusion that a significant part of the difference between its cost allowance and actual cost in 2003/04 may arise from the financial impact of some of the Renewal Plan being delayed beyond 2003/04 (i.e. part of the £354m will impact after 2003/04). Hence some care is needed to avoid trying to draw too many conclusions from a single outturn year. Royal Mail has made significant progress since its launch over two-and-a-half years of the three-year Renewal Plan. The business is on track to deliver the financial objectives of the Renewal Plan**.**

Volumes

2.8 The number of price controlled items of mail increased between 2002/03 and 2003/04. The rate of growth without competition was less than expected, primarily because of lower than expected economic growth and a greater underlying trend in e-substitution. However this was more than compensated by delays in entrants taking volume from Royal Mail arising from Postcomm delaying the introduction of its long-term licensing regime for bulk mail from April 2002 to January 2003; delays in reaching agreement on the terms of access such that access traffic commenced after 2003/04 in May 2004; and delays in end-to-end entry arising from the uncertainty created by the delays in reaching agreement on the terms of access. The access terms were ground breaking for the postal sector and therefore particularly complex to conclude. Since the conclusion of the first access contract, the market is developing rapidly with further entrants.

2.9 While noting that there is a possibility that the total mail market could also grow, Royal Mail believes that most of the access volumes will result in reduced end-to-end volumes for Royal Mail. It also notes that this is not only likely but is already happening. Royal Mail also believes that entry through access will also lead to further entry in end-to-end services. This is also something that appears to be envisaged by Postcomm's consultants, Frontier Economics, in its report "Scope of the Price Control" (see Chapter 5 for further comment).

2.10 Postcomm's document indicates, in the first year of the current control, a 2.0% growth in volume for the products in the price control or deemed to be universal service at the time of setting the last control. Royal Mail believes that the volume growth equivalent was 1.8%, but that the underlying growth rate should be expressed as a growth rate per working day, which was 1.6%. Royal Mail understand the reasons for the presentation of the figures set out in Postcomm's document, but believes it may be more intuitive and helpful to set out the figures for the existing price controlled area or Postcomm's definition of "regulated activities" that it is using for the price control review in future documents. This would exclude, for example, inward international services.

Comparing allowed revenue with actual revenue in 2003/04

2.11 Royal Mail notes that it over-recovered its revenue by £15m on a total regulated revenue of nearly £5800m in 2003/04. Hence the over-recovery was less than 0.3% of regulated revenue and relatively small.

2.12 The over-recovery was caused almost entirely by a lower outturn service performance in 2003/04 than predicted at the time of setting the prices in 2002. If Royal Mail had met its targets for service performance, as expected at the time of setting the prices, Royal Mail would have over-recovered by £3m rather than the £15m. Moreover, the issue of the service performance during 2003/04 was not clear until towards the end of the year. Consequently, Royal Mail believes the over-recovery in 2003/04 primarily relates to the service performance and notes that this is also a conclusion in the independent auditors report presented to Postcomm to fulfil Royal Mail's requirements under the licence for the April 2005 price changes.

Royal Mail's pricing behaviour

2.13 Royal Mail has successfully implemented a number of price changes that improve the cost reflectivity of its prices and will continue to use the pricing flexibility provided within the control to do so. However, it notes that the scale of rebalancing required in some cases to align with costs significantly exceeds that allowed within the licence. Royal Mail can apply to Postcomm to seek a direction to allow individual price increases above the thresholds (secondary caps) in the licence.

2.14 Royal Mail has applied for a price increase above the threshold in two ways. Firstly, Royal Mail sought and obtained a direction in respect of a 1p increase on to the basic weight step of 2nd Class Response Services which very marginally exceeded the threshold increase but was consistent with a 1p increase on the 2nd Class Standard Tariff Letter price that was allowed within the existing thresholds. Secondly, in August 2003, Royal Mail made an application for the introduction of Size Based Pricing, part of which referred to the need for a direction to allow several prices to change in excess of the existing thresholds. Postcomm has recently consulted on this application and Royal Mail awaits its conclusion. In the light of the deliberations by Postcomm over such price changes, it has not yet sought further price changes in excess of the thresholds. Royal Mail believes the implementation of Size Based Pricing is an essential part of the future development of the market.

New products and innovation

2.15 Royal Mail introduced a number of new products within the first year of the price control - including Mailsort 3 120 and Special Delivery 9am. In the second year of the control is has (to-date) introduced a Response Service Plus and additional tracking service available for Packetpost (referred to as Packetpost Plus). It considers Mailmedia to have been a product before the start of the current control as reported in supplementary documents for 2002/03 Regulated Accounts (see Chapter 5 for further comment).

2.16 Royal Mail welcomes the emphasis of the need for innovation in Postcomm's Market Opening document. Royal Mail's plans are for significant product change in the next price control period to be more cost reflective and more customer orientated. While the current licence *requires* the provision of products and services deemed to be outside of the universal service, Royal Mail believes that this is not necessary under the Act. It limits the innovation for non-universal services. In addition, greater scope for change to the non-price terms is needed to facilitate innovation and benefit customers overall. In this regard, the non-price terms are constrained to excess by the current licence (licence condition 19(1)) by focusing on the potential detriment, with no account of magnitude, to a single customer.

2.17 Royal Mail has also introduced the access service and believes this to be a very significant step in offering choice to the customer and developing a competitive market.

Quality of service performance

2.18 Royal Mail suffered a deterioration in service performance in 2003/04 arising from, amongst other things, changes to its operations as part of the implementation of its Renewal Plan. It has taken time to address the issues, but service performance has improved in recent months and the outturn over the remaining period of the current control is encouraging. Royal Mail believes that a different incentive regime is required to maintain and improve quality of service in a more competitive environment.

CHAPTER 3: OBJECTIVES FOR THE REVIEW

Summary

3.1 Royal Mail believes that the key objectives that Postcomm should consider in its review of Royal Mail's price and service quality are first and foremost those duties ascribed clearly and unequivocally to Postcomm under the Postal Services Act 2000 in the order of primacy set out within it. Royal Mail believes that Postcomm's primary objective for the setting of the price control for Royal Mail is to ensure the provision of the universal service of a uniform tariff at an affordable price throughout the UK. It is, however, crucial to the development of a fully liberalised postal sector that included within the overall objectives are the necessary checks and balances to ensure that the market develops in a fair and equitable way with obligations to protect the integrity of the postal market and avoid a chaotic free for all which could occur if clear and precise rules and procedures are not set out and properly policed.

3.2 Royal Mail believes that Postcomm should set out clear unambiguous rules and protocols on all potential licensees and undertake a degree of due diligence to ensure that those entering the postal market are fully able to meet the obligations expected of them as postal operators. Royal Mail believes that this will be fully endorsed by postal operators who wish to see the development of a vibrant market with the customer fully involved and at the centre.

3.3 As Postcomm indicate, the ownership of Royal Mail is an issue for the Government, as shareholder. However, as referenced in this chapter, the recent changes to the Board of Royal Mail over the past few years and the significant improvement in financial performance demonstrates that Royal Mail does operate on clear commercial grounds and that the company is responsive to financial incentives. It is noteworthy that the longest serving Executive Director of Royal Mail has been with the Company less than four years.

3.4 The Government, as shareholder, requires that Royal Mail delivers incremental profit growth, is commercially viable and a sustainable business in the long term. To this end, Government has taken significant steps to ensure that Royal Mail operates on clear commercial grounds and is responsive to financial incentives.

Statutory duties under the Postal Services Act 2000

3.5 Royal Mail believes that Postcomm's primary objective for the setting of the price control for Royal Mail is the same as that clearly and unequivocally set out in the PSA 2000 – namely to ensure the provision of the universal service of a uniform tariff at an affordable price throughout the UK. The Universal Service Obligation for the UK is transferred solely to Royal Mail though its Licence and it is imperative that, whatever other objectives Postcomm wish to follow, that the primacy afforded this duty is recognised and that, again as required under the PSA 2000, Royal Mail is allowed to recover sufficient revenues to finance its licensed activities. This obligation means that Postcomm must ensure that the impact of any other objectives, such as the promotion of effective competition between postal operators does not adversely effect this prime responsibility and that, where applicable, caution must be applied in the other developmental areas. Royal Mail discusses how Postcomm can strengthen the price control to meet this primary objective through the treatment of risks that are not primarily under Royal Mail's control later in this response (see Chapters 4, 7 and 9).

3.6 Subject to the primary duty and the need to ensure that, under the Postal Services Act, Royal Mail as Universal Service provider can finance its obligations, Royal Mail would concur with the view expressed by Postcomm that regulation should be a proxy for competition and should not be required where a competitive market exists. In the period to 2010/11, Royal Mail expects significant market entry as some very financially strong competitors enter the market. This requires not only the prospect of "*light touch*" regulation but demonstration of it with clear and precise guidelines as to what is needed for services and products to be taken out of the control (see Chapter 5). Ultimately, Royal Mail believes that regulation should be limited to those areas where there is no realistic likelihood of customers being offered the prospect of a competitive postal offering.

3.7 Royal Mail welcomes the stated objective for the review of, "*To give Royal Mail some flexibility to respond to competition through introducing new and innovative products, setting its prices and revisiting its pricing structure*" (3.2). Royal Mail expects to rebalance and restructure its prices significantly within the next price control period to be more geared to costs and the requirements of its customers. It believes that there are already sufficient safeguards both within the Licence under which Royal Mail operates and contained within the Competition Act (1998) to deal with any issues of anti-competitive behaviour (see Chapter 7). Again, how Postcomm deals with this issue will provide an indication of how it will demonstrate its concept of "*light-touch*" regulation.

3.8 Royal Mail welcomes the stated objectives for the review of providing it with strong incentives in the area of efficiency, volume growth and to exceed quality of service targets. However, any incentives must be relevant and achievable. For example, efficiencies must relate to what is realistically achievable in a postal market and over a realistic time frame; volume growth relies on a vibrant postal market easily understood by all those involved and where prices are related to costs and quality of service targets need to be meaningful, relevant to customers and reflect the price/quality trade off. Moreover, any targets should be restricted to the USO market and should not be applied to non-USO services (see Chapter 4).

3.9 The objective for the review that the price control is simple and easy to understand and enforce and which provides a degree of certainty is to be applauded, subject to it adequately addressing the risks of the business. Royal Mail also agrees with the need for transparency, subject to Royal Mail's commercial confidentiality being honoured. As Postcomm is aware, the evolution of markets reduces the amount of information that is able to be made available due to the changing market environment. It is imperative that commercially confidential information is not made available to the market.

Ownership of Royal Mail

3.10 As Postcomm rightly point out, the ownership of Royal Mail is an issue for the Government, as shareholder. Royal Mail understands the shareholders objectives include ones of delivering incremental profit growth and providing a foundation for a commercially viable and sustainable business in the long-term. As referenced by Postcomm (for example, 3.25), Royal Mail is responding to the challenges of a competitive environment and has introduced some of the most far-reaching changes in the history of the company and of UK industry in the recent past with the various programmes of the Renewal Plan. There is no evidence, therefore, to suggest, as Postcomm do that, "*there is a risk that this [responsiveness to financial incentives] could be a lesser extent than might be expected from a publicly listed company*" (3.26). Royal Mail believes that it has demonstrated and continues to demonstrate its improvement but would urge Postcomm to recognise the differences between the postal market (labour intensive and universal service obligation) compared to other regulated sectors.

CHAPTER 4: IMPROVING QUALITY OF SERVICE

Foreword

4.1 Royal Mail will be setting out its views on future targets in its response to Postwatch's October 2004 consultation document "*The Future of Quality of Service Targets*". The current response therefore concentrates on how targets should be used to incentivise Royal Mail in the transition to the competitive market Postcomm seeks to bring about, without prejudice to Royal Mail's views on what targets should be in the future.

Summary

4.2 Royal Mail is currently heavily incentivised to improve quality of service with 28 Licence targets and penalty regimes worth up to around £200m pa, in addition to fines and individual compensation payments. Customers of three products received the maximum 5% discount on 2003/4 prices under this regime.

4.3 Royal Mail does not accept that it is applying the bulk compensation scheme incorrectly, and considers that further constraints on the allowed revenue, by extending the C-factor to bulk mail, are unnecessary at this stage. Royal Mail also disagrees that the current test on reasonable endeavours is insufficiently demanding.

4.4 The combination of Royal Mail's prices, targeted performance levels and penalty regime may be perceived by some potential entrants to be challenging to compete with in some end-to-end services. Royal Mail believes that a different incentive regime is required to improve or maintain quality of service in a more competitive environment.

4.5 It is appropriate to have Licence targets for some or all USO products. However the number of targets should be considerably reduced and the incentive regime linked to ranges of performance rather than simple pass-fail targets. Good performance should be rewarded in addition to penalties for poor performance.

4.6 Non-USO products should not have Licence targets but performance should be properly measured and reported by all major operators as well as Royal Mail. An incentive regime could remain until these products operate in an established market.

4.7 Royal Mail believes that Postcomm should give serious consideration to this approach and take the opportunity to develop a regime that is better suited to the evolving market.

4.8 Royal Mail sets out further initial views below and further details are provided in Annex A.

General

4.9 Royal Mail currently has 28 targets, all relating to transit time of mail, i.e. the speed with which it moves from posting to destination. As the targeted products for the most part go through the same processes, problems affecting the achievement of one target are likely to affect most others to a greater or lesser extent. This makes it much more likely that Royal Mail will either achieve most of its targets or fail most of them in any given period.

4.10 All these targets were originally based on Royal Mail's historic internal targets. Some areas were increased in 2003, as part of the overall package surrounding the current price control.

4.11 A consideration of regulatory regimes, competition, and prices in other EU countries indicates that there is no simple relationship between these and quality of service performance, although those countries with very high (over 95%) first class quality also have high prices (for example in Finland it costs the equivalent of 43p to post an item weighing up to 50g and in Sweden the equivalent cost is 38p for an item weighing up to 20g). This comparison also suggests that:

(a) Royal Mail is more heavily targeted and penalised than other countries.
(b) Its compensation arrangements are among the most generous.
(c) Its prices for second class mail are the lowest in Europe and its prices for first class mail are amongst the lowest
(d) Its <u>achieved</u> quality of service for first class mail is average for Europe
(e) Its <u>achieved</u> quality of service for second class mail is among the highest in Europe, if not the world.

4.12 Further details are given in Annex A.

A different incentive regime for Royal Mail in a competitive market

"Postcomm would welcome views about whether compensation for not meeting service targets is a factor that should be given greater or less emphasis in the next price control, and whether it should be given effect through the existing scheme or by adjustment to the price control." (Postcomm's document, para 4.13)

4.13 Before considering how to incentivise Royal Mail to achieve its targets Postcomm needs to consider whether those targets are the right things to measure and whether they are set at the correct level in relation to Royal Mail's infrastructure, prices and competitive environment. By trying to make the incentives of the existing schemes stronger before these issues have been considered fully in the context of the evolving market, Postcomm runs the risk of unbalancing the postal market and pushing Royal Mail into a downward spiral of quality failures and price reductions.

4.14 If it is the case that Royal Mail must operate at the limit of its current infrastructure in order to achieve some or all of its targets then it is always going to be uncertain whether those targets will be achieved, even if all reasonable endeavours are made to do so. This leads to the situation where Royal Mail is publicly criticised for failing its targets, pays tens of millions of pounds out in compensation and faces extensive investigation, fines and C factor penalties for what may be very small failures to achieve its targets and with a performance that may in absolute terms still be acceptable to customers, and even world class. This is not a satisfactory situation for Royal Mail, nor ultimately for Postcomm or Postwatch or the customer (or even competitors).

4.15 Royal Mail is incentivised to achieve its targets through a number of means:

(a) *Enforcement action and fines.* The use of targetry and fines allows

Postcomm to apply an element of discretion not built into the current C factor. However both the C factor and the compensation schemes will be better from the customer's point of view, as they return revenues to customers.

(b) *Price control C factor.* As currently devised by Postcomm this incentive creates an automatic penalty of up to £25m pa. There is no discretion for factors such as industrial action and no consideration of whether all reasonable endeavours have been made to achieve the targets. The construction of the C factor is weighted heavily towards performance of first class stamped and metered mail, which accounts for 70% of the potential penalty, even though it only makes up 47% of the revenue and 37% of the volumes in the revenue streams used to calculate the penalty. Although the C factor returns revenues to customers they are not necessarily customers of those products that have failed their targets, so from the customer's point of view this may be less satisfactory then bulk compensation.

(c) *Statutory bulk compensation scheme.* The maximum payments under the scheme amount to some £167m pa. The scheme does align redress to money spent and has some sensible exclusions but costs Royal Mail money to administer.

- Royal Mail agrees that the statutory bulk compensation scheme may be perceived by some possible entrants to be challenging to compete with in some end-to-end services, as it has the potential to offer a 5% discount on prices, and this level of discount was paid in 2003/4 for three of Royal Mail's targeted products.

- This is clearly a level of discount Postcomm has concerns about, as elsewhere Postcomm has said it wishes Royal Mail to levy 5% VAT on its prices in order to avoid distortion.

- Postcomm therefore needs to be very careful that the targets it agrees with Royal Mail going forward and the arrangements it imposes under the bulk compensation scheme (or indeed the C factor) do not combine to distort the market. Postcomm's own arguments logically lead to non USO products being removed from formal targetry and compensation.

(d) *The payment of statutory retail compensation for delays of over three working days.* This depends on individual valid claims, not on the achievement of targets. However there is an overlap between these payments and the C factor, as the same failure may give rise to payments under both systems. This overlap is one reason why it is appropriate that the C factor impact is kept to a relatively low level.

4.16 All these incentives work only in one direction: they penalise Royal Mail for failure to meet targets but do not reward it for exceeding the targets, even though many of these targets are stretching for Royal Mail to achieve. However, there is no practical reason why Royal Mail could not be allowed more revenue for retail as well as bulk products via the C factor mechanism. Increasing use of positive incentives is being made in other regulated industries and could be applied in the postal industry as well (see Annex A).

4.17 Royal Mail's quality of service targets and incentive regimes, in combination with current prices may be perceived by some potential entrants to be challenging to compete with in some end-to-end services. An international analysis clearly demonstrates that Royal Mail has very low prices in relation not only to its quality targets but also in relation to its achieved levels. It is possible that quality targets and prices are unbalanced for some or all products. Both the Roland Berger study carried out by Postcomm and the MORI study carried out by Postwatch with Postcomm and Royal Mail suggest little appetite for higher advertised quality of service levels, although lower levels are not generally acceptable and on balance customers would rather have better quality than lower prices. Therefore Postcomm must take care when incentivising Royal Mail financially to achieve agreed quality levels, that it does not unbalance the price-quality relationship still further. Postcomm cannot necessarily assume that greater competition will result in higher quality, certainly at similar prices to now, if this is not what major customers want. Rather than await competition Postcomm should modify its penalty approach to incentivise entry.

4.18 At the same time Royal Mail recognises that Postcomm needs to offer some degree of protection to customers from poor quality of service and appropriate redress if things go wrong. This should apply to customers of <u>all</u> operators, not just Royal Mail, particularly if Postcomm believes quality is very important to customers, as well as price. The degree of protection should vary depending upon whether the product is part of the USO or not, and the degree of competition it faces.

Products outside the Universal Service Obligation

4.19 Products outside the USO should not have Licence quality of service targets as this could restrict Royal Mail's ability to offer what customers want. However, the transit time performance of these products should continue to be measured and reported in accordance with the appropriate European CEN Standards in order to facilitate customer choice. This requirement to measure and report should be extended to **all** operators over a given size, including operators accessing Royal Mail downstream, and this measurement and reporting should again be in accordance with EU standards. Smaller operators should not be required to measure or report transit time performance but any published performance should be derived from proper measures (i.e. in accordance with the CEN standards) to ensure customers are given valid information against which to make a choice. Quality results should be adjusted for force majeure, which should include extensive unofficial industrial action. The same rules for force majeure should apply to all operators.

4.20 Until such time as the non-USO products are operating in an established market then some form of incentive regime to meet future quality targets could remain, preferably via the bulk compensation scheme. Any incentive regime should be pitched at an appropriate level in proportion to the return to the shareholder and that neither distorts the market nor jeopardises Royal Mail financially. A minimum 1% tolerance should be allowed before penalty or reward kicks in and the size of the penalty or reward should be capped (the current 5% should probably be the maximum considered). As competition progresses the penalty/reward regime should be removed. Postcomm should set out a clear timetable for this within the revised Licence so that both other operators and Royal Mail are aware of the plans. The Competitive Market Review would be an appropriate vehicle for this.

Products under Universal Service Obligation

4.21 Royal Mail recognises that it is appropriate to have regulatory performance standards for some or all USO products. However, it considers that the targets should be based around incentives to over achieve as well as penalties to under achieve, to enhance a culture of positive change within the business. These targets need to be measurable, consistently achievable and manageable in number, concentrating on the key factors of importance to customers.

4.22 In order to protect customers and encourage Royal Mail to improve or maintain performance, Royal Mail recommends the adoption of a different approach to the Licence performance standards. This would be to introduce ranges of performances instead of simple pass-fail targets. A similar system is currently used in the water industry. For example, Royal Mail could have four bands of performance for each target:

(a) Excellent, rewarded by additional revenue under the C factor
(b) Good, no penalty or reward incurred
(c) Needs improving, revenue withheld under the C factor or bulk compensation paid
(d) Unacceptable, fines considered in addition to the penalties above (but still subject to all reasonable endeavours).

4.23 The use of banding would facilitate a realignment of the historical targets with Royal Mail's current infrastructure capability and future aspirations. It would also allow some room for manoeuvre in managing disruption resulting from operational improvements and perhaps minor instances of force majeure, although all reasonable endeavours must still be a consideration where major problems have occurred. It would provide a "backstop" level of performance beyond which Royal Mail would suffer financial redress if it fails to give adequate service to customers without very good reason, instead of punishment for failing a lot of targets by a small margin. It would allow some movement in the current price-quality gridlock, which could discourage some operators from offering end to end services in the market. Finally it would allow Royal Mail recognition of its world class levels of performance on some second class products and an incentive to invest in its infrastructure to improve services to a higher level.

4.24 Royal Mail believes that Postcomm should give serious consideration to this approach and take the opportunity to develop a regime that is better suited to the evolving market.

Other Points Raised by Postcomm

"Postcomm would be interested in stakeholders' views on the merits of making a greater proportion of Royal Mail's allowed revenue dependent on it meeting its quality of service commitments, particularly in relation to bulk services. Postcomm would also welcome views on whether there are other measures it should consider for improving the regulatory framework for quality of service, including imposing a more demanding licence test than "all reasonable endeavours"". (Postcomm's document, para 4.7)

4.25 Royal Mail would strongly disagree that the current test of undertaking "all reasonable endeavours" is insufficiently demanding. Royal Mail believes that it would not be reasonable to expect Royal Mail to do more than all reasonable endeavours to achieve targets that are in themselves very demanding. As correctly mentioned in Postcomm's document, the imposition of further obligations in the test could mean that Royal Mail would need to spend very large sums of money to achieve very small quality improvements.

4.26 Royal Mail, therefore, firmly believes that an even more demanding test than 'all reasonable endeavours' would be disproportionate and unnecessary.

4.27 Royal Mail would also oppose a substantial increase in the proportion of allowed revenue dependent upon meeting targets, particularly if the current target structure were to remain in place. Royal Mail's exposure on failed performance standards is already around £200m pa – broadly equivalent to a 1p increase in the price of a stamp. Postcomm recognises the potential distortion to competition this may cause; why therefore does Postcomm seek to increase this at a time when it wishes to promote competition? If Royal Mail is already operating at or close to the maximum performance it can with its current infrastructure then Postcomm risks pushing Royal Mail and with it the main UK postal infrastructure, into an unsustainable price-quality downward spiral. Postcomm needs to be very sure that Royal Mail can sustain a performance with its current infrastructure at all of its targeted levels before it increases the financial impact of failing to do so. Royal Mail has seen no evidence to suggest that Postcomm enjoys this assurance.

4.28 Moreover if Postcomm wished Royal Mail to make changes in order to become more efficient, innovative or higher performing, then Postcomm would need to allow for the possibility of temporary disruption to the existing levels of performance or services offered in its incentive regime.

4.29 Royal Mail therefore considers that further constraints to the allowed revenues, by extending the C-factor to cover bulk services, would not be appropriate at this stage.

"Postcomm is working with Postwatch, DTI and Royal Mail to clarify the position under the Postal Services Act 2000 so that compensation for loss, damage and delay can be put on a clear and consistent footing. Postcomm will do everything it can to achieve this in time for the next price control." (Postcomm's document, para 4.11)

4.30 Postcomm's document implies that Royal Mail's existing arrangements for loss and damage compensation under the Postal Schemes do not operate on a clear and consistent footing. Postcomm's document does not state what objections Postcomm has to the way in which Royal Mail operates these schemes. Loss and damage of untracked postal items is difficult, if not impossible, to prove or disprove. Royal Mail is strongly aware of the problems with fraudulent claims and a rising compensation culture in present UK society and will not weaken its right to refuse any claims it considers are invalid, spurious or fraudulent.

4.31 Royal Mail's discretionary schemes for loss and damage are generous and operated professionally and flexibly, giving the benefit of the doubt to many customers who cannot prove that loss or damage has occurred. Royal Mail therefore disputes that the schemes are not operated consistently and clearly.

"Early indications from the operation of the bulk compensation scheme are that it is open to dispute in some aspects of its application. We believe this is

unsatisfactory. Although changes may well be made following the review of the scheme in January 2005, Postcomm would nonetheless welcome views on whether the scheme should be replaced in the next price control by an equivalent of the "C" factor operating on the appropriate revenue streams." (Postcomm's document, para 4.12)

4.32 Royal Mail does not agree that that moving the bulk compensation scheme payments to an automatic penalty under the price control is either necessary or appropriate at this stage. The exclusions and elements of discretion in operating the scheme are appropriate and Royal Mail does not accept that it is applying the scheme incorrectly. Postcomm needs to be consistent with its statements in this regard, for if as regulator it believes this to be the case then it should take the appropriate action.

4.33 If the penalties for bulk mail products were to be levied under the price control instead of via the compensation scheme Royal Mail would certainly expect substantial changes to the ways in which the C factor currently operates. Royal Mail remains unwilling to accept individual claims for compensation in relation to bulk mail items, for reasons that are already well documented.

4.34 Royal Mail continues to believe that Postcomm's inflexible attitude to any allowance for industrial action is in conflict with its desire for a more innovative and efficient Royal Mail. Significant change can lead to issues that need resolution. By tying Royal Mail's bulk compensation scheme into a structure that gives no allowance for Industrial Action, Postcomm adds to the difficulty of major change. A more punitive C factor along these lines would simply make matters worse.

CHAPTER 5: COVERAGE

Summary

5.1 The current price control has an extensive coverage of Royal Mail's mail services and facilitates the rebalancing of prices through having the prices for those services within a single basket. In Chapter 5 of Postcomm's document, and by reference to a report by Frontier Economics (FE), Postcomm proposes a change to the single basket coverage and structure of the control. Royal Mail believes that such a change in structure is neither appropriate nor necessary. Royal Mail believes that fundamental rebalancing of its prices is still necessary to become more cost reflective and customer orientated and that this is best achieved through the retention of a single basket (with the possible exception of excluding international regulated services for reasons other than competition).

5.2 Royal Mail recognises that the FE report is the first piece of analysis presented on behalf of Postcomm to indicate how it proposes to assess the development of competition in Royal Mail's regulated services. It builds on Postcomm's previous consultation paper regarding the five areas it considers appropriate to consider when looking at the competitiveness of services. In many respects it also builds on the work undertaken in the telecommunications sector in which products and services deemed to be prospectively competitive are taken into a separate basket and then, ultimately, out of the control.

5.3 Royal Mail is concerned that FE's report makes recommendations on the structure of the control when the scope of the report is limited to the competitiveness of services. It is unclear how Postcomm intends to take account of its other duties, including its primary duty to ensure the provision of the universal service and other duties of promoting economy and efficiency and having regards to the financial viability of the licensee. These other duties are critical to any assessment of the coverage and structure of the control for, in the presence of competition, Royal Mail needs to be able to finance the provision of the universal service and provide a commercial return to its shareholder.

5.4 Royal Mail is also concerned by the limited amount of evidence and analysis, particularly of a quantitative nature, relied on by Postcomm and FE in drawing conclusions. Royal Mail believes that a rigorous approach has not been followed, particularly regarding the definition of the relevant market (for which there is significant precedence in cases at, for example, the Office of Fair Trading) and the ability of Royal Mail to increase prices, and therefore Postcomm has relied upon subjective and largely unsubstantiated judgement. Royal Mail is concerned that the fundamental changes to the structure of the control put forward by Postcomm and FE emerge from their analysis of coverage and are not based on a sufficiently evidenced approach.

5.5 At present, Royal Mail believes that, of the services and products discussed by FE, Access products, Mailmedia and Special Delivery 9 am should remain outside of the control (i.e. in Group 4). Royal Mail believes that the distinction drawn by FE between Group 1 and Group 2&3 customers is a distinction between residential and business senders and, as such, it would be more consistent to include PPI/meter customers in Group 2&3. Royal Mail believes that the distinction drawn between Groups 2&3 is not well defined.

5.6 Royal Mail's sets out further initial views below.

Identifying the end-to-end services to regulate

"Postcomm would welcome initial views on which products should be included within the next price control, on the basis of the present competition assessment. Postcomm would welcome comment on the analysis in Frontier Economics; report and its grouping of products". (Postcomm's document, para 5.24).

General philosophy

5.7 Royal Mail recognises that the FE report is the first piece of analysis presented on behalf of Postcomm to indicate how it proposes to assess the development of competition in Royal Mail's regulated services. It builds on Postcomm's previous consultation paper regarding the five areas it considers appropriate to consider when looking at the competitiveness of services. In many respects it also builds on the work undertaken in the telecommunications sector in which products and services deemed to be prospectively competitive are taken into a separate basket and then, ultimately, out of the control.

5.8 Postcomm set very narrow boundaries for the report as "*Postcomm asked us* [FE] *to focus our analysis of the scope of the control on a competition assessment for each product only*" (p67). The FE report's emphasis is therefore in respect of the promotion of effective competition, Postcomm's second duty under the Act. It is unclear how Postcomm intends to take account of its other duties, including its primary duty to seek to ensure the provision of the universal service and other duties of promoting economy and efficiency and having regards to the financial viability of the licensee. These other duties are critical to any assessment of the coverage and structure of the control for, in the presence of competition, Royal Mail needs to be able to finance the provision of the universal service and provide a commercial return to its shareholder.

5.9 FE advises Postcomm that setting up subgroups for separate controls will "*minimise risk*" (p67). The primary issue of the report is to look to introduce subgroups to diminish or eliminate Royal Mail's freedom to rebalance prices and, in particular, to reduce prices in services that may prospectively become more competitive (i.e. providing "*no risk of cross-subsidy or inefficient rebalancing in respect of other products*" (p67)). Under normal circumstances price reductions would be seen to be beneficial to customers, but in this report price reductions are seen as a means of retaining mail volume that would otherwise transfer to competitors and therefore is an obstacle to the promotion of competition. Consequently, the report believes that competition law and the licence are insufficient to promote effective competition because they, of themselves, do not obstruct or limit price reductions. Furthermore, the report not only seeks means of restricting Royal Mail's ability to reduce prices in prospectively competitive areas, it also seeks to limit the scope to increase prices in the non-competitive areas.

5.10 Royal Mail has several concerns with the philosophy summarised in the preceding paragraph.

(a) the primary duty of Postcomm is to ensure the provision of the universal service and in so doing to have regard to the financial viability of Royal Mail. Postcomm's primary duty is around this risk and not the risk that Royal Mail may reduce its prices in prospectively competitive markets.

(b) the limitations of the current price control to rebalance and restructure prices means that Royal Mail's prices are not well geared to cost. Consequently, they include significant cross-subsidies that are widely recognised. Far from creating "no risk of cross-subsidy" the sub-grouping proposed in the report would potentially lock Royal Mail's prices into its existing cross-subsidies that distort the market at a time when Postcomm is actively fully opening up the market to competition.

(c) the reduction of prices in prospectively competitive markets is not only limited by UK competition law and the licence, but also by the EU Directive requirement for prices to be more geared to cost. The implication of this is that price movements are required to be more cost reflective.

(d) limiting rebalancing prices to be just within each sub-group is likely to be distortionary. For example, the price of Cleammail and other presorted products (proposed for Groups 2&3) is based on the PPI/meter price of Standard Letter Tariff (STL) (proposed for Group 1). On the basis of product substitutability and avoidance of introducing price distortions, this would mean placing PPI/meter prices in Groups 2&3. This would then leave Group 1 as stamps only. This highlights one of the fundamental cross-subsidies that currently exists within Royal Mail prices – namely that between stamps and PPI/meter – on which Postcomm has recently consulted. Within that consultation Postcomm notes that the average unit cost difference between stamps and PPI/meter is about 7p. To achieve this differential, stamp prices will need to increase. Still further increases in the stamp price will be needed to ensure a reasonable commercial return to the shareholder in the presence of full market opening.

(e) while the current price control allows for prices to increase for any service, the extent to which this can be done is severely restricted by the secondary caps within the control.

5.11 To ensure financial viability, to remove significant cross subsidies, to become more cost reflective, to limit price increases and to have a significant level of competition, Royal Mail believes that, on average and in real terms, its prices in sub-group 1 (the "non-competitive" services) will need to increase significantly by 2010/11[1]. Under the proposed structure of the report, Postcomm would need to set the control to lock into this level of increase to ensure its primary duty. Conversely, Royal Mail believes that, on average and in real terms, its prices in Group 2/3 (the prospectively competitive services) will need to decrease by 2010/11. Hence a similar outcome could be achieved within the existing structure of the control. This would avoid having to allocate between subgroups in a manner that could prove to be distortionary and by FE's own admission is somewhat "arbitrary" (p5).

5.12 In conclusion, Royal Mail believes that the structure proposed in the FE report and adopted in Postcomm's document is not appropriate for the next control and that the single basket approach of the current control and existing legal constraints on pricing are appropriate for Royal Mail for the next price control.

[1] Royal Mail believes there is significant scope to do this as the basic weight step prices for first and second class public tariffs are amongst the very lowest in Western Europe and that this should be taken into account when assessing the affordability of prices.

While this approach was applied in other sectors (most notably for BT network charge controls, where network services were put in one of four categories according to the level of competition in the relevant market), the primary duty of the regulator in that sector was not one of seeking to ensure the provision of the universal service[2]. Furthermore, by the time the regulator introduced the different sub-caps the network charges of BT were already reasonably aligned to cost, as compared with those of Royal Mail[3]. Royal Mail also believes that the structure set out in the FE report is not *necessary* for the next control because the same outcome could be achieved through the current structure of the control. Indeed, to-date economic academic literature (for which there is no reference in the FE report) supports the retention of the existing structure (which resembles a global cap of retail services) as a means of establishing welfare maximising, cost-reflective pricing. Indeed it indicates that the (volume) weights can be set in such a way as to achieve this outcome[4].

The treatment of new services

5.13 FE proposes to include in the coverage of the next price control all services that have been introduced within the current price control, with the exception of Special Delivery 9am. This view is based solely on the report's view of the development of competition.

5.14 Royal Mail notes that Mailmedia was introduced <u>before</u> the current price control, but was not included in it. Hence, Postcomm has not just taken account of a view of the development of competition. Royal Mail believes that a more balanced approach is needed to avoid stifling innovation that is to the benefit of customers.

5.15 Royal Mail believes that a new product takes time to become established and that during that time its specification and price may need to be revised. Until the service becomes established Royal Mail does not believe it is reasonable or appropriate to be "locked into" a specification (through Licence Condition 19(1)) or through its initial price (through Licence Condition 19(11)). Royal Mail believes that early "locking-in" would significantly impair innovation and the introduction of new services. Consequently, Royal Mail believes that new services introduced in the current control should remain excluded from the price control if they are not well-established and that new services within the next control period should remain outside of the control.

5.16 This approach then requires a test for when a new product introduced within the current control is well-established. Royal Mail would expect this to include consideration of:

(a) the number of customers on the new service;
(b) the size of the revenue relative to the next nearest substitute.

5.17 On this basis, Royal Mail believes that, under any reasonable application of such

[2] Indeed, Oftel's goal was to achieve the best deal for consumers in terms of quality, choice and value for money by promoting competition.
[3] Oftel and BT agreed the starting charges for the control period on a forecast of the relevant incurred incremental cost plus mark-up for each service on October 1997. Thereafter BT was free to set its own charges, subject to two underlying constraints, RPI-X control and a 'floors and ceilings" test, given by a floor of incremental costs and a ceiling of stand alone costs.
[4] Laffont, Jean-Jacques and Jean Tirole. 1996. "Creating Competition through Interconnection: Theory and Practice." Journal of Regulatory Economics (10): 227–56.

a test, both Mailmedia and Access remain services that are not well-established. Both are subject to further development, changes to product specification and prices. Consequently, both should be kept out of the price control pending their further development. Further discussion and reasons for the exclusion of Access services from the next price control are set out later in this Section.

Proposed criteria for sub-grouping

5.18 The proposed sub-grouping primarily arises from FE's consideration of the development of competition and the substitutability of products. FE's report does not to refer to "prospectively competitive" as criteria. Nevertheless, this is essentially the criteria used for BT network charge controls and appears to best summarise what FE is actually proposing. Essentially, FE's report concludes that Group 1 services are not expected to be sufficiently competitive to be removed from the control by 2010/11 while Groups 2&3 services are expected to be sufficiently competitive to be removed from the control by 2010/11. The distinction that the FE report seeks to draw between Groups 2&3 is arbitrary and unsubstantiated because, in both cases, the report concludes that currently competition is not sufficient developed and by 2010/11 will be sufficiently developed. Royal Mail therefore views these two groups as one. This would also be consistent with the approach adopted by Oftel, by which the degree of control was set to depend on whether the services were considered to be competitive, prospectively competitive or non-competitive.

5.19 Consequently, the report really identifies three subgroups: (a) end-to-end services in which customers are the primary sender as prospectively non-competitive and allocated to Group 1; (b) end-to-end services in which businesses are the primary sender as prospectively competitive and allocated to Group 2&3 and (c) access services as non-competitive and allocated to Group 4. This would then be more transparent if the report also considered the distinction between stamps and PPI/meter as discussed in paragraph 10(d) above.

5.20 The report itself acknowledges a lack of quantifiable evidence to support its conclusions. Royal Mail believes that this somewhat undermines the credibility of some of its conclusions – for example, such as the distinction between Group 2&3. Consequently, Royal Mail does not believe the actual criteria provide the transparency that the market and itself would wish to seek in tracking the competitive development of sub-markets within letter mail. A proper separation of baskets according to the level of competition should be supported by appropriate data to ensure that products with different levels of competition are not put together. The analysis of FE is mainly qualitative and speculative at times. As mentioned below, a more quantifiable competition-based test would need to be in place in order to have more confidence that the grouping of products is adequate for the setting of separate baskets within the control and based on the categories of competitive, prospectively competitive and non-competitive.

5.21 The FE report acknowledges that its purpose is not to address the subject of the criteria and tests for taking out services between the start of each price control. Royal Mail considers this to be a serious omission. Currently, there are no transparent criteria for this as Royal Mail stated in its response to Postcomm's November 2003 consultation. Royal Mail had sought discussions on the quantifiable measure that could be used to inform and make more transparent such a test but this has not yet been forthcoming. It is possible that the information requirement listed in Section 6.3 of the FE report could form a starting point for taking this forward.

Coverage for the next price control

5.22 Royal Mail agrees that competition is limited at present and that there is little current market evidence to support the removal of any existing Controlled Services from the price control. Royal Mail notes that Postcomm's and FE's rationale for removing existing Controlled Services from the control is not based on the current but on the prospective market. It then notes that the duration of the proposed control will be a factor to take account in the prospective development of the market. While FE believes that competition will be sufficiently developed in some services to remove them from the control by 2010/11, the inference from their report is that they do not believe that they should be removed if the duration were shortened.

5.23 Royal Mail then has several concerns over the specific methodology used including:

(a) the FE analysis does not undertake a rigorous analysis of the definition of markets. The lack of proper market definition analysis further calls into question the accuracy of the proposed product grouping. FE implicitly assumes that the definition of markets is primarily product based and secondly based on the split between business and residential senders. Royal Mail believes that the relevant market definition is a pre-requisite for any assessment of competition and needs to take account of a broad range of factors including substitutability, demand functions and price elasticities (as demonstrated by many cases, for example, at the Office of Fair Trading). Moreover, Royal Mail believes that this is a standard approach to the definition of markets that has not been applied in the FE report.

b) the FE report makes bold conclusions that some products are, in effect, prospectively competitive by 2010/11. However the report contains no projections of traffic for Royal Mail products (to assess market shares and switching to competitive and other Royal Mail services) and no quantitative assessment to gauge what constitutes non-competitive, prospectively competitive and competitive. Royal Mail believes that such a quantitative approach is necessary because firstly it will assist transparency and secondly it will enable the approach to be more generally applied (e.g. for the removal of products and services during the control and in considering the implications of a shorter duration).

5.24 Royal Mail is concerned by the limited amount of evidence and analysis, particularly of a quantitative nature, relied on by Postcomm and FE in drawing conclusions. Royal Mail believes that a rigorous approach has not been followed, particularly in respect of definition of the relevant market and ability of Royal Mail to increase prices, and therefore Postcomm has relied upon subjective and largely unsubstantiated judgement. Royal Mail is concerned that the fundamental changes to the structure of the control put forward by Postcomm and FE emerge from their analysis of coverage and are not based on a sufficiently evidenced approach.

Other issues

5.25 The FE report makes reference to some other points which Royal Mail comments on below:

(a) it appears to support the continuation of some zero price goods. Royal Mail believes that competitors will only provide such services if there is a positive price and return to be made. Continuation of a zero price for these services both ensures that Royal Mail has to cross-subsidise the service and that there are no incentives for competition to enter the market. Royal Mail is unclear how this squares with Postcomm's duties under the Postal Services Act.

(b) it refers to what amounts to be cream-skimming opportunities for entrants under the uniform pricing constraint of Royal Mail. Royal Mail welcomes recognition of the risk. Postcomm should take this into account when considering its primary duty to ensure the provision of the universal service and Royal Mail's finances.

(c) it refers to businesses being in a position to reclaim VAT. Royal Mail welcomes this recognition. Royal Mail notes that other reports by Postcomm have indicated VAT may be less significant than initially believed.

(d) it refers to the survey research by Roland Berger (Section 3.3). Royal Mail has reviewed the Roland Berger data in detail and sets out its views in a Royal Mail's response to Postcomm's CMR document.

(e) it proposes that the Special Delivery 9am product is not price controlled. Royal Mail has introduced this product as an express rather than standard mail service. Hence it believes that it is a product that is in the express market, which is fully open to competition and is well-established as a highly competitive market.

Access services

"Postcomm would welcome comments on its proposal to bring access products within the price control from April 2006, in the absence of appropriate arrangements to regulate access. We would also welcome comments on whether it would still be appropriate to consider price controlling access products if an access code was proposed by Royal Mail". (Postcomm's document para 5.31)

5.26 Postcomm correctly states that the access arrangements are regulated by Licence Condition 9 in contrast to end-to-end services that are regulated by Licence Condition 19. Postcomm's document neglects to say that each contract includes a cap on the change in the access price between any two years that reflects the overall level of within the control for end-to-end services.

5.27 The motivation for Postcomm to place access products within a price control is unclear from the document:

(a) if it is to regulate the level of the price increase, these are already capped within the contracts freely entered into between Royal Mail and access entrants;

(b) if it is to ensure that contracts are standardised so that there is limited delay in their implementation, once a contract has been developed it is open to all and there is no delay in its implementation because of lack of standardisation. Any 'delay' is caused by the inevitable details that need to be understood and actioned by both parties. This is evidenced, in fact, by early access entrants who signed contracts that were more or less identical. However, if entrants want to have changes to the standard existing contracts, this necessitates a period of discussion between the entrant and Royal Mail to complete the details of the contract. Since an entrant may want a variant on an existing contract, this always remains a possibility whether or not the access products are controlled. Consequently, standardisation is not a rationale for including access products in a control per se.

5.28 The motivation for Postcomm is perhaps clearer from its publication on access prices made after the agreement between UK Mail and Royal Mail and its preceding documents[5]. These documents indicate that Postcomm may want to (a) set the access price at a lower level than that agreed between Royal Mail and a number of third parties; (b) exclude some contract clauses freely entered into by both parties; and (c) allow direct access to delivery offices (even though this has not been precluded within any contract). Royal Mail believes that such intervention could destabilise the market because:

(a) a lower access price could distort the market. The level of access price will affect the type of entry. The current level of access prices will facilitate entry through both end-to-end and downstream access. In other sectors (e.g. mobile telephony) more innovation is driven by full network competition rather than pure reselling access, which may reduce prices in the short run where access prices are low, but is less likely to deliver long term changes in technology. A lower access price, whether actual or implied, through the inclusion of the service in the price control would send a signal to the market that it is not worth investing in bypass of Royal Mail and reduce entry in end-to-end services and the associated market innovation[6].

(b) a lower price access could lead to financial shortfalls for Royal Mail. The potential for regulatory intervention to distort the market is particularly acute while end-to-end price themselves need to be adjusted to be more cost reflective. There is a need to enable prices of access and their close substitutes to be aligned and consistent to avoid significant swings of end-to-end volume to access that could lead to a financial shortfall for Royal Mail.

(c) extension of the access service to include delivery office access will create numerous logistical and technical problems, many of which are

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[5] See "*Promoting effective Competition in UK Postal Service through Downstream Access: Observations on the agreement between Royal Mail and UK Mail Ltd on access to Royal Mail's delivery network*", Postcomm March 2004.

[6] When the 1997 network charge controls were set up, Oftel considered that '*the prospect of excessively restrictive regulation could deter innovation and prevent operators from benefiting from the new service offering.*' Oftel, however, considered that if the new service becomes an important input into retail services and if it became clear that BT was abusing a dominant position, then the regulator would intervene to adjust the level of charges of new services.

insurmountable (e.g. space constraints) while others would significantly increase Royal Mail's costs. This issue was discussed in some detail in Royal Mails response to Postcomm's original draft determination on UK Mail's request for access (August 2003).

5.29 Royal Mail believes that it should be allowed to offer entrants the existing contract arrangements and believes that there is no real delay in an entrant taking up such an offer. Royal Mail believes that it should be allowed to negotiate with potential entrants over proposed changes to the existing access arrangements, as currently required by Licence Condition 9. Royal Mail recognises that if such negotiations fail then the matter can be referred to Postcomm for determination. Royal Mail believes that sufficient safeguards are currently in place both for entrants and Royal Mail to continue the development of access arrangements. This is borne out by the level of interest being shown in downstream access in the postal sector.

5.30 Royal Mail believes that the current level of access prices, as well as leading to entry through access, is generating consideration of entry in end-to-end services. Given the development of access services over the past twelve months, there is particular focus at this time on access as an entrant strategy and therefore a call from some interested parties for lower access prices. Royal Mail believes that the present access arrangements facilitate entry through both access and bypass (end-to-end), in balancing between those interested in seeing lower and higher access prices. Furthermore, Royal Mail believes that moves to more cost reflective access and end-to-end pricing will ensure that entry is more efficient.

5.31 Postcomm indicates that the establishment of an access code may not be a significant factor in whether access products are or are not price controlled. Royal Mail is proceeding to develop its access code. The access code will focus primarily on the processes, procedures and outputs of the service. Under its Licence (Condition 9, Part 2(3b)) it will also refer to the charges for access.

5.32 In summary, Royal Mail is unclear from Postcomm's document as to Postcomm's motives for proposing a change to include access services in the price control. Royal Mail believes that:

(a) the current access terms have led to entry into access services and there is significant evidence of new parties continuing to enter into the arrangements for access.

(b) the current access terms allow a very real prospect of further end-to-end entry – the recent zonal access arrangements enable competitors to 'pick and mix'.

(c) the year-on-year price increase for access prices is already constrained under each contract.

(d) the level that an access price could increase to is constrained both by contract terms and by the price of end-to-end substitutes that Postcomm propose remain within the coverage of the control.

(e) moves to have more cost reflective access and end-to-end pricing will ensure that entry is more efficient.

(f) access terms are subject to determination by Postcomm in the event of a failure to agree terms.

Hence, Royal Mail concludes that a change to the current regulatory arrangements for access is unnecessary. The price control should remain focused on end-to-end services only with end-to-end prices being rebalanced and restructured to become more cost reflective in the next control.

New products

"Postcomm would welcome comments on how it should regulate "new products" in the next price control, so that genuinely new products would remain outside the price control. (Postcomm's document, para 5.35)

5.33 Royal Mail has set out its views on the treatment of new services above. Supplementary to these views is a consideration of what constitutes a "new product". While "new products" are treated as being outside of the control, existing products and minor variants of existing products are treated as being inside the control. This raises the question as to what constitutes a major or minor variant. To assist Royal Mail in answering this question, it has looked at what Postcomm has said about some of the variants.

5.34 Firstly, Postcomm deemed Mailmedia to be a recently introduced "new product" for the current price control. Mailmedia combines the characteristics of two existing services – a Response Service product and a pre-sorted product. Consequently, Royal Mail has concluded that the combining of two existing products constitutes a "new product" or major variant.

5.35 Secondly, Postcomm deemed Special Delivery 9am (and Mailsort 3 120) to be "new products" for the current control. Both products involve a difference in the time taken between collection and delivery relative to existing products. Consequently, Royal Mail has concluded that a difference in the time taken between collection and delivery relative to existing products constitutes a "new product" or major variant.

5.36 Thirdly, Postcomm deemed a new machinable only variant of the existing Response Service product to be outside of the current control. The existing product includes both machinable and non-machinable mail. Consequently, Royal Mail has concluded that the introduction of a machinable mail only product in the presence of a product that is both machinable and non-machinable mail constitutes a "new product" or major variant.

5.37 In most of the other cases encountered to-date, Royal Mail believes that the variances have been minor and have not constituted a "new product" of minor variant. For example a variant of Cleanmail (e.g. Cleanmail Plus) introduces a variant to the existing specification regarding a minor enhancement to the machine readability of mail. The main exception is the tracking system of Packetsort Plus which Royal Mail considers to be a additional service not previously offered.

5.38 Royal Mail believes that it may be useful to confirm common guidelines for what constitutes a "new product" for the next price control. This could improve transparency and build on the existing rationale. However, Royal Mail would be concerned if this led to delays or increased restrictions on innovation. While the present arrangements create some constraints on innovation, Royal Mail has been able to innovate to some degree and believes that it is essential that scope for this should remain in the future.

Removing services from the control

"Postcomm welcomes views on its proposal to formalise the process for considering applications from Royal Mail to remove products from the price control because competition is sufficiently developed. Postcomm would also welcome comments on the specific process that Postcomm is considering proposing to be included in Royal Mail's licence. (Postcomm's document, para 5.40)

5.39 Royal Mail believes that the document has focused on establishing processes and timetables. However, it believes that much of this is premature because, at an early stage, Postcomm should focus on establishing quantitative guidelines and tests that will make the decision making more transparent. The FE report specifically says that this was not within the scope of the report. Consequently, Postcomm has not published anything on this subject as yet. Once the quantitative guidelines and tests have been confirmed consideration can be given to processes and timetables.

5.40 Royal Mail notes that the current price control requires the prices for Controlled Services in April each year to be audited independently and published by the preceding 31 December. Royal Mail is also required to publish a forecast under and over-recovery position by this date. This means that prices are finalised and audited in the last few months of the calendar year. This implies that confirmation as to whether a product is to be removed from the price control the following April is best known by the preceding 30 September. The expected period for Postcomm to process the application then depends on the quantitative guidelines and tests applied. With the quantitative guidelines and tests known, the time required for Royal Mail to submit an application should be specified for a decision by 30 September.

5.41 Royal Mail believes that the removal of a product from the current control is most easily done, from the perspective of the calculations, at the end of a Formula Year (which is not necessarily 31 March). However, Royal Mail believes that the methods for adjusting the calculations were it to be undertaken mid-year are largely in place (and approved independent auditor) because they are little different from mid-year price changes. The only additional requirement would be to establish how much revenue was recorded in the accounting system up to the date of its removal. Consequently, Royal Mail does not believe that there is a need to restrict the timing of a service from the control or the timing of the application.

5.42 Royal Mail also believes that once its process for its market review is established it could be updated regularly during the year for areas of particular interest and development. While a single annual report may review the whole market, the timetable for removing specific products from sub-markets should not be restricted by the timetable for this overall annual market review, as appears to be the case in Postcomm's document.

5.43 In conclusion, Royal Mail believes that it would be helpful to clarify the quantitative guidelines and tests for the removal of a service. With this known, it may be possible for Postcomm to indicate how long it would expect to take between receipt of the application and a decision. Royal Mail would expect this duration to be reduced the more transparent and quantitative the nature of the guidelines and tests.

CHAPTER 6: FORM AND DURATION

Summary

6.1 Royal Mail believes that a RPI-X type of control is more appropriate than that of Rate of Return Regulation. It believes that the price control review should consider further how to address volume risk and that, depending on the specific mechanism, this could be viewed as a form of profit sharing. More regulation and micro management of Royal Mail's business must be avoided.

6.2 Royal Mail believes the application of a retail prices index (RPI) within the current price control arrangement is more appropriate than a consumer prices index (CPI) but also believes that a further refinement would be for the annual price adjustment to take account of variations on the national average wage, given that the majority of Royal Mail's costs are direct labour costs.

6.3 While Royal Mail believes that it may be possible to set it a 5-year control, it also believes that the longer the duration, the more significant is the potential impact of a change to costs that are primarily outside the control of Royal Mail and the more difficult it may be to ensure that the final price control (licence) is able to address the risks directly and in a satisfactory manner. Ultimately, this may lead to consideration of a shorter duration to better enable the final price control to address, directly and in a satisfactory manner, the risks that are primarily outside of Royal Mail's control.

6.4 Royal Mail believes that addressing risks that are primarily outside of Royal Mail's control is consistent with good regulatory practice and consistent with approaches adopted by other regulators including CAA and Ofwat. In providing greater transparency in the treatment of costs that are primarily outside of the control of Royal Mail, the regulator could show that it going some way to seek to ensure the provision of the universal service while creating appropriate regulatory incentives for Royal Mail to become more efficient.

Form of Control

"Postcomm would welcome views on its proposal to use RPI-X as the form of the next price control for Royal Mail" (Postcomm's document, para 6.13)

6.5 As Postcomm sets out, "RPI-X" is the form of control most often used by UK economic regulators when setting price controls and is the current format for Royal Mail's price control set in 2003. Royal Mail recognises the incentive properties of RPI-X price control and believes that it is important to retain such properties when setting price controls. One cautionary note, though, is that Royal Mail believes that too tight an "RPI-X" type of control could detract from Royal Mail's ability to implement change and improvement, through concern over the financial viability and the means for implementing change.

6.6 Royal Mail believes that an "RPI-X" type of control is more appropriate than the alternative rate of return (ROR) regulation as a means of creating the incentive for greater efficiency. Nevertheless, Royal Mail believes that a reasonable return on investment is an essential part of the RPI-X type of control and is discussed further in Chapter 9.

6.7 Royal Mail also recognises that if the control includes an adjustment mechanism to address volume risk this could be viewed as a form of profit sharing, in that the customer shares the benefit if volumes exceed those on which the price control was set and the customer shares the cost if volumes are below those on which the price control was set. Royal Mail believes that further consideration should be given to directly addressing volume risk for the next price control and notes that it is one that has been applied in other regulated industries (e.g. by CAA for NATS) as a means of better managing this risk (see Chapter 7 for further details).

6.8 Postcomm's document also refers to the work undertaken by the National Audit Office (NAO) on "pipes and wires", which gave strong support to the incentive properties of RPI-X. It is important to recognise that the work undertaken was almost entirely focussed on the provision of "monopoly" services whereas Postcomm is introducing more competition into the UK postal market, with the declared intention of making the market fully competitive in 2006. Any comparisons between the NAO report and the increasingly competitive postal sector should be viewed with caution.

Choice of Price Index

"Postcomm would welcome views on whether to continue to use RPI as the measure of inflation or whether CPI should be adopted instead" (Postcomm's document, para 6.17).

6.9 Royal Mail recognises that the CPI is more stable and relatively more straightforward to forecast because its composition does not include changes relating to mortgage interest payments. The ability to forecast the figure relatively accurately is likely to be one of the main attractions for its use as a target measure by HM Treasury.

6.10 Royal Mail notes that the present price control has been set up so as not to require a forecast of RPI. The average RPI for the six months to September in any year is known at the time of setting the prices for the following April. This was agreed by Postcomm and Royal Mail to avoid spurious forecasting errors arising from forecasting RPI, that in the case of Royal Mail could be quite material given the scale of the regulated revenue around £6bn p.a.). Hence the need to move to CPI to reduce forecasting error does not apply to Royal Mail's current control.

6.11 Further, during the last price control review, the case for retaining RPI rather than CPI was made on the basis that Royal Mail's costs are primarily labour related and that changes in those costs are more related to RPI than CPI. Wage negotiations relate to RPI, partly because they include elements relating to the housing sector. Hence, to keep revenues and costs more aligned, Royal Mail believes that the inflation index should remain RPI. Royal Mail notes that this is consistent with the application in other regulated industries, as stated in Postcomm's document. Should Postcomm pursue the option of CPI further, to the extent that the expected value of inflation from CPI is lower than that for RPI, Royal Mail would expect the value of the X to be adjusted to result in the same expected revenue.

6.12 As a further refinement to the application of the use of RPI, Royal Mail believes that the index could be adjusted to take account of the variation in national average wage rates from the mean. This is particularly relevant because of the high portion of labour costs within its allowed revenue (at more than 60% this is higher than any other regulated business in the UK)[7]. The formula could be one of RPI+bW-X where b reflected the portion of allowed revenue related to labour costs and W was the change in the national average wage index in excess of RPI.

6.13 Royal Mail recognises that historically the change in the national average wage index has exceeded RPI and hence the value of X would need to be adjusted accordingly based on expected wage inflation and retail price inflation. The main advantage of this refinement is that it reduces the risk of misalignment of revenue and cost through annual variations in the difference between wage inflation and retail price inflation. The main obstacles to its application are that the value of "b" will vary over time and the national wage index will take some account of changes to Royal Mail's wages. However, these are not likely to be material. Consequently Royal Mail considers this refinement to be worthy of consideration as a means of partly managing Royal Mail's financial risk.

Developing "RPI-X" regulation

"At this stage Postcomm seeks views as to whether the benefits of such a rolling mechanism for Royal Mail to maintain operating and capital expenditure efficiencies for a fixed period irrespective of when the efficiencies are made will be sufficient to outweigh the additional complexity of introducing such a system" (Postcomm's document, para 6.22).

6.14 As Royal Mail provides the universal service, it is reasonable to apply the long-term incentive properties to the costs of providing this service, given that the USO is an obligation that falls on Royal Mail and is a benefit to all customers throughout the UK as recognised by the legislation.

6.15 Royal Mail recognises that efficiency incentives could be enhanced through retention of the benefit of savings for a fixed period (of 5 years or so) irrespective of when the efficiencies are made within the control period. Without this incentive, the benefit of implementing change towards the end of the price control period would be more limited.

6.16 Postcomm's document refers to the complexity of such an approach, but does not explain this further. Therefore, there must be some merit in giving this further consideration ahead of the next consultation. Further issues around the incentives for capex are discussed in Chapter 9.

Duration of control

"Postcomm would welcome views on its proposal for the duration of the price control" (Postomm's document, para 6.33).

6.17 Postcomm's document (paragraph 6.24 and 6.25) describes the main issues when considering the period over which the next price control should operate. Outside of the postal sector, Royal Mail notes that most UK regulated network

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[7] As Postcomm is aware, one of the key differences between the regulation of the postal sector and of other sector regulation is the split between labour and capital. In most other regulated sectors, such as gas transportation, electricity distribution and transmission, telecommunications and water, the companies operating in these sectors are more capital than labour intensive. For example, in the water sector, the regulator takes account of building indices**.** Royal Mail's main costs relate to labour, given the labour intensity of its regulated activities. Royal Mail believes, therefore, that cognisance has to be taken of wage inflation rather than retail price inflation.

businesses where there is no competition (and no real scope for competition) have price controls of 5-years duration. However, Royal Mail notes that for the UK regulation of businesses in the initial years of developing competition (notably BT retail, gas supply and electricity supply) the duration of the control was less than 5 years and, on occasions, 2 years. As noted in the document, the primary reasons for the 5-year duration were to increase incentives for savings and investment and for the shorter duration were to avoid the controls being misaligned due to significant change within the market or to costs as competition evolves.

6.18 Royal Mail understands Postcomm's motives and preferences for a 5-year control as being ones of:

(a) enhancing the period of retained savings when retained savings cannot be carried beyond a single price control.

(b) clearing regulatory resources for the consideration of other aspects of postal regulation.

In respect of (a), Royal Mail believes that further consideration needs to be given as to whether this could be addressed more directly through retaining savings beyond the price control period (as discussed in paragraphs 6.14-6.16). In respect of (b), Royal Mail believes that this is an issue for both the regulator and regulated business, but is of significantly less importance than the appropriate management of incentives, risks and rewards within the setting of the price control.

6.19 Royal Mail welcomes the recognition by Postcomm that its primary duty is to ensure the provision of the universal service and believes that the longer the duration of the price control, the greater is the risk to fulfilling that duty. Postcomm's document refers to a re-opening clause within the licence, but Royal Mail believes that this is not good regulatory practice for the treatment of costs that are primarily outside the control of the regulated business. Rather than roll these into a clause which Postcomm's document indicates it does not expect to use (and even if it were to have to use would lead to significant regulatory work), Royal Mail believes that such risks should be addressed in a satisfactory and direct manner within the control. For Royal Mail these risks include:

(a) changes to the pension requirements - primarily driven by the financial markets and trustees
(b) changes to volume – primarily driven by entrants and GDP (and e-substitution)
(c) changes to the treatment of taxes and in particular VAT – primarily driven by Government and EU policy

6.20 Royal Mail believes that other UK regulators have set controls of 5-years duration that have directly addressed the risks associated with changes to the pensions and volume. Consequently, while Royal Mail believes that it may be possible to set it a 5-year control, it also believes that the longer the duration, the more significant is the potential impact of a change to costs that are primarily outside of Royal Mail's control and the more difficult it may be to ensure that the final price control (licence) is able to address the risks directly and in a satisfactory manner. Ultimately, this may lead to consideration of a shorter duration to better enable the final price control to address directly and in a satisfactory manner, the risks that are primarily outside of Royal Mail's control.

6.21 In summary Royal Mail believes that the key issue is to ensure the financial viability of Royal Mail to provide the universal service and that this requires recognition by Postcomm of the uncertainties and to ensure that measures are put in place to mitigate these uncertainties to a reasonable degree.

Re-opening the price control

"Postcomm would welcome comments on its proposal to maintain the current re-opening mechanism" (Postcomm's document, para 6.39)

6.22 Postcomm's document indicates the need for the re-opening clause to the price control as a means of allowing regulatory intervention to ensure the provision of the universal service. It also emphasises that Postcomm does not expect to use it so as to retain the incentives of an RPI-X type of control.

6.23 Royal Mail recognises the need for a re-opening clause to the price control as a means of facilitating regulatory intervention geared to ensuring the provision of the universal service and meeting the Universal Service Obligation (USO) for the UK. However, Royal Mail believes that the current clause and control does not adequately address risks to fulfilling the USO that are primarily outside of its control. While Postcomm's document states that "*regulation is intended to be a substitute for competition and in competitive markets companies would not necessarily be able to raise prices to recover unexpected costs*.." (6.34), there are several examples where this has been applied in the price control of regulated businesses. Examples include the treatment of rates within electricity, the treatment of volume risk for NATS, the treatment of pensions for water and electricity (and by the Competition Commission) and the treatment of cost shocks for water. Royal Mail believes that this is good regulatory practice.

6.24 Royal Mail believes that further consideration is needed through the remainder of the review to identify risks that are primarily outside of the control and establish clear rules for addressing these directly and satisfactorily within the control. Regarding these two considerations Royal Mail notes that:

(a) Postcomm's document appears not to recognise any risks as being primarily outside of Royal Mail's control. It states that "*most of Royal Mail's costs are within its reasonable control*" (Paragraph 6.34). The document does not state Postcomm's definition of "*most*" and what Postcomm believes lies outside of this definition. Clarity on this subject is necessary and sought from Postcomm to establish the costs that it considers to be primarily outside of Royal Mail's control. As already noted above, Royal Mail believes that there are risks that are primarily outside of its control and present a significant financial risk. For the avoidance of doubt, these risks include: (i) changes to the pension requirements - primarily driven by the financial markets and trustees; (ii) changes to volume – primarily driven by entrants and GDP (and e-substitution) and (iii) changes to the treatment of taxes and in particular VAT – primarily driven by Government and EU policy.

(b) In Chapter 7 of its document, Postcomm appears to recognise that its finances will be significantly affected by volume and thereby entry. It has invited a response setting out, in principle, how this could be applied and Royal Mail has set this out in more detail in its response to Chapter 7and

Annex B. In addition, in Chapter 9 of its document, Postcomm refers to pensions and in Chapter 9 of this response document Royal Mail discusses the treatment of pension costs for the price control. Royal Mail believes the first step to addressing the VAT issue is a clear statement within the licence as to whether the prices within the formulae include or exclude any VAT charged by Royal Mail to its customers.

6.25 Royal Mail believes that addressing risks that are primarily outside of Royal Mail's control is consistent with good regulatory practice. In providing greater transparency in the treatment of costs that are primarily outside of the control of Royal Mail, the regulator could show that it is going some way to seek to ensure provision of the universal service while creating appropriate regulatory incentives for Royal Mail to become more efficient.

CHAPTER 7: STRUCTURE

Summary

7.1 Royal Mail's prices are fundamentally misaligned with cost so sending wrong signals to customers and distorting the pattern of competitive entry. Royal Mail seeks to rebalance and restructure its prices significantly in the next price control to become more cost reflective.

7.2 Royal Mail believes that the structure of the end-to-end service, for at least the next price control, should remain as a single basket for the inland Controlled Services in Licence Condition 19. There is no regulatory precedent for setting a structure of a control with tariff baskets in the presence of (a) the primary duty of the regulator being to ensure the provision of the universal service and (b) the existing prices being well-adrift from costs. While this approach was applied in other sectors (most notably for BT), the primary duty of the regulator in that sector was not one of ensuring the provision of the universal service and the prices of BT were already reasonably aligned to cost relative to those of Royal Mail. Royal Mail believes that a move to cost reflective prices and the avoidance of regulatory intervention to distort market prices are fundamental to fulfilling the regulator's primary duty and are best achieved through the present structure of the control and Licence Condition 9 (for the reasons stated in Chapter 5 of this response).

7.3 Royal Mail believes that:

a) Access products should continue to be regulated by Licence Condition 9;

b) for the international Controlled Services, it may be appropriate to place these in a separate basket depending on the position taken regarding changes to the structure of the prices and the recovery of international delivery costs.

7.4 Royal Mail believes that any thresholds are applied in the next control should be set significantly higher than is the case under the current control to reduce market distortions, create a more stable market environment and allow for price rebalancing.

7.5 Royal Mail believes that the current price control has operated well. Further consideration could be given to whether the control should use historic or forecast volumes (and adjustments), or a variant of the forecast volumes and historic adjustments.

7.6 Royal Mail believes that further consideration should be given as to how to address the risk to Royal Mail's finances in the presence of volume uncertainty as a means towards ensuring the provision of the universal service and illustrate a relatively simple way as to how this could be developed for the price control in Annex B.

7.7 Royal Mail sets out further initial views below.

A single basket for inland end-to-end services

"Postcomm would welcome comments on its proposal for separate controls for products serving "captive" and "non-captive" customers". (Postcomm's document 2004, para 7.11).

7.8 Royal Mail's prices are fundamentally misaligned with cost so sending wrong signals to customers and distorting the pattern of competitive entry. Royal Mail seeks to rebalance and restructure its prices significantly in the next price control to become more cost reflective, as discussed in Chapter 5.

7.9 Postcom's proposal for separate baskets originates from the FE report and its views on coverage expressed in Chapter 5 of its document. In Chapter 5 of this response document, Royal Mail set out its response both to the FE report and Postcomm's proposals in Chapter 5.

7.10 Postcomm's document states that "*the main drawback of this proposal is that it will require an up-front attribution of costs between the two controls"* (7.10). This identifies a drawback as being the need for Postcomm to undertake some extra work to allocate costs. Royal Mail's response in Chapter 5 indicates clearly that this is not the only drawback for Postcomm and the potentially serious consequences of pursuing this approach at this stage (see, for example, Chapter 5 under General Philosophy).

7.11 Fundamentally, there is no regulatory precedent for setting a structure of a control with tariff baskets in the presence of (a) the primary duty of the regulator being to ensure the provision of the universal service and (b) the existing prices being well-adrift from costs. While this approach was applied in other sectors (most notably for BT), the primary duty of the regulator in that sector was not one of ensuring the provision of the universal service and the prices of BT were already reasonably aligned to cost relative to those of Royal Mail. Royal Mail believes that a move to cost reflective prices and the avoidance of regulatory intervention to distort market prices are fundamental to fulfilling the regulator's primary duty and, for the next price control at least, are best achieved through the present structure of the control and Licence Condition 9 (for the reasons stated in Chapter 5 of this response).

The treatment of non-inland end-to-end services

"Postcomm would welcome views on its initial thoughts about which products should be included in each control and whether additional controls are needed for other products like access and international products". (Postcomm's document, para 7.14)

7.12 Royal Mail states very clearly in Chapter 5 and above why it believes that Access products should not be included in the coverage of the next price control (and remain commercial arrangements developed between commercial parties) and its views of the sub-grouping recommended by FE and proposed by Postcomm.

7.13 Royal Mail believes that there is a case for putting the price controlled international services (e.g. Airmail and Surface Mail) into a separate basket. These services form about 5% of the total regulated revenue of Royal Mail and were largely overlooked during the last price control. The current pricing structure for these services is very complex, outdated and in need of simplification and re-alignment:

(a) there are many thousands of separate price points within this product range;

(b) the structure is based on historical charges for international delivery that are content related and have been superseded in by size based pricing in many countries;

(c) the costs for delivery into Europe have increased substantially relative to the Rest of the World.

7.14 Royal Mail believes that there is a need to both restructure and realign these prices. The present price control locks in the structure of the pricing and limits the realignment (rebalancing) of prices. The licence does allow Royal Mail to submit an application for a significant change to its prices, but the experience of its application of size-based pricing illustrates that this process is not very well-defined.

7.15 Royal Mail believes that the control of prices for the international regulated services could be taken forward in a number of ways:

(a) as currently within a single basket alongside inland services but with a disaggregated structure reflecting a revised pricing structure;

(b) a separate basket for regulated international services but with an aggregated, single average revenue control ;

c) a separate basket for regulated international services, but with a disaggregated structure reflecting a revised pricing structure;

7.16 Royal Mail believes that there is a case for putting the price controlled international services (e.g. Airmail and Surface Mail) into a separate basket either (a) to facilitate Royal Mail restructuring its prices from the current emphasis on content within the existing prices; or (b) to have some means of allowing full recovery of international delivery costs each year.

Operation of the current control

"Postcomm's initial view is that it will be appropriate to continue with the existing form of tariff basket structure of control. Given the strong link with the structure of charges, however, Postcomm may need to consider this in the light of progress made on Royal Mail's proposed changes to the structure of charges". (Postcomm's document, para 7.21)

7.17 Royal Mail believes that the present "tariff basket" has operated well in addressing the risks associated with changes in product mix. Since the volumes have exceeded Postcomm's expectations, it has also led to an improvement in the financial viability of the business.

7.18 Royal Mail also believes that it operates in a reasonably predictable manner. Royal Mail notes that, if the effect of the "C" factor is removed, Royal Mail's over-recovery in 2003/04 would have been just £3m on a turnover of close to £6bn.

7.19 Royal Mail also believes that the control does allow for changes in structure because it allows any individual price to be disaggregated. As an example Royal Mail has received clearance from its independent auditors for the present price of a 1C Standard Tariff Letter to be disaggregated into stamps and meters/PPI (see Postcomm's consultation November 2004). In a similar manner, these prices could be disaggregated into Letters, Flats and Packets (see Royal Mail's application for size based pricing (August 2003)).

7.20 Postcomm's document indicates that the current "tariff basket structure" obstructs changes to the structure of prices proposed for size based pricing. This is incorrect because an average of any set of disaggregated prices can be formed to correspond to the allowed price. Royal Mail is very disappointed that this has only come to light through this consultation and has not been raised by Postcomm at any stage during its processing of Royal Mail's application for size based pricing. Nevertheless, it is the case that if the proposed changes for size-based pricing were accepted then the present structure of the current tariff basket would not need so many weight steps and could be simplified.

Disaggregated average revenue yield or tariff basket

"Postcomm is currently intending to maintain the current "k" correction factor mechanism, but would welcome views on whether to move to using historic volume weights for a tariff basket approach to enable the allowed revenue to be calculated ex-ante. Postcomm also seeks views on how the "C" factor could be addressed under such an approach." (Postcomm's document, para 7.26)

Introduction

7.21 Royal Mail believes that the current price control has operated well. It is really a disaggregated revenue yield calculation rather than the pure tariff basket referred to in the academic literature. The primary distinction is that a revenue yield calculation has a "k" factor correction because it uses a forecast of volumes when setting the prices that is subsequently corrected with outturn volumes (and is therefore ex post). The pure tariff basket uses historic volumes and has no "k" factor correction (and is ex ante).

Volume measure for the control

7.22 Royal Mail believes the first step in the consideration of an ex-ante or ex-post control is to consider the measure of volume that will be applied within the control. Within the postal sector there are several issues to consider with respect to volume measures:

(a) there are different methods applied to measure mail volumes;
(b) the reported volumes within the accounts are not externally audited;
(c) the mails volumes are not always recorded alongside the revenue sales within Royal Mail's accounting systems;
(d) there are many thousands of separate prices within Royal Mail's regulated services.

7.23 In setting the current control, these considerations led to the use of revenues and published prices as the primary source of data for the operation of the control. Disaggregated revenues are divided by representative tariffs to create the volumes to use within the price control formulae.

7.24 Royal Mail believes that this approach remains appropriate for deriving the volumes to use within the price control. Royal Mail believes that the level of dis-aggregation applied for these calculations is worthy of further consideration and particularly so in the light of the proposed changes to the structure of prices.

Ex-post and ex-ante

7.25 Once the source of the volumes has been identified, the second step is to consider whether these volumes should be used within an ex-post or ex-ante formula. In this regard consideration needs to be given to the following:

(a) *extent of the control*: An ex-post control is a control over the total regulated revenue. While the total revenue can be adjusted for volume (etc), any excess pricing within the regulated services has to be returned to the customer (with interest) in a subsequent year. An ex-ante control is a control over those prices that correspond to the volumes. As indicated above, the derivation of the volumes may place a practical constraint on the degree of dis-aggregation and set of controlled prices.

(b) *process*: An ex-post control requires a forecast of volumes, and accompanying calculations, at the time of setting prices and an outturn of volumes at the end of the year. Both the forecast and outturn volumes are externally validated by independent auditors to reassure the regulator and public that Royal Mail is meeting the requirements of the control. An ex-ante control requires historic volumes, and accompanying calculations, to be externally validated. Royal Mail would still need to undertake forecasts for its own internal purposes but these figures would not form part of the price control; in addition, there would be no need for an end of year audit.

(c) *other adjustments*: For the current ex-post control, there is an adjustment to the allowed revenue for quality performance (the "C-factor"). Within this response, Royal Mail also raises the potential need for an adjustment for pensions and significant deviations in actual volume from these used in setting the control. Within an ex-ante control these adjustments can be forecast and applied. Errors in these forecasts, if not addressed by within-year price changes, appear in the K-factor and are returned to customers in subsequent years. For the ex-ante control, using the same derivation of volume but on an historic basis would mean that prices for year 't' would be set on outturns in 't-2' (including a potential adjustment for service performance, pensions and volume). This involves lags that could be significant if volumes (mix and totals) change markedly or less significant if volumes do not change significantly.

(d) *price changes*: An ex-post control allows for price changes to be introduced at any time of year with any over/under recovery adjusted for in a subsequent year. Within these calculations is a means of splitting yearly data into part year. The same approach for the price neutrality for part year changes could be applied ex ante, with no adjustment at the end of the year.

7.26 In the light of these considerations at the time of setting the current control, the price control was based on an ex-post approach. The main advantage of this approach is that it provides greater coverage and thereby reassurance over the control of regulated revenue in the presence of a significant number of prices. If the number of prices reduces significantly or the prices used within the ex-ante approach in some way restrict the prices outside of it, this advantage is diminished. In such circumstances, the ex-ante approach has the advantage of a single audit per year and no need for a K-factor mechanism. Indeed, in addition to these two approaches, a variant of the ex-post approach, in which the additional adjustments (for quality performance, pensions and significant volume deviations from those used to set the control) are ex-ante, may also be worthy of consideration.

Thresholds (secondary caps)

"Postcomm would welcome views on giving Royal Mail more freedom than the current price control to rebalance prices if separate tariff baskets are introduced for products serving "captive" and "non-captive" customers." (Postcomm's document, para 7.31)

7.27 Royal Mail believes that the need for "thresholds" (secondary caps) depends fundamentally on the speed with which Postcomm wishes to see Royal Mail's prices become well-aligned to costs. Within any structure for the control, "thresholds" will slow this process down and maintain existing distortions and cross-subsidies.

7.28 Royal Mail's application for size based pricing (August 2003) reflects the scale of some of the price changes required and therefore the level of thresholds that may be required. It is Royal Mail's view that significant step changes associated with size based pricing should be implemented from April 2006, but that further significant changes will be required (e.g. stamp prices) to some prices subsequently.

7.29 Royal Mail believes that the prices should be moved rapidly to ones that are well-aligned to costs and commercially orientated so that the entrant can develop in a more stable environment and the customer can benefit from efficient and economic entry.

Addressing volume risk

"It is therefore Postcomm's initial view that it is not appropriate to include an additional mechanism in the price control to adjust allowed revenues for differences between actual and forecast volumes. However, Postcomm would consider this position if respondents to this consultation can suggest such a mechanism that does not result in perverse incentives or other unfortunate side effects, such as those identified above." (Postcomm's document para 7.38)

7.30 The existing licence provides scope for Royal Mail to apply for the price control to be re-opened if Royal Mail is so adversely affected by a factor outside of its control and to such a degree that Royal Mail's financial viability is threatened and can demonstrate that it is either an efficient operator or has endeavoured to become an efficient operator.

7.31 This aspect of the licence requires further work to clarify definitions and expectations including:

(a) identifying adverse effects that would be considered to be outside of Royal Mail's control.

(b) identifying the criteria required for the threat to Royal Mail's financial viability to be met.

(c) identifying the definition of the efficient operator and the criteria for the endeavouring to become an efficient operator to be met.

7.32 There are significant areas of risk that are outside of Royal Mail's direct control (see Chapter 6 of this response). To better manage these risks and the level of allowed revenue required for the finances of Royal Mail's in setting the control, there is a need to:

(a) set out more explicitly the definitions identified above.

(b) identify where the licence could be amended to address the risk more directly.

(c) identify where explicit reference may be written into the licence to ensure the allowed revenue remains well defined (e.g. the price control should be applied to prices that are exempt of VAT).

7.33 As an example, Royal Mail believes that further consideration should be given as to how to introduce an adjustment to the allowed revenue in the event that there is a significant change in the volumes from the forecast used to set the control. Postcomm may endeavour to set the control on an "accurate" forecast of volumes. However, the reality is that while volumes prior to competitive entry can be predicted with some degree of accuracy, there is considerable uncertainty as to the speed with which entry will occur. Hence there is considerable additional uncertainty and risk associated with future volumes in the presence of a fully open market (see also Chapter 9).

7.34 Royal Mail notes Postcomm's statement that the current risk is symmetric about the forecast volume, namely that the financial benefit of exceeding the forecast volume is the same as the financial loss of being below the forecast. Royal Mail believes this will need further consideration once the volume forecast, on which the price control is set, is known. Nevertheless, assuming symmetric risk, Royal Mail believes the a mechanism to moderate the financial benefit of exceeding the forecast volume and the financial loss of being below the forecast can:

(a) be achieved while still retaining an incentive for growth;

(b) be achieved while still retaining an incentive to reduce costs;

(c) increase the financial stability of the regulated business in the presence of significant market change and thereby is a practical means towards ensuring the provision of the universal service;

(d) be implemented reasonably simply.

7.35 Postcomm's document makes a specific point of stating that the mechanism will "*increase complexity to the price control*"(7.37). While it would certainly require some additional elements to the control, Royal Mail believes that the change could be introduced relatively simply into the current price control. An illustrative formula for this is included in Annex B and could be considered and developed further for the price control. The illustration is relatively simple; it could be set up to trigger only in exceptional circumstances and could be focused on the areas where there is significant volume uncertainty.

CHAPTER 8: FINANCE

Summary

8.1 An efficient regulatory framework for the finances of Rail Mail is required to safeguard the universal service and ensure Royal Mail can finance its licensed activities and provide a reasonable, commercial return for its shareholder. It would also promote efficient competitive entry into the postal market, support equitable consumer pricing and provide efficient investment incentives and incentivise efficiency gains.

8.2 Royal Mail is concerned that Postcomm continues to hold the view that the "cash flow approach" used for setting the current price control is still appropriate for the next control. This approach does not satisfy the framework set out above primarily because it does not allow for a commercially and financially viable Royal Mail. It

(a) *does not value the investment that the shareholder has made in Royal Mail*: The proposed price control effectively values Royal Mail at zero, since it is not allowed to earn a cash flow return over the period of the price control on the assumption that all of Royal Mail's assets have been funded by customers. This would imply that the government is prepared to give Royal Mail away to an entrant for zero, whereas in reality an entrant would incur substantial investment costs to build a network that could provide Royal Mail 's current service and volumes.

Royal Mail does not accept that the returns on investment during the 1990 should be factored into the opening RAB value. Fundamentally, this is backward looking and therefore does not reflect the market value of the business going forward and, in particular, the market value that an investor would ascribe to such a business. This is particularly important given that the market is being opened up to competitors. They will expect Royal Mail's finances to reflect the competitors' access to financing and funding in a commercial market environment and a reasonable and commercially compatible return on both the market value and investment. Royal Mail will submit its assessment of the value of the regulated business separately as part of its response to Postcomm's information request.

(b) *does not provide efficient investment incentives or support equitable consumer pricing*. It undermines efficient investment incentives for shareholder and investors. Notably the value to the shareholder of future investment is brought into question because the value of historic investment is eliminated and no shareholder returns are recognised. Further, by failing to recognise the price levels consistent with providing for market based shareholder returns the 'cash flow approach' allows room *only* for "cream skimming entry" that follows from the current non-cost reflective prices.

8.3 An efficient regulatory framework will require Postcomm to recognise a market based ("enterprise" or RAB) value of the business in which Royal Mail will earn a return on its market-based value. This is consistent with the approach taken for other regulated industries in both the UK and other jurisdictions. It recognises that the shareholder's (plus debt holders) value in Royal Mail's regulated business should be remunerated, recognises efficiently incurred costs and encourages

efficient competition, as new entrants will be able to achieve a return on their invested capital, rather than having to exploit cream skimming opportunities.

8.4 In this response, Royal Mail defines explicitly the differences between the "cash flow approach" and the "regulatory value approach", for which it discusses two variants. Both variants of the "regulatory value approach" incorporate a return on the opening market value (the Regulatory Asset Base or RAB). One variant allows for a return on future capital expenditure investment, while the other variant allows for future capital expenditure to be fully funded each year.

8.5 Royal Mail believes the market-based value of the mails business is significantly in excess of the net HCA tangible assets of the business. This result may be confirmed in a number of ways including through estimates based on the values of market comparables and the full shareholder value of the assets of the business.

8.6 Royal Mail believes it should also be allowed a return that compensates it for the risk inherent in its business. The Weighted Average Cost of Capital (WACC) of the mails business may be estimated by a variety of approaches including the Capital Asset Pricing Model (CAPM). Under the CAPM it will be necessary to recognise that the asset beta of Royal Mail is significantly higher than that of regulated network utilities, for example, through its very high operational leverage[8] and driven by the requirement to provide the high cost USO network. Royal Mail does not accept that the return is 6% pre-tax real. Royal Mail estimates the weighted average cost of capital for Royal Mail's regulated business at a value significantly greater than 6% pre-tax real based on the CAPM. Royal Mail will submit its assessment of the weighted average cost of capital separately as part of its response to Postcomm's information request.

8.7 Royal Mail sets out further initial views below.

Approach to finance

"Postcomm would welcome views on whether its analysis suggests that the drawbacks of using a "cash" approach may not be significant in Royal Mail's case. It also seeks views on whether its initial view to continue with the "cash" approach is appropriate and whether respondents believe that any other options should be considered". (Postcomm's document, para 8.27)

Introduction

8.8 In terms of the principles that Postcomm should apply in determining the financial requirements for Royal Mail's regulated business, Royal Mail believes that an efficient regulatory framework is required to safeguard the universal service and ensure Royal Mail can finance its licensed activities and provide a reasonable, commercial return for its shareholder. It should also promote efficient competitive entry into the postal market, support equitable consumer pricing and provide efficient investment incentives and incentivise efficiency gains. It would also ensure regulatory consistency and best practice.

8.9 Postcomm's document discusses both a "cash flow approach" and "regulatory value approach". Royal Mail's response clearly sets out the different approaches

[8] Level of operating cost relative to Regulatory Asset Base.

so as to bring greater clarity on the subject in moving forward. Two different approaches, with two variants of the second approach, are discussed below.

Approach 1: Postcomm's document refers to this as the "cash flow approach" used in setting the allowed revenue for the current price control. The allowed revenue, based on a forecast of traffic, is set equal to the discounted sum (over the period of the control) of:

Cash operating costs
\+ Cash pension costs
\+ Cash exceptional costs (e.g. redundancy costs)
\+ Cash capital expenditure.

Approach 2A: This is a "regulatory value approach", with net investment (capital expenditure) being added to a regulatory asset base (RAB) and depreciation of the RAB being subtracted from the RAB each year (i.e. $RAB_t = RAB_{t-1} + INV_{t-1} - REG\_DEP_{t-1}$)[9]. In addition the allowed profit is the multiple of the average opening and closing RAB and the cost of capital (estimated by the Weighted Average Cost of Capital). This is the approach used by most UK regulators. The allowed revenue, based on a forecast of traffic, is set equal to the discounted sum (over the period of the control) of:

Cash operating costs
\+ Cash pension costs
\+ Cash exceptional costs (e.g. redundancy costs)
\+ Regulatory depreciation of opening RAB
\+ Allowed return on opening year RAB
\+ Regulatory depreciation on capital expenditure (investment).
\+ Allowed return on capital expenditure (investment).

Approach 2B: This is a "regulatory value approach", with the opening year RAB being allowed a return and depreciated and, separately, net investment (capital expenditure) is recovered in the allowed revenue each year. This is the approach that was used by the Rail Regulator. The allowed revenue, based on a forecast of traffic, is set equal to the discounted sum (over the period of the control) of:

Cash operating costs
\+ Cash pension costs
\+ Cash exceptional costs (e.g. redundancy costs)
\+ Regulatory depreciation of opening RAB
\+ Allowed return on opening year RAB
\+ Capital expenditure (investment).

Review of Approach 1

8.10 In setting the last price control Postcomm chose to set the level of the control using Approach 1, for the reasons it states in its document. It also stated that the result from this approach was equivalent to a "cross check" calculation using Approach 2A. Postcomm's "cross check" calculation made no allowance for cash exceptional costs nor a return on capital expenditure. It also significantly understated the RAB and WACC. Postcomm's document again refers to a WACC of 6% pre-tax (paragraph 8.6).

[9] This calculation assumes constant prices (i.e. all components are in real terms).

8.11 Royal Mail stated very clearly in a response to Postcomm's final proposals that, while it was prepared to accept the licence modifications for the price control, it did not accept the approach (Approach 1) and analysis used for setting the allowed revenue of the next control. Royal Mail does not accept that Approach 1 is valid nor allows a regulated company to finance its activities. No other regulator has applied this approach because it is erroneous. Postcomm is referred back to that document for further details.

8.12 Royal Mail is concerned that Postcomm continues to hold the view that the "cash flow approach" used for setting the current price control is still appropriate for the next control. This approach does not satisfy the criteria set out above primarily because it does not allow for a commercially and financially viable Royal Mail. It

(a) *does not value the investment that the shareholder has made in Royal Mail*: The proposed price control effectively values Royal Mail at zero, since it is not allowed to earn a cash flow return over the period of the price control on the basis that all of Royal Mail's assets have been funded by customers. This would imply that the government is prepared to give Royal Mail away to an entrant for zero, whereas in reality an entrant would incur substantial investment costs to build a network that could provide Royal Mail 's current service and volumes.

Competitors are likely to make a decision as to whether or not to enter a market on the basis of the returns they would expect to make on the investments that they would make. By Postcomm setting the revenues for Royal Mail on the same basis, it can be more confident that it will be setting the appropriate price signals for new entrants.

Although Approach 1 could be augmented by an additional allowance to reflect these risks (as proposed by Postcomm and discussed in greater detail below) this approach provides no means to assess what the correct level of this allowance should be. By contrast, it is only possible to rationalise financial aspects of the price control, particularly the appropriate level of profit, in reference to the assets used and invested in the business and the riskiness associated with that investment.

(b) *does not provide efficient investment incentives or support equitable consumer pricing*. It undermines efficient investment incentives for shareholder and investors. Notably the value to the shareholder of future investment is brought into question because the value of historic investment is eliminated and no shareholder returns are recognised. Further, by failing to recognise the price levels consistent with providing for market based shareholder returns the 'cash flow approach' allows room *only* for "cream skimming entry" that follows from the current non-cost reflective prices.

If it proves necessary to continue to regulate aspects of Royal Mail's business beyond the next price control, Approach 1 provides greater uncertainty and instability for Royal Mail. This increased regulatory risk is of detriment to both the company itself and its customers.

As the Water Industry Commissioner for Scotland[10] has acknowledged in his recent document where he sets out the reasons for moving from his version of a cashflow approach to a regulatory value approach, using a regulatory value approach increases the transparency of the regulatory process. It allows much easier comparisons of the regulatory environment in different sectors, allowing comparisons to be drawn on issues such as the risk/reward balance of the regulatory framework and the financial stability of the regulated company.

Review of Approaches 2A and 2B

8.13 An efficient regulatory framework will require Postcomm to recognise a market based ("enterprise" or "RAB") value of the business in which Royal Mail will earn a return on its market-based value. This is consistent with the approach taken for other regulated industries in both the UK and other jurisdictions. It recognises that the shareholder's (plus debt holders) value in Royal Mail's regulated business should be remunerated, recognises efficiently incurred costs and encourages efficient competition, as new entrants will be able to achieve a return on their invested capital, rather than having to exploit cream skimming opportunities.

8.14 This market-based value approach has several advantages over the "cash based approach". These include:

(a) promoting efficient entry by setting prices consistent with new entry costs;
(b) allocating risks and returns such that there is an efficient structure of investment incentives;
(c) enabling Royal Mail to attract capital and finance its mails business;
(d) Supporting equitable consumer pricing, in particular by not exposing consumers to stranded cost risk;
(e) incentivising efficiency gains through allowing market-based returns against realistic efficiency and performance targets; and
(f) ensuring regulatory stability by providing a sustainable regulatory framework in the context of increasing competition and other significant challenges facing the mails business.

8.15 While Postcomm's document still refers to it as a "cash flow approach" (which is potentially very confusing for the reader), Postcomm also appears to refer to an approach akin to Approach 2B. There are two reasons for making this inference from the document:

(a) Postcomm is considering a return;

(b) Postcomm is considering capital expenditure being fully allowed each year in setting the allowed revenue.

In terms of its application of Approach 2B, Postcomm also believes that the opening year RAB and therefore return on the opening year RAB is close to zero.

8.16 It is important to distinguish between the remuneration of Royal Mail's ongoing capital programme and the remuneration of previous investment. It is perfectly feasible for ongoing capital investment to be funded on a pay as you go basis with the RAB reflected previous investment, as was taken until recently, to a

[10] Water Industry Commissioner for Scotland (2004) 'Our Work in Regulating the Scottish Water Industry: The Calculation of Prices' Vol. 3, September.

broad extent, by the Office of the Rail Regulator. To this extent, in principle, the scale of the forward-looking capital programme neither validates nor invalidates use of the regulatory value approach and is the distinction made between Approaches 2A and 2B in this response (both of which are a regulatory value approach).

8.17 Royal Mail believes that a proper application of Approach 2B is a valid means of setting the allowed revenue for the price control. However, it believes that the level of capital expenditure is material and that the life of the assets involved can significantly exceed the 5 years referred to in Postcomm's document. Royal Mail notes that the asset life assumptions in its statutory and regulatory accounts are in many cases much longer than the 5 years. While there is no need for accounting depreciation policies and regulatory depreciation policies reflecting useful economic lives to necessarily coincide, this would certainly suggest that some assets have lives longer than 5 years. Consequently, Royal Mail also believes that Approach 2A may be more appropriate.

8.18 Postcomm's document appears to suggest that the "regulatory value approach" (Approaches 2A or 2B) may not be appropriate for the postal sector because it "*by implication at least, implies that there may be a requirement for continued price regulation*" (Postcomm's document, paragraph 8.24). Royal Mail does not believe that a "regulatory value approach" means that there will be a requirement for continued price control. Postcomm's document elsewhere refers to the criteria for removing from and retaining services within the control and none refer to the "regulatory value approach". The use of a "regulatory value approach" is not inconsistent with the development of a competitive market because it is applied in telecommunications[11]. The use of a "regulatory value approach" is not inconsistent with some services being treated as excluded revenue outside of the price control because this has been applied in most other regulated sectors. When services are removed from the control the assets associated with those prices would also need to be removed, as has happened in other regulated industries.

8.19 The prospect of future competition strengthens the case for establishing the price control on a regulatory value or asset base approach. Most investment decisions, including those of new entry, are made on the basis of whether the returns on the assets invested will be greater than the cost of capital. By setting Royal Mail's price control on an equivalent basis, Postcomm could be more confident that entry would take place where it was efficient to do so, and competition would not be distorted.

8.20 Royal Mail believes it should be allowed a return that compensates it for the risk inherent in its business. The Weighted Average Cost of Capital (WACC) of the mails business may be estimated by a variety of approaches including the Capital Asset Pricing Model (CAPM). Under the CAPM it will be necessary to recognise that the asset beta of Royal Mail is significantly higher than that of regulated network utilities, for example, through its very high operational leverage[12] and the requirement to provide the high cost USO network.

8.21 Postcomm's document makes reference to a 6% pre-tax return, but provides no

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[11] While Oftel commenced with this approach and has moved from a RAB-based to LRIC approach, more recently it remains the case that assets are valued on a CCA basis and is in an environment where existing prices are closely geared to costs.
[12] Level of operating cost relative to Regulatory Asset Base.

details to support this figure. Royal Mail does not accept that the return is 6% pre-tax real. The weighted average cost of capital is significantly more than the 6% stated in Postcomm's document. Royal Mail will submit its assessment of the weighted average cost of capital separately as part of its response to Postcomm's information request.

8.22 Royal Mail believes that the opening year RAB value is not close to zero. Postcomm's document reference to the possibility that Royal Mail may already have received its returns in full for past investments ("most, if not all, of Royal Mail's capital expenditure prior to the start of the next control will already have been paid for by customers" (Postcomm's document, paragraph 8.19) could imply that it believes Royal Mail's opening year RAB value was close to zero. Royal Mail has yet to be shown the analysis supporting Postcomm's claim, but irrespective of whether it is the case:

(a) It only goes back to the 1990s and does not reflect the financing and funding of the business by the shareholder prior to that period. Even if it were the case that investment in the 1990s was fully funded, a shareholder would expect returns on funding and financial investments made prior to this date.

(b) It is backward looking and therefore does not reflect the market value of the business going forward and, in particular, the market value that an investor would ascribe to such a business. This is particularly important given that the market is being opened up to competitors. They will expect Royal Mail's finances to reflect the competitors' access to financing and funding in a commercial market environment and a reasonable and commercially compatible return on both the market value and investment

8.23 Royal Mail believes the market-based value of the mails business is significantly in excess of the net HCA tangible assets of the business. This result may be confirmed in a number of ways including through estimates based on the values of market comparables and the full shareholder value of the assets of the business. A 'bottom-up' or net market valuation has the strong advantage that it reflects the costs that an entrant would face in replicating Royal Mail's network. Academic work has illustrated, and other regulators have recognised, that this is the appropriate basis on which prices and profits should be set when trying to set prices that reflect the outcome of a competitive market. A top-down or "comparative approach", trying to replicate the way in which asset values for other regulated utilities have been determined, was used by the Water Industry Commissioner for Scotland (WICS) [13]. The value of the regulated business from these approaches is significantly more than implied by Postcomm's document. Royal Mail will submit its assessment of the value of its regulated business separately as part of its response to Postcomm's information request.

[13] Water Industry Commissioner for Scotland (2004) 'Our Work in Regulating the Scottish Water Industry: The Calculation of Prices' Vol. 3, September.

Allowed return

"Postcomm would welcome views on whether it would be appropriate within a cash approach to setting the price control, to make an allowance to reflect risks and, if so, how this should be determined. Postcomm would also welcome comments on the fair attribution of risks between the company and its customers in setting such an allowance." (Postcomm' document, para 8.33)

8.24 As stated above, Royal Mail believes the cash flow approach (Approach 1) is not valid, but that either Approaches 2A or 2B, if applied properly, are valid in setting the allowed revenue for the control. Since both Approaches 2A and 2B include a return on assets it follows that Royal Mail believes the approach used should include a return on assets.

8.25 Further, the allowed level of the return (or WACC) should reflect the risks faced by the business. These are substantial. Therefore it is inappropriate merely to quote a level for the WACC from those used for other regulated businesses. The risks faced by Royal Mail reflect the specific characteristics of the postal sector - especially the very high operational leverage[14]. Royal Mail believes the risks exceed those of any other UK regulated business and that this should be reflected in a higher WACC than any other UK regulated business. As stated above, Royal Mail will submit its assessment of the weighted average cost of capital separately as part of its response to Postcomm's information request.

[14] Level of operating cost relative to Regulatory Asset Base.

CHAPTER 9: SETTING THE LEVEL

Summary

9.1 Royal Mail believes the allowed revenues should explicitly include all operating costs reasonably and efficiently incurred by Royal Mail.

9.2 Royal Mail welcomes the recognition in Postcomm's document of the need to address pension costs appropriately. This is a very significant issue for Royal Mail. Royal Mail believes that all its pension obligations should be funded through increased revenue allowances and price increases. These should include ongoing pension contributions and funding the pension deficit as Royal Mail's customers have benefited from past pension holidays through lower prices. Royal Mail notes that other regulators, faced with pension deficits in other regulated businesses, have included the provision for the payment of pension deficits when setting the allowed revenue.

9.3 Royal Mail welcomes the recognition in Postcomm's document of the need to enhance the incentives to invest in capital. It sets out alternative means for providing these incentives.

9.4 Royal Mail agrees that the benefit to its profitability from exceeding the expectations of the current price control should not be "clawed back" in the subsequent control as this would be contrary to the basis on which it accepted the control and obstruct the incentive-based mechanism of the RPI-X control. It believes that the structure of the next control should be altered to better manage volume risk as discussed in Chapter 7 of this response.

9.5 Royal Mail notes that there is a significant margin of uncertainty in projections of the future path of Royal Mail's letter volumes. This will also be the case for Postcomm's projections of future volumes. The critical implication of this inherently high level of uncertainty on volumes is that the next price control should be designed to be robust to a wide range of possible volumes outturns and that it has within it a credible and effective way of handling this key risk.

9.6 In the preceding chapter, Royal Mail expressed its concern over the "cash flow approach" (Approach 1) Postcomm proposes to set the level of allowed revenue for the next control. It believes that the level of P0 and X should be set to achieve the level of profit outlined in Chapter 8 and allowed costs, through the use of a "regulatory value approach" (Approach 2A or 2B). Supplementary to this approach, cover ratios and other financial performance indicators resulting from the WACC and market-based value should be cross-checked to ensure that the mails business is financially robust and able to finance its activities.

9.7 Royal Mail sets out further initial views below.

Overall approach

"Postcomm would welcome comments on its overall approach to setting the level of the price control, and how Postcomm should consider the short term interests of customers lower prices with the longer term interests of allowing sufficient headroom for competitors to enter the market". (Postcomm's document 2004, para 9.7)

9.8 In Chapter 8, Royal Mail set out its concerns over the approach and application to setting the current price control that Postcomm adopted. Royal Mail believes that Postcomm's approach is at odds with other regulators, competitors and the financial community and that a "regulatory value approach" is appropriate for setting the control. Supplementary to this approach, cover ratios and other financial performance indicators resulting from the WACC and market-based value should be cross-checked to ensure that the mails business is financially robust and able to finance its activities.

9.9 For most regulated businesses the level of P0 reflects the adjustment required to meet the target allowed profit in the initial year of the control and the X reflects the long-term, underlying efficiency improvement within the business to maintain that allowed profit in subsequent years.

9.10 For Royal Mail, historic efficiency improvement, in the presence of end-to-end traffic growth is between 1% and 2% p.a. The underlying productivity improvement, excluding end-to-end traffic growth, is 1% p.a. The current control applied a 3% P0 increase to make Royal Mail profitable in the first year of the control with a 1% reduction relative to RPI in subsequent years to reflect this underlying historic productivity.

9.11 Royal Mail believes that there are several factors that place upward pressure on costs and unit costs in both the first year and subsequent years of the control. These include:

(a) its end-to-end traffic is not expected grow in the future to the same extent as the past in the presence of e-substitution and greater competition that will reduce the scope for scale economies;

(b) the loss of end-to-end traffic will be to competitors seeking the more lucrative (profitable) parts of the traffic which, even in the presence of some switching to Royal Mail's downstream access services, will lead to additional upward pressure on the end-to-end average unit cost;

(c) the need to fund pension costs in full based upon the independent Actuary's and Trustees' recommendations and changes arising from new pensions legislation and accounting standards.

9.12 To meet the level of the allowed profit targets consistent with the financial considerations in Chapter 8, Royal Mail believes that the average revenue will need to increase again in the initial year. If this does not meet the allowed profit target in the initial year, the average revenue may need to increase further in real terms in subsequent years.

Efficiency review

"Postcomm seeks views on this approach to the assessment of an efficient level of operating and capital expenditure for the next price control". (Postcomm's document, para 9.14)

9.13 Royal Mail believes the allowed revenues should explicitly include all operating costs reasonably and efficiently incurred by Royal Mail. Royal Mail has submitted a significant amount of information to LECG and will be interested to see how this is used by Postcomm's consultants.

Incentives for capital expenditure

"Postcomm would welcome comments on whether additional incentives are required for Royal Mail to invest in capital expenditure and the merits of these specific options. Postcomm would also welcome suggestions of any other mechanisms not identified above, that could be used". (Postcomm's document, para 9.21)

9.14 Royal Mail believes that the price control should create the correct incentives and that the current price control provides insufficient incentives to invest. The current control gave no revenue allowance for any return on any investment in the period of the control and indicated that, in the future, the allowed return could be 6% pre-tax real and possibly even less (under Approach 1 in Chapter 8 of this response).

9.15 The first step to creating the right incentives to invest is to allow a reasonable return. Royal Mail estimates the weighted cost of capital to be significantly in excess of the 6% pre-tax real figure quoted in the document. This is particularly pertinent for an industry where there is considered to be a need for significant capital investment.

9.16 For Approach 2A (see Chapter 8 of this response) the allowed return attributed to proposed new capital expenditure, is only set for one control. If it is not spent it is not added to the RAB and included in the setting of the allowed revenue for a subsequent period. This would significantly enhance the incentive to implement capital expenditure.

9.17 Both Postcomm and Royal Mail would need to keep a clear record of the reasons and projects for the capital expenditure allowed for within the setting of the price control. This would facilitate consideration of future efficiency spend.

9.18 Having set out the changes that Royal Mail believes are necessary to create the right incentives for investment, it comments below on the three options referred to in Postcomm's document. Postcomm views these options as means of being "assured that Royal Mail will execute any capital expenditure to a good quality and in a well planned" (Postcomm's document):

(a) "*A long term regulatory commitment to link a proportion of price controlled revenues to quality of service performance*" (Postcomm's document 9.20)

Postcomm's document sets out an option in which there is an additional revenue allowance if Royal Mail meets a set of service performance targets. Postcomm's document then links this additional revenue to an incentive for Royal Mail to invest capital. It is unclear whether Postcomm refers to a "long term regulatory commitment" as being "long" in duration or "long" in terms of some distant time in the future.

Royal Mail believes in the principle of incentive regulation, as already indicated elsewhere in this response. It recognises that an additional revenue allowance for meeting a range of performance targets could provide incentives to meet that range provided that, having taken account of the risks, the expected benefit to the business exceeds the expected cost. In essence, the current "C-factor" provides a similar incentive, although it is structured as a penalty for failing the revenue targets (i.e. revenue is deducted and only recovered through meeting specific performance targets).

However, service performance is not just a matter of capital investment and Royal Mail therefore believes that the additional revenue allowance should be neither directly nor indirectly linked to the level of capital expenditure. Royal Mail believes that any such linkage would require both a review of its performance targets and significantly greater understanding of the linkages between service performance and cost. For the next control, Royal Mail believes that the level of the "C-factor" type of arrangement should be commensurate with the return on investment and assets directly attributed to service performance.

b) "*A requirement for Royal Mail to consult customers on its annual capital expenditure plans*" (Postcomm's document 9.20)

Postcomm's document refers to the requirement for other regulated businesses to consult annually with customers. These consultations are based around documentation published by the regulated business of the network providers with reference to the codes of operation and development for those networks. These codes include the Distribution and Grid Codes for electricity, security and maintenance codes for rail and environmental codes for water. In these cases the supplementary documentation and consultation by the regulated business relates to location specific information (e.g. demand and supply, environmental measures and security measures). These serve to provide locational signals to customers. The locational signals indicate, for example, where future investment may be required should demand locate in particular areas. Consequently they refer to potential investment projects that are location specific without significant detail as to the specific projects but with supporting reference to the relevant codes. Annual capital expenditure plans are not detailed, are hypothetical rather than firm and do not constitute the primary purpose of the consultation.

In other sectors an allowance for capital expenditure is made in setting the price control based on expected requirements against the relevant codes. Expenditure in excess of that allowed is built into the regulatory asset base for the setting of the subsequent control provided that it was efficiently incurred. Royal Mail believes that this is appropriate for the postal sector. However, at present, the postal sector does not have anything equivalent to the codes in other regulated sectors; these provide the basis on which the need for various investments are required in other regulated sectors. At present, the uniform tariffs of universal service means that few locational signals are being given to customers in the postal sector; these locational signals are the primary driver for the consultation in other regulated businesses. Consequently, it believes that customer consultation of annual capital investment plans is less relevant and helpful for the postal sector. Nevertheless, Royal Mail believes that an access code will require governance and customer consultation and may provide a framework in which to consider future investment needs.

c) "*Incentive related to specific capital expenditure projects*" (Postcomm's document 9.20)

Royal Mail believes that special incentive for specific projects should be avoided as they would require rules that could be discriminatory. It believes that investment incentives should be broadly applied and enhanced as clearly stated above.

Pensions

"Postcomm would welcome comments on the principles it proposes to adopt when assessing the level of allowance for on-going pension contributions and funding of deficits in the pension scheme". (Postcomm's document, para 9.28)

9.19 Royal Mail welcomes the recognition in Postcomm's document of the need to address pension costs appropriately. This is a very significant issue for Royal Mail. Pensions from a key part of employees' benefits and remains one of the key enablers for the continued engagement of the workforce in the transformation of the business. Royal Mail believes that all its pension obligations should be funded through increased revenue allowances and price increases. These should include ongoing pension contributions and funding the pension deficit as Royal Mail's customers have benefited from past pension holidays through lower prices. Royal Mail notes that other regulators, faced with pension deficits in other regulated business, have included the provision for the payment of pension deficits when setting the allowed revenue.

9.20 Postcomm's document also makes passing reference to the treatment of pension costs by other regulators and that some regulators have not allowed for a full recovery of pension costs in setting the control. Royal Mail believes that this reflects different circumstances to that faced by Royal Mail and that the price control should be set to recover pension costs in full. This should be based upon the independent Actuary's and Trustees' recommendations and taking into account scheme specific funding standards and deficit correction periods. This, for instance, would suggest that a more reasonable period for covering deficits should, in line with industry wide best practice, be the average remaining service lives of active members.

9.21 Royal Mail believes that the "broad principles" outlined in Postcomm's document (paragraph 9.26) to assess the pension allowance are reasonable with one important exception. If Royal Mail makes a larger contribution to the pension fund than allowed for in the proposed control, primarily at the direction of the trustees (such as additional funding from a change in the long term investment strategy), then Royal Mail should be given an additional allowance to recover this subsequently. The consequence of not doing this is that the regulator, rather than the trustees, sets the level of contribution. This would not be appropriate.

9.22 Royal Mail also believes that rather than wait until the next price control to recover any deficit or surplus relative to the pension allowance in the allowed revenue, it would be more appropriate to have a year-on-year amendment or an interim review provision, especially in the event that any change had a significant impact on the financial viability of the company. This should include any changes arising from new pensions legislation, new accounting standards (IAS 19) etc.

Profile of prices

"Postcomm seeks views as to the profile of any price movements throughout the duration of the control". (Postcomm's document, para 9.31)

9.23 Royal Mail has already indicated earlier in this Chapter some factors that will influence the levels of the P0 and X. It recognises that a different X for each year provides the scope to profile the allowed average revenue in a different manner from a single pairing of P0 and X. In general, the provision within the allowed revenue should be recovered in prices in a manner that reflects the costs that contribute to that allowed revenue.

Volume projections

"Postcomm will expect it [Royal Mail] to explain why its previous volume forecasts were incorrect and what changes it has made to its analytical approach to take account of the reasons for the problems. Postcomm will also expect Royal Mail's analytical approach to reflect the limited loss of market share since the first stage of market opening in January 2003 and the relatively slow loss of market share in other countries that have liberalised their postal markets, including New Zealand and Sweden". (Postcomm's document, para 9.33)

9.24 Royal Mail welcomes the invitation to explain the differences between Royal Mail's volume forecast during the last price control review and the outturn to-date. A detailed review of volume projections is set out in Annex C and is summarised below.

9.25 Royal Mail's forecast of volumes is undertaken in two main steps. Firstly, advanced statistical techniques (econometric techniques) on historic data are used to establish relationships between key explanatory variables (e.g. economic growth) and volume. Forecast volumes are then made on the assumption that these relationships will hold in the future and on the basis of forecasts of the explanatory variables. To this are added estimates of factors where the future trend is expected to change, most notably electronic substitution. This is a pre-entry volume. Secondly, Royal Mail applies a model of entry into the market to assess the expected reduction from pre-entry volume to post-entry volume.

9.26 Royal Mail was asked by Postcomm to provide projections in two parts: firstly, in August 2002, when only end-to-end entry was included; and, secondly, in November 2002 at "illustrative" prices for access of which Postcomm chose one at "14p". In the event entry proved to be less than projected. The reasons for this included:

(a) Postcomm delaying the introduction of its long-term licensing regime for bulk mail from April 2002 to January 2003, which affected the level of entry during 2002/03;

(b) Delays in reaching agreement on the terms of access such that access traffic commenced after 2003/04 in May 2004;

(c) Delays in end-to-end entry arising from the uncertainty created by the delays in reaching agreement on the terms of access.

9.27 At the same time, projecting volumes on the basis of historical trends alone using Royal Mail's econometric model would have led to a projection of volumes which would have been too high. While Royal Mail's econometric model forecast pre-entry growth of about 8% from 2001/02 to 2003/04, the outturn over this period was about 4%, a difference of 4%. Of this:

(a) 1% is attributed to changes in the outturn explanatory variables from forecast (most notably economic growth being less then expected); and

(b) most of the remaining 3% is attributed to an underlying trend reduction in volume growth akin to e-substitution.

9.28 Royal Mail used net trend adjustments applied to projections from its econometric model to anticipate part of this change in trend due to factors such as e-substitution. As explained in Annex C this is an important component in developing an overall projection of volumes.

9.29 Postcomm's document states it is concerned that "*Royal Mail has an incentive to provide pessimistic volume projections for major regulatory reviews*" (9.33). A review of the pre-entry forecast and outturn shows that Royal Mail's forecast was over-optimistic. A review of the post-entry forecast and outturn suggests that changes to the market were the primary causes of the forecasts turning out to be over-pessimistic.

9.30 Royal Mail has taken both of these factors into account in its more recent projections for the current price control review. Its projections forward are more conservative than previous forecasts and contain detailed forecasts of both end-to-end and access volumes. Nevertheless, there is a significant level of uncertainty in the future path of volumes both because of e-substitution and the extent of competitive entry. Postcomm's primary duty is to seek to ensure the provision of the universal service and this requires it to consider means of securing the finances of the business in low volume scenarios of the future.

9.31 The basis of Postcomm's own forecast of volumes during the previous price control was very unclear and Royal Mail believes that Postcomm should be transparent as regards to the development of its own forecasts for the current price control review. Royal Mail notes that Postcomm has recruited consultants to prepare volume forecasts for Postcomm and regards it as essential to the setting of an effective control that the volume forecast and their basis should be subject to full outside scrutiny.

9.32 It remains the case, however, that there is a significant margin of uncertainty in projections of the future path of Royal Mail's letter volumes. This will also be the case for Postcomm's projections of future volumes. Postcomm have requested high and low projections in addition to a central case, which acknowledges this fact. However, on its own, this is not sufficient. The critical implication of this inherently high level of uncertainty on volumes is that the next price control should be designed to be robust to a wide range of possible volumes outturns and that it has within it a credible and effective way of handling this key risk.

No claw back

"Postcomm would welcome views on its proposal not to "claw back" any profit from Royal Mail in the next price control as a result of higher than forecast volumes when the current control was set". (Postcomm's document, para 9.41)

9.33 Royal Mail agrees that the benefit to its profitability from exceeding the expectations of the current price control should not be "clawed back" in the subsequent control. This would be contrary to the basis on which it accepted the control and obstruct the incentive based regulation of an RPI-X control. However, it believes that further consideration should be given as to how to directly address volume risk as discussed in Chapter 7 of this response.

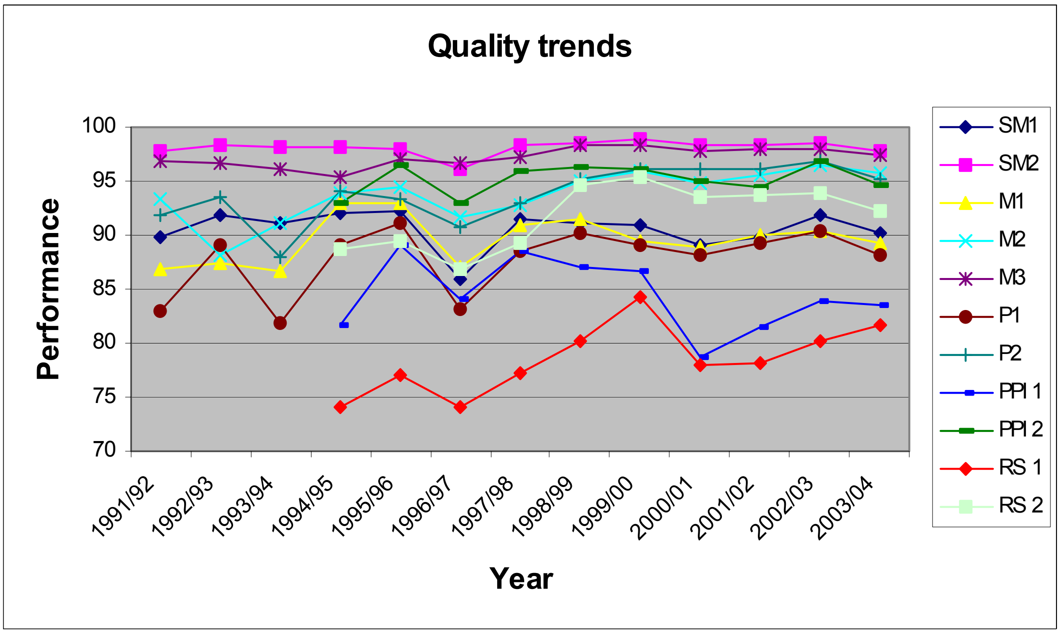
9.34 Royal Mail comments above (see, for example, paragraph 13 above) on the appropriate treatment of capital expenditure for the next price control.

ANNEX A
SUPPLEMENTARY INFORMATION RELATING TO THE QUALITY OF SERVICE

Performance Trends

1.1 RM currently has 28 targets, all relating to transit time of mail, i.e. the speed with which it moves from posting to destination: There are thirteen targets relating to performance against specification, and thirteen relating to the performance of mail missing that specification (the "tail of mail"). The other two targets (which in themselves encompass some 239 sub-targets) set minimum levels ("floors") for the performance of first class stamped and metered mail posed in each postcode area, and posted and delivered within each postcode area.

1.2 The performance of the main measures since 1991 is set out in the graph below. Performance in 1996/7 (and to a lesser extent 2003/4) has been affected by serious industrial action.



1.3 As the targeted products for the most part go through the same processes, problems affecting the achievement of one target are likely to affect most others to a greater or lesser extent. This makes it much more likely that Royal Mail will either achieve most of its targets or fail most of them in any given year.

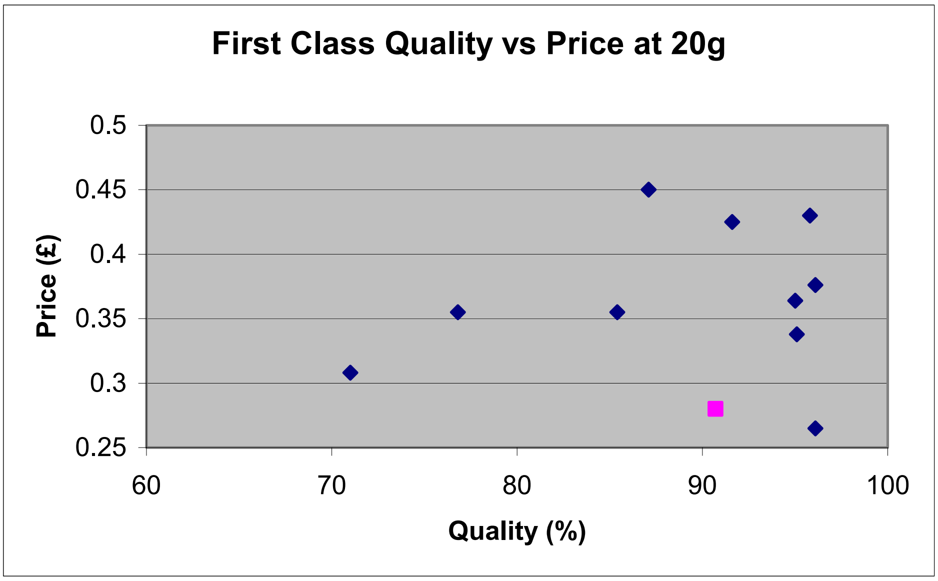
1.4 Postcomm assumes in its discussion there is a simple relationship between its regime of competition, Licence targetry, price control, C factor penalties, fines and statutory compensation, and Royal Mail's performance.

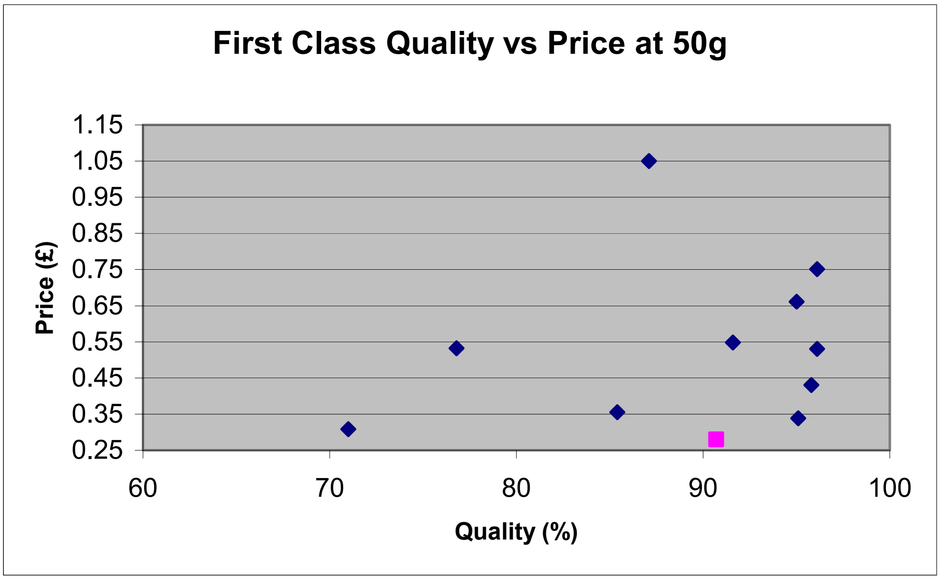
1.5 In practice things are far more complex. Allowing for the impact of strikes and the major changes in Q4 of 2003/4, Royal Mail's quality of service performance in most areas has remained static for the past 10 years. The regulatory regime of the past three years has on the face of it had little impact on the achievement of targets, in spite of the considerable efforts made by Royal Mail.

Comparison with other European Postal Operators

1.6 A consideration of regulatory regimes, competition, and prices in other EU countries suggests that there is no simple relationship between these and quality of service performance, although those countries with very high (over 95%) first class quality also have high prices. This comparison also suggests that:

(a) Royal Mail is more heavily targeted and penalised than other countries.
(b) Its compensation arrangements are among the most generous.
(c) Its prices for second class mail are the lowest in Europe and its prices for first class mail are amongst the lowest
(d) Its <u>achieved</u> quality of service for first class mail is average for Europe.
(e) Its <u>achieved</u> quality of service for second class mail is among the highest in Europe, if not the world.





Graphs are based on quality for 2003[15] taken from regulator/operator web-sites and prices as at November 2004, adjusted for purchasing power parity.

UK is shown in pink. Other countries considered were France, Germany, Ireland, Finland, Denmark, the Netherlands, Sweden, Belgium, Portugal and Italy.

[15] France quality figures are for 2001 and Finland quality figures are for 2002 as no more recent figures are published.

Comparison with Other Regulated Postal Industries

1.7 The number of targets Royal Mail has in its Licence is unprecedented in the postal industry. It is not dissimilar to the number of targets imposed on other regulated UK industries in the early days of regulation although these targets were much broader in scope. For example, in 1994 British Gas had 34 standards including making and keeping appointments, energy efficiency advice to customers in debt, meter reads on moving house, attendance at uncontrolled gas escapes, debt and disconnection, quotation to provide a gas supply and restoration of interrupted gas supply. However these targets have been reduced over time and other regulated industries now have far fewer targets than Royal Mail, as shown in the table below.

Industry	Current standards
Electricity distribution	Each company must report on 6 overall standards. Ofgem proposes to revoke these.
Electricity supply	Suppliers must report on 5 overall standards.
Gas transportation	Transco must report on 6 overall standards.
Gas supply	Suppliers must report on 5 overall standards.
Telephone	None at present but Ofcom proposed in September 2004 that fixed line service providers should report on 5 quality parameters, and is considering KPIs for BT on Wholesale local access.
Water	Water companies report on 8 service standards.

1.8 A number of other regulated industries make use of positive incentives to reward good performance. For example:

(a) Electricity distributors currently have positive and negative incentives under their price control to meet targets in three areas. Ofgem proposes to retain and extend this to four areas in the next price control and to introduce a discretionary reward scheme for best practice in other areas.

(b) Ofgem recently published a report on the 2003/4 quality of service performance of the 14 electricity distribution companies in Great Britain. The best overall performer was Western Power Distribution (WPD). In recognition of their strong performance Ofgem has said they will be rewarded with a 1 per cent increase in revenues during the next distribution price control, due to take effect in April 2005.

(c) Ofgem also proposes new transmission network reliability incentive arrangements for National Grid Company plc. From 1 January 2005 it will be rewarded up to 1.0 per cent of its transmission revenue requirement or penalised up to 1.5 per cent of its revenue depending on the level of energy unsupplied from the England and Wales transmission system in any given year.

(d) The Strategic Rail Authority incentivises many operators to run a better service, paying bonuses and imposing penalties when performance is better or worse than benchmark. In order to make sure that the bonuses and penalties flow through to the right parties from the SRA incentive regime, there is a separate incentive regime operating between the train operator and Network Rail.

(e) The CAA currently has a small two-way financial incentive on the national air traffic control operator NERL. In its November 2004 price control proposals, the CAA intends to strengthen this by doubling both the penalties and bonuses involved.

ANNEX B

SUPPLEMENTARY INFORMATION ON A POTENTIAL MEANS FOR ADDRESSING SOME ASPECTS OF VOLUME RISK

Postcomm's document seeks clarification as to how a mechanism could be applied to address volume risk. Royal Mail believes that following six steps could go some way to addressing this subject and would be relatively simple to apply.

(a) an additional term, AD_t, to be added to the definition of AR_t;
(b) a total volume term, VA_t, equal to the v_t for a collection of Controlled Services;
(c) the forecast total volume term, VF_t, used to set the control;
(d) Y is a percentage change in volume from that forecast to trigger a non-zero value for AD_t;
(e) an average margin term $MR_t = MR_{t-1}.(RPI_{t-1}-X)$;
(f) such that:
if $VA_{t-1} > (1+Y).\ VF_{t-1}$ then $AD_t = - MR_{t-1}.\ (VA_{t-1} - VF_{t-1})$ or
if $VA_{t-1} < (1-Y).\ VF_{t-1}$ then $AD_t = MR_{t-1}.\ (VA_{t-1} - VF_{t-1})$ or
otherwise $AD_t = 0$.

In Step (b) the collection of Controlled Services and Price Ranges could b focused on those services and Prices Ranges where there is significant uncertainty over the speed of entry.

ANNEX C

SUPPLEMENTARY INFORMATION ON VOLUME PROJECTIONS FOR PCR2

1. Introduction

1.1 In Chapter 9 of its consultation document (para 9.35), Postcomm requests Royal Mail to provide an explanation of differences between Royal Mail's volume projections for PCR2 and actuals. It also requests Royal Mail to explain changes to its analytical approach for the next price control given Postcomm's assertion that Royal Mail has an incentive to provide pessimistic volume projections. This annex responds to these requests from Postcomm.

1.2 Royal Mail notes that Postcomm has invited Frontier Economics to develop volume forecasts to compare with Royal Mail's forecasts. Royal Mail welcomes the opportunity to comment on Frontier's approach once Postcomm has published the basis for its own volume projections and has made available Frontier's models for comment and review.

2. Projections and Actuals

2.1 Royal Mail developed its projections for PCR2 in a number of stages. At the first stage, Royal Mail used its econometric model of inland letter traffic (ILTM) to project volumes for Royal Mail traffic on the basis of historical trends and explanatory variables such as economic growth and letter prices.[16] A second stage added estimates of factors either not included or only partially included in the econometric model which were expected to change the future trend of traffic from its historical path. The most significant of these factors was the future prospects for electronic substitution and the accompanying erosion of the demand for mail. A final stage modelled the impact of competitive entry given particular liberalisation scenarios using Royal Mail's model of competitive entry (EPM).[17] This framework made extensive use of models and so allows an assessment to be made of the reasons for differences between projections and outturns.

2.2 The projections reported by Postcomm in tables 2.3 and 2.4 were provided by Royal Mail to Postcomm in two parts. In August 2002 Royal Mail responded to a request for projections. The projections assumed that all entry would be on an end-to-end basis. This projection was developed following the three stages outlined above with the initial econometric model projection and allowance for other factors such as e-substitution being based on work at the start of 2002 for Royal Mail's Interim Strategic Plan (ISP). Indeed some of the assumptions, for example on economic growth, were made at the start of the cycle of work for that Plan in the second half of 2001. That work had also made use of Postcomm's January 2002 proposals document on market opening which envisaged bulk mail liberalisation in April 2002.

2.3 Later in the Autumn of 2002 Postcomm requested further projections for a

[16] Nankervis, John, Sophie Richard, Soterios Soteri and Frank Rodriguez. 2002. "Disaggregated Letter Traffic Demand in the UK". In *Postal and Delivery Services: Pricing, Productivity, Regulation and Strategy*, edited by Michael A. Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.

[17] Robinson, Richard and Frank Rodriguez. 2000. "Liberalisation of the Postal Market and the Cost of the Universal Service Obligation: Some Estimates for the UK". In *Current Directions in Postal Reform*, edited by Michael A. Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.

number of "illustrative" prices for downstream access. Postcomm adopted one of these (access at "14p") as its main case and both Postcomm and Royal Mail used Royal Mail's forecasts for access. Access displaces or substitutes for some end-to-end traffic. Postcomm adjusted the August 2002 projection by adding access and also reducing end-to-end traffic in line with the forecasts from Royal Mail. The totals reported by Postcomm in Chapter 2 also included estimates for USO international mail, USO parcels and special delivery.

2.4 For the purpose of comparison between projections and outturns it is useful to report volumes as index numbers (2000/01 = 100). These are reported in table 1 where there are six series in all. Columns (1) and (2) report series from March 2002 prepared as part of the ISP but including an adjustment made for the 1p/1p increase in prices assumed to occur in April 2003 at the start of PCR2. This was the pre-competitive entry base for the projections provided to Postcomm, inclusive of competitive entry effects, in August 2002. Columns (3) to (5) are the projections provided to Postcomm with (4) and (5) corresponding to the figures reported by Postcomm in tables 2.3 and 2.4. Column (6) shows outturns.

Table 1

Index Numbers of Volume Projections, 2000/01 to 2005/06[1]

	ISP: March 2002 (Pre-competitive Entry Base)		Data to Postcomm: August 2002	Data to Postcomm: November 2002 (14p Access Price)		Outturns
	(1)	(2)	(3)	(4)	(5)	(6)
	ILTM (2000)	= (1) plus Additional e-sub		E2E Volume = (3) + E2E Change	Delivered = (4) + Access	
2000/01	100	100	100	100	100	100
2001/02[2]	105	105	104	104	104	104
2002/03	105	105	101	101	101	102
2003/04	108	106	98	97	99	104
2004/05	111	108	94	90	96	
2005/06	115	109	88	82	92	

1. The series in columns (1) and (2) include an estimate in all cases from ILTM (2000) for the 1p/1p increase assumed to occur in April 2003. The index numbers for columns (3) to (5) are calculated using outturn data for 2000/01 and 2001/02.
2. 53-week year.

2.5 As can be seen, outturns have been above the August 2002/November 2002 post-competitive entry projections but below both the pre-competitive entry projections reported in the table. This raises two related questions which can best be addressed in the following order. First, why have outturns been <u>above</u> the <u>post-competitive entry</u> projections and secondly, why have outturns been <u>below</u> the <u>pre-competitive entry</u> projections in series (1) and (2).

2.6 It is clear that up to March 2004, very little loss of traffic had occurred due to competitive entry. There were a number of reasons for this. There was very little entry during 2002/03. Postcomm delayed the introduction of its long term licensing regime for bulk mail from April 2002 to January 2003 and the short-term licences in place before that time appear to have created uncertainty among potential entrants. In terms of lack of entry during 2003/04, the key factor was the delay in agreeing terms for access. Access mail began to enter Royal Mail's network in May 2004, after the end of FY 2003/04, so that no access volumes were handled during either 2002/03 or 2003/04. This also had a knock-on effect into the end-to-end market with entrants waiting to see the terms of access, particularly prices, that would be put in place before committing to offer service through access or their own delivery network. It is also the case that the phasing assumptions for entry which were set in around 2001 were probably too rapid at $\left(\frac{1}{6},\frac{1}{3},\frac{1}{3},\frac{1}{6}\right)$. This phasing implied that all impacts would be in place within four years. As more evidence has become available, it appears more likely that the supply-side takes longer to develop so that even if access, which was the main factor in delaying entry, had been settled earlier the extent of bypass entry might still have been slower to build up and hence more muted than projected.

2.7 Given that little entry occurred through bypass or at all through access, the reported outturn for addressed inland letter traffic might have been expected to have been extremely close to the pre-competitive entry projections made with the version of the ILTM at that time, ILTM(2000).[18] This was the business projection in early 2002 of how volumes would have increased if there had been no opening of the market. In fact, table 1 also shows that outturn volumes were below the pre-competitive entry projection in all three years for which outturn data are available.

2.8 The reasons for the differences between the pre-competitive entry projections and outturns could be the assumptions for independent variables in the econometric model (for example, on economic growth), the elasticities and coefficients in the model itself (which were estimated on data up to 1999 Q2) or trend/ unexplained elements. The three factors can be brought together in the following way:

(Actual Growth – Projected Growth)	=	Difference due to outturns for input variables used in ILTM (2000)
		+
		Difference due to model update
		+
		Residual Difference

The difference due to input variables can be assessed by running the original model, ILTM (2000), with outturn values for economic growth, prices and other explanatory variables rather than the forecasts made for these variables in December 2001. For example, if economic growth outturned lower than projected in a particular year then if the correct lower value had been used the projection using ILTM (2000) would have been correspondingly lower measured by the elasticity impact of that variable times the difference in the input variable. Secondly, the difference due to the model can be assessed by comparing the projection made, using outturn rather than original data, of a later version of the model incorporating all of the outturn data. This can be done by running the latest version of the model, ILTM (2004), and ILTM (2000) with the outturn data and recording the difference between the projections of the two models. If, for example, ILTM (2004) gives a lower impact (elasticity) to a particular variable then its projection would have a smaller effect for the same data as ILTM (2000). In this exercise, ILTM (2004) is taken to be a more accurate model than ILTM (2000) as its estimation contains an additional four years of information. Finally, even allowing for an updated model and data an unexplained element or residual will remain which should be small.

2.9 Estimates of these differences are summarised in table 2. In December 2001, pre-competitive entry, ILTM(2000) projected total inland letter traffic to increase by about 8% in the three years 2001/02 to 2003/04 after allowing for an estimate for

[18] Note also that the projection for Postcomm also included international and other traffic. However, this represented less than 5% of all traffic and the analysis here focuses on addressed inland letter traffic.

the effect of the 1p/1p price increase assumed for April 2003 of around 1% (column (1), table (1). However, traffic growth outturned at only about 4% (column (6), table 1).

2.10 Table 2 provides a decomposition of the respective impacts of input values for variables, models and residuals. Correcting the values of input variables to their outturn values would have reduced the projection by about 1% to about 7%. The main factor here was economic growth which was lower in 2002 and to a lesser extent 2003 than expected when the growth forecast was made in 2001 at the start of the planning round although this was partially offset by telecom prices, an explanatory variable in ILTM(2000), declining by less than assumed.

2.11 The re-estimated version of ILTM accounts for the remaining difference of 3% rounded to the nearest interger. The impact of economic growth, prices and other factors, <u>except</u> those linked to e-substitution, are little changed between ILTM(2000) and ILTM(2004). However, in ILTM(2004) a negative trend term and changes in other e-substitution related variables account for much of the remaining difference of 3% between projected and actual traffic growth. A projection of the underlying trend of letter traffic pre-competitive entry made purely on the basis of historical trends would have been too high and the impact of e-substitution on mail volumes appears to have strengthened over these years. In this regard the series in table 1 including an allowance for additional e-substitution (column (2)) is closest to the actual path of volumes.

Table 2

Summary of Differences Between Projections and Outturns
Total Inland Letter Traffic, 2001/02 to 2003/04

			Percentage Change, 2001/02 to 2003/04
1	Pre-competitve entry Projection 2001/02 to 2003/04		8
	+ Impact of correcting values of input variables	-1	
2	Projection after correcting input values for variables		7
	+ Impact of change to ILTM(2004)	-3	
3	Projection after change of model and corrected values of input variables		4
4	Outturn		4
5	Difference : Outturn minus Revised Projection[1]		0

[1] There is in fact a small residual of 0.2%.

3. Implications for Royal Mail's Approach to Projecting Traffic Volumes

3.1 Royal Mail's overall approach to developing its volume and revenue forecasts remains as set out above. For a given scenario a projection is developed of traffic in the absence of competitive entry which uses Royal Mail's econometric model and reflects historical trends; an allowance is then made for factors which may change the future path of traffic from these historical trends (other than competitive entry), most notably e-substitution; and finally an assessment is made of the impact of competitive entry using Royal Mail's entry pricing model. Clearly, different scenarios, for example regarding economic growth or pricing or e-substitution or the competitive environment will yield a different set of projections as will different assumptions that feed into these models. However, as an overall approach Royal Mail remains strongly committed to the use of an integrated set of formal, analytical models in preparing its volume and revenue projections.

3.2 With regard to the specifics of this analytical framework and the development of models, there are a number of implications that Royal Mail draws from the PCR2 forecasting round.

3.3 On pre-competitive entry projections, ILTM(2004) confirms that, apart from the telecom variable, all the other factors in the new model are in line with those in the previous version of ILTM with elasticities which are little changed. Projections on economic growth and prices, in particular, remain critical to the overall volume projection. The key finding from the review of the pre-competitive entry projections is, however, that the ILTM(2000) projection was too optimistic with regard to the underlying weakening of demand growth for letter traffic, most of which will have been associated with the effects of e-substitution. It is important, therefore, that an allowance continues to be made explicitly for <u>future</u> deterioration in the trend of traffic volumes to try to avoid over projecting the underlying growth of volumes. Accordingly, the projections for PCR3 will include a quantitative allowance for prospective changes in the future in net trends. The implication of this is that when a future version of ILTM is estimated and compared to ILTM(2004) this would then be expected to have a larger negative trend than in the current model in the same way as ILTM(2004) projects an appreciably lower underlying rate of growth of volumes than ILTM(2000).

3.4 With regard to post competitive entry projections, the main implication is that the supply side appears to take longer to develop than the phasing assumed in earlier versions of the EPM. Further work has been undertaken to improve the phasing assumptions in EPM(2004) compared with earlier versions of the model. This uses an analysis by the US postal regulator of the speed at which competition develops in the postal market.[19] It should be noted also that for the updated version of the EPM all parameter values have been reviewed and a number revised. In some cases these changes have tended to lower the estimate of competitive entry for a given scenario and in others it has tended to increase it.

3.5 It remains the case, however, that there is a significant margin of uncertainty in projections of the future path of Royal Mail's letter volumes. This will also be the case for Postcomm's projections of future volumes. Postcomm have requested high and low projections in addition to a central case, which acknowledges this fact. However, on its own, this is not sufficient. The critical implication of this

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[19] Cohen, Robert H., Matthew Robinson, Renee Sheehy, John Waller and Spyros Xenakis. 2005. "Would Entry into a Liberalized Delivery Market Attract Investors". In *Regulatory and Economic Changes in the Postal and Delivery Sector*, edited by Michael A. Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.

inherently high level of uncertainty on volumes is that the next price control should be designed to be robust to a wide range of possible volume outturns and that is has within it a credible and effective way of handling this key risk.