Royal Mail

The Real Network

RESPONSE TO POSTCOMM'S CONSULTATION DOCUMENT "REVIEW OF CONSIGNIA PLC'S PRICE AND SERVICE QUALITY REGULATION – PROPOSAL FOR A SECOND PRICE CONTROL"

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KEEPING THE USO ALIVE

Postcomm's proposal in its October document for Royal Mail's next price control is unacceptable:

(i) ***Royal Mail's weak financial position means the universal service is completely dependent on a reasonable proposal from Postcomm.*** Royal Mail lost over £500 million last year providing licensed universal services. Royal Mail expects that the licensed universal services should yield a reasonable economic return. From January, given Postcomm's liberalisation proposals, well-funded European operators will enter the UK market and cream-skim Royal Mail's profitable products and customers. To sustain the universal service, Royal Mail needs enough cash from this price control review in conjunction with that borrowed from the National Loans Fund to ensure it can fund its aggressive Renewal Plan, which involves up to 30,000 job losses over the next three years, and withstand the inevitable loss of profitable market share to competitors.

(ii) ***Postcomm has seriously mishandled the price control process and displayed a fundamental misunderstanding of many of the core issues***. Postcomm accepts that Royal Mail's finances are weak, that competitors are about to enter the market and that volumes - on which Royal Mail's cash flows crucially depend - are therefore particularly difficult to forecast. Yet, perversely, it fails to deal with these issues in the price control. As a result, Royal Mail's customers, employees and shareholder are left dangerously exposed, and the universal service is at risk.

(iii) ***A sensible price control for Royal Mail and its customers must be built on a set of simple principles***. First and foremost, these principles must ensure sufficient cash-flow is available to maintain the universal service under a range of reasonable outcomes both around costs and volumes. They should also offer sensible commercial incentives to Royal Mail to cut costs, improve quality and grow the business, while giving it the flexibility it needs to respond to competition. In addition, the price control should provide an automatic mechanism for unexpected cost and volume shocks. As is standard practice for all regulated utilities, the regulatory framework should also allow Royal Mail an adequate economic return in line with the returns made by TPG and Deutsche Poste, which Royal Mail estimates is at least a 7% return on sales.

(iv) ***Postcomm's price control proposals put the universal service at risk***. Postcomm's proposed average revenue cap would result in a funding need of £460 million in excess of the funding already required by Royal Mail's Renewal Plan of £465 million, which means £460 million more than Royal Mail's shareholder has agreed to finance. It therefore leaves a black hole in the balance sheet that may make it impossible to continue providing the universal service. Furthermore:

a. It provides no downside protection against lower than expected volumes - despite huge uncertainty, and despite each additional percentage point of volume lost costing Royal Mail £55 million of revenue a year.
b. It takes no account of further downside risks, such as pension funding requirements, increases in National Insurance and funding costs which, together with Postcomm's price control proposals, could lead to a total

funding requirement of £1655 million over the price control period. Funding requirements are set out in the table at the end of this precis.

c. It restricts Royal Mail's flexibility to respond to competition just as well-funded competitors are being encouraged into the market by profit opportunities that do *not* require providing a universal service.

d. It reduces commercial incentives that would make it even more difficult to meet customers' needs and respond effectively to competition.

e. It increases the burden of regulation just as Royal Mail needs to focus everyone in the business on delivering the Renewal Plan and providing a competitive, quality service to customers.

(v) ***Royal Mail's counter proposal on price control structure would meet Postcomm's objectives.*** Royal Mail's preferred option caps individual prices and allows price changes that are revenue neutral. This approach provides Royal Mail with some flexibility to rebalance and restructure prices and product specifications to meet the competition. By being rules based it promotes Postcomm's objectives of transparent, predictable regulation. When combined with a downside revenue trigger it also ensures Royal Mail's ability to fulfil the universal service obligation for the UK should volumes fall off dramatically.

(vi) ***Postcomm has not considered the impact of network access in its proposals even though access further severely erodes Royal Mail's cash-flow***. Postcomm has been dealing with price control and access price as two separate issues but these need to be considered together in its final price control proposal. Postcomm has indicated to Royal Mail a range of access prices which could cost another £250 million over the price control period – or more than £1 billion if a determination by Postcomm forces Royal Mail to price its workshare and other retail products on the same basis. This cost is on top of the increased funding the business would require under Postcomm's price control proposal alone. Moreover, Postcomm's indicative access prices would offer Royal Mail a derisory return on delivery, the crown jewel in Royal Mail's portfolio of services.

(vii) ***Royal Mail may require Postcomm to agree to additional price increases.*** Royal Mail believes the 1p/1p offered by Postcomm may not be sufficient to provide the funds necessary to make an acceptable return, preserve the USO or offset the projected contribution loss through access. Moreover, it does not provide funding to meet additional National Insurance and other risks such as additional pension contributions almost certain to arise during the price control period.

(viii) ***While fully committed to the principle of compensation, the terms and scale of the proposed scheme are unacceptable.*** Postcomm has proposed that customers will be able to claim up to £27 for loss of a 27p first class letter without any proof of purchase. It has also proposed a punitive rate of penalty payment under the industry scheme. Royal Mail has separately proposed alternative arrangements for compensation.

This price control is critical to the financial viability of Royal Mail and the ongoing provision of the universal service. It needs to take into account all of the major regulatory decisions Postcomm is currently considering, particularly the introduction of competition and the pricing of network access. Royal Mail looks forward to completely revised proposals from Postcomm that meet the needs of the industry.

Funding requirements and downside risks to Royal Mail's Renewal Plan,
£ million of funding requirement over 2003/04-2005/06

Funding requirement in Renewal Plan	**465**
Impact of Postcomm's price control proposals	460
Increased National Insurance payments	120
Additional pension funding requirement	330
Cost of funding	280
Potential total funding requirement before Renewal Plan risks and access	**1,655**
Risks to Renewal Plan	400-600
Direct contribution impact of Postcomm's indicated access prices	250
Impact of having to reprice products	930
Potential total funding requirement after Renewal Plans risks and access	**3,235-3,435**

RESPONSE TO POSTCOMM'S CONSULTATION DOCUMENT "REVIEW OF CONSIGNIA PLC'S PRICE AND SERVICE QUALITY REGULATION – PROPOSAL FOR A SECOND PRICE CONTROL"

EXECUTIVE SUMMARY

1. The importance of the price control to Royal Mail.

This price control review is critical to Royal Mail's future given the commercial crisis facing the business, the imminence of aggressive competition and the need to fund a Renewal Plan that will make Royal Mail fit to compete.

The outlook for Royal Mail's profitability is poor

Royal Mail has a recent history of low profits, driven by slowing volume growth, deep-rooted industrial relations sensitivities, and declining prices in real terms over the last ten years to levels lower than any comparable European postal operator (except for Spain).

The market for First Class – Royal Mail's most profitable product – is flat. Second Class mail loses money – the 19p stamp price is the same today as it was in 1993. Only direct mail has been growing strongly, but has now been hit by the advertising downturn.

Licensed universal service products lost more than £500 million in 2001/02 and continue to depend on other non-Licensed universal service products for cross subsidy. Without this cross subsidy, there could be no universal service at today's prices.

Aggressive competition is imminent

Postcomm's market opening strategy will encourage large overseas operators to enter the UK market. Companies such as DPWN and TPG are major international players with large financial resources protected by statutory domestic monopolies and are actively expanding operations in the UK market.

The top 60 customers in the UK account for a significant part of Royal Mail's marginal contribution, and will be highly vulnerable to competition from January 2003. Without pricing flexibility, Royal Mail risks losing these customers as it will not be able to match well-funded competitors' discounts. In addition, with the potential introduction of third party access to Royal Mail's network, competitors will immediately be able to establish a high volume position in the market, while building a delivery capability for the medium term – TPG, for example, already has coverage of 80% of UK address points following its acquisition of Circular Distributors. The combination of bulk liberalisation and access to Royal Mail's downstream network provide a barrier-free UK entry strategy to the best players in continental Europe.

Absence of a level playing field

Royal Mail believes in the principle of increased competition in order to stimulate innovation and efficiency. However, Postcomm's liberalisation programme will promote inefficient competition attracted primarily by cream-skimming opportunities. For example, it is self-evident that:

(i) Competitors will attack profitable products – products whose contribution is essential to Royal Mail's viability and which cross subsidise the social mail products that Royal Mail carries at very low prices.

(ii) Uniform national tariffs will encourage competitors to enter the market and bypass Royal Mail in low cost delivery areas and rely on the arrangements provided by downstream access for Royal Mail to deliver in high cost delivery areas.

(iii) Six day a week delivery – required to provide the universal service – will be undercut by operators providing more limited delivery services. This will drive up Royal Mail's unit costs, further undermining its financial viability.

No potential entrant has shown any interest in providing a universal service in the UK.

This is not competition on a level playing field. Postcomm's price control proposal substantially exacerbates an already risky outlook for Royal Mail by constraining its ability to respond.

Royal Mail has launched an aggressive Renewal Plan to transform the business

To respond to the commercial crisis it faces, Royal Mail has launched an aggressive Renewal Plan to transform the business, driving down costs at a speed and to a level that is unprecedented in Royal Mail's history. The Renewal Plan is programmed to deliver £1400 million per annum of gross savings by the end of the three-year period. (Even if implemented with complete success, however, it would still result in a return to only modest profitability and modestly positive cash flows, albeit with much improved customer service and improved levels of employee satisfaction.) It also involves up to 30,000 job losses and a fundamental transformation in the way the business is run.

A wide range of projects will transform the mails business under the Renewal Plan. To secure the funding required from the National Loans Fund to deliver this programme, Royal Mail must be able to project the minimum cash-flow position – *negative* £465 million - laid out in its Strategic Plan (which Postcomm has), and be able to demonstrate to its shareholder the operational and commercial flexibility needed to respond to downside risks. Without these, the plan will not be financed.

2. Postcomm has mishandled the price control

Despite the importance of the price control to Royal Mail and despite Postcomm's statutory duties, Postcomm's handling of the price control process has been inadequate:

(i) ***Postcomm's regard for process has been poor throughout***. Postcomm has refused to engage with Royal Mail on some of the key elements of the price control process, including Royal Mail's response to Postcomm's November 2001 consultation paper, Royal Mail's submission of six papers on the price control in July 2002, and Postcomm's financial model – the final version of which Royal Mail has still not received despite expressing deep concerns about its core elements. The results of the 16-month W S Atkins efficiency review still have not been published despite the fact that they have clearly influenced Postcomm's thinking on operating costs in its October document, and despite Royal Mail having submitted over one thousand documents during the review. Finally, since publication of the October document Postcomm has communicated to Royal Mail that it is considering alternative options to its proposed average revenue control – including one termed the "simplified approach with flexibility" – but without making any of its thinking public.

(ii) ***Postcomm has indicated a willingness to dilute the primacy of its statutory duty to ensure the provision of a universal postal service***. Postcomm's October document dilutes the primary duty of ensuring the provision of the universal service under the Postal Services Act (2000) and treats the need to promote competition and the need to reduce prices for consumers as of equal importance to the need to maintain the universal service.

(iii) ***There are fundamental contradictions in Postcomm's proposals.*** While Postcomm speaks of the 'weakness' of Royal Mail's current financial position and despite the enormous risks inherent in the Renewal Plan and the liberalisation programme, Postcomm's proposals would worsen the negative £465 million cash-flows in Royal Mail's Strategic Plan by a further £460 million, and would offer no protection against very significant risks.

As a result of Postcomm's limited engagement with Royal Mail, Postcomm has fundamentally misunderstood some of the key issues. Postcomm's statements about Royal Mail's concerns suggest a lack of understanding of Royal Mail's written submissions, and Postcomm's modelling of volume and cost projections fails to take into account the most self-evident consequences of the market liberalisation, namely cream-skimming.

3. The required regulatory framework

Given the failures in process so far, it is important to be clear on the principles that should underpin regulation of Royal Mail. The regulatory framework should:

(i) Ensure that Royal Mail has sufficient baseline profit and cash flow to continue to be able to provide the universal service and to fund the Renewal Plan. This requires at a minimum the emergency 1p/1p price on the "Inland 6" products – First Class, Second Class, Mailsort, Walksort, Response and Packetpost – together with price increases at inflation on International, Special Delivery and USO[1] parcels. Any projections of cashflows must be based on reasonable, fact-based analyses of volumes, prices and costs.

(ii) Provide a financial framework for the regulated business that is robust and flexible enough to deal with poor outturn cashflows. Recent examples of inflexible financial frameworks in rail and in air traffic control have left incumbent licence operators with too little cash to meet licence obligations, with extremely damaging consequences.

(iii) Provide an appropriate level of allowed profit based on required returns to the shareholder. Royal Mail's own estimate of an economic return in line with the returns made by TPG and Deutsche Post is at least a 7% margin on sales.

(iv) Provide strong commercial incentives and flexibility to compete. Royal Mail should not be prevented from responding to competition through rebalancing its prices, introducing new products and modifying the product coverage of the USO, by lengthy regulatory processes as exist today. Royal Mail recognises the significance of its initial market share and agrees that safeguards are required to protect appropriately aggregated customer groups. But these are already in place in Conditions 10 and 11 of its licence and in the provisions of the Competition Act (1998).

(v) Minimise the burden of regulation. Royal Mail is regulated by Postcomm with regard to, amongst other things, prices and has Postwatch as a watchdog with particular interests in improving service performance. The requirements of Postcomm and Postwatch come together in the licence. Regulatory involvement should be eliminated wherever competition is established.

[1] Universal Service Obligation

4. Postcomm's proposal is unacceptable

Postcomm's proposal does not follow these principles. Postcomm has proposed an average revenue control that fails to deliver the cash required for the Renewal Plan, that minimises commercial flexibility, that reduces commercial incentives and that brings back under the price control products previously treated separately. More generally, its proposal extends regulatory discretion and greatly restricts Royal Mail's commercial freedom to respond to competition. Postcomm's proposal is based on flawed assumptions and will put the universal service at risk.

Postcomm's proposal is based on a flawed set of assumptions

Postcomm's assumptions on reasonable returns, volumes and operating expenditure are flawed:

(i) ***Postcomm's assumptions do not offer the prospect of reasonable economic returns****.* Even based on Postcomm's over-optimistic projections of traffic growth and achievable operating expenditure reductions, Royal Mail's total cashflow over 2003/04-2005/06 is only £46 million at 2000/01 prices. This represents a margin of approximately 0.3% averaged over the price control period, rising to 2.3% in 2005/06.

Royal Mail's estimate of an economic return is at least £400 million profit per annum on an efficient cost basis. Postcomm's projection of an average £15 million cashflow per annum cannot be based upon any reasonable concept of an allowable return.

(ii) ***Postcomm's volume assumptions are clearly unrealistic and point to the need for a downside protection mechanism in the price control****.* Postcomm's volume assumptions are based on the arbitrary assumption that Royal Mail will lose 20% of each product group to competitors. This assumption of equal losses across products, customers, formats, weight steps and geographies is clearly wrong. There are huge cream-skimming opportunities available to competitors, as any commercial operator is well aware. TPG for example has stated: "*let's be realistic – private operators will, at least in the short term, target business customers*". [2]

Postcomm's projection that Royal Mail's traffic will decline by only 4.3% over 2003/04-2005/06 is very optimistic. Postcomm's own consultants (WS Atkins) conclude that "*Postcomm has no good reason to take its price control decision on a different set of volume projections form those put forward by Consignia in Version 4 of its Strategic Plan*"[3].. Royal Mail's forecast – based on detailed modelling of competitive dynamics that has been reviewed by leading international academics – is that volume will decline by 11.1% over the period.

While Royal Mail thinks Postcomm's forecasts are wrong and that its consultants' conclusions are closer to the mark, at a minimum the gap between these forecasts demonstrates the difficulty of predicting how competition will develop. Given the need to ensure the provision of the universal service and thereby protect Royal Mail's financial viability, there is a very strong case, therefore, to include in the price control an automatic mechanism that protects against lower than expected revenue outturns.

(iii) ***Postcomm's assumptions on cost reduction are unreasonable.*** Royal Mail is committed to deliver £1400 million per annum of gross savings by the end of the

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[2] "TPG's response to the price control for Consignia", TPG, May 2002.

[3] "An Efficiency Study of Consignia's Inland Letters Business", Version 17, paragraph 50, WS Atkins, November 2002. .

period of the price control, including £850 million of gross savings related to the regulated business. This translates into real annual operating cost reductions of 6.4% per annum over 2003/04-2005/06. By contrast Postcommpresent hypothetical projections produced by its consultant W S Atkins, that Royal Mail should be able to reduce costs by 7.8% per annum over this period.

Postcomm's additional cost savings are partly driven by a generalised (and unexplained) efficiency factor of 1% per annum applied to total operating expenditure. Postcomm provides no indication of how or where these savings can be made, and they represent a clear double count with the Renewal Plan savings. In addition, Postcomm has made incorrect assumptions about the achievable efficiencies from the Renewal Plan and other identified areas. Royal Mail's planned savings are both wide ranging and extremely stretching, and Postcomm's estimates for incremental efficiencies are wholly without foundation.

Nearly 70 per cent of Royal Mail's letter service operating costs are labour costs and with a workforce numbering some 170,000, Postcomm's extra savings imply thousands of extra job losses in addition to up to 30,000 already identified and committed to by Royal Mail. Postcomm gives no indication of how these extra savings could be driven out.

Postcomm's price control proposal will put the universal service at risk

Postcomm's proposal on the price control fail each of the five core principles above and are unacceptable:

(i) ***Postcomm's proposal will cost Royal Mail approximately £460 million over 2003/04-2005/06 beyond the already negative cash flows in its Strategic Plan.*** Postcomm proposes to bring back into the price control "Category B" products – International, USO parcels, Special Delivery, Presstream and the core inland products above the licensed threshold (currently 350g, but set to reduce to 100g in January 2003). These products are already exposed to competition and, under the current licence, Royal Mail is able to increase prices in line with inflation. Taking these products back into the control will mean that Category B product prices can no longer be increased at RPI without offsetting price reductions elsewhere. Including these Category B products in the control will cause Royal Mail to undershoot its Strategic Plan by approximately £130 million over the price control period.

The proposal allows for no adjustment to product mix, which in the plan shifts the average price up over time as competition captures share in lower priced Mailsort products. This effect will force Royal Mail to make price reductions on other products to meet the average price cap. Royal Mail estimates that this will cost a further £300 million over the price control period.

Although Postcomm has declared that the proposals are for a "price freeze" following the initial price change, the decision to set "X" at 2.5% rather than RPI, leaves Royal Mail facing further reductions as, with inflation continuing below 2.5%, Royal Mail consequently faces a further price reduction. This will potentially cost Royal Mail a further £30 million over the price control period.

(ii) ***Postcomm has proposed no automatic protection for Royal Mail in the event of revenue downside.*** Royal Mail's revenue outturns are highly uncertain, given that they are subject to macroeconomic conditions, technological change (e.g., e-substitution) and liberalisation to both full-service competitors and potentially to third parties accessing Royal Mail's network. Moreover, as Postcomm has itself recognised, Royal Mail's cashflows are extremely sensitive to traffic outturn.

The recent experience at National Air Traffic System (NATS) is illuminating here. The revenue falloff due to September 11th combined with NATS being subject to a pure price control with no automatic protection for volume risk – as Postcomm is proposing for Royal Mail – almost forced NATS into bankruptcy. The CAA has now proposed to introduce a mechanism whereby NATS can increase prices by a pre-agreed amount in the event that revenues fall below a certain level. Royal Mail believes that a similar mechanism is critical for its price control too, given the high degree of uncertainty and sensitivity of cash-flows to volume.

(iii) ***The proposal does not deliver the prospect of an economic return to the shareholder.*** The funding requirement in Royal Mail's strategic plan within the three-year price control period is some £465 million, which will be met by a Government-approved finance package from the National Loans Fund upon a satisfactory outcome from the price control consultation. This cash-flow profile does not represent anything close to an economic return over the next three years, yet Postcomm proposes to worsen the cash flows by a further £460 million over the period. Royal Mail has stressed to Postcomm that a target of at least £400 million per annum of profit on efficient costs represents a reasonable return to the shareholder, but Postcomm has refused to engage in discussion. As Postcomm knows, Royal Mail is facing downside risks such as pension funding requirements, increases in National Insurance charges and funding costs which could sum to an additional £730 million over the period of the control. In addition, Royal Mail faces risks to its Renewal Plan in the range of £400-600 million.

(iv) ***The proposal will limit Royal Mail's flexibility to compete and will reduce commercial incentives.*** The average revenue control gives the potential flexibility to rebalance and restructure prices in a manner that is necessary to prepare the business for the new competitive market and make prices more cost reflective. However, this commercial freedom is taken away from the business by excessively tight supplementary caps on individual prices. In addition, the proposed average revenue control reduces the incentive for sales growth in higher priced items by forcing Royal Mail to cut prices if high priced products grow more quickly than low priced products.

(v) ***The proposal increases the regulatory burden substantially.*** Existing Category B products are, under the proposal, being brought into a tighter price control. In addition, all new products are to be included in the control, subject to an undefined competition test.

(vi) ***Postcomm's indicative prices for access will intensify the detrimental impact of its price control proposal.*** Postcomm has not considered the impact of access in its proposal. However, Postcomm has indicated to Royal Mail a range of access prices which could cost another £250million over the price control period – or about £1.2 billion once Royal Mail has to price its workshare and other retail products on the same basis. This cost is on top of the £925 million of funding the business would require under Postcomm's price control proposal. Moreover, Postcomm's indicative access prices would accelerate cream-skimming competitive entry at a price that provides Royal Mail with a derisory return on delivery, the crown jewel in Royal Mail's business.

5. An acceptable price control for Royal Mail

There are at least two workable price controls that meet Royal Mail's and Postcomm's objectives – the hybrid average revenue control and the simplified approach with flexibility. Under both of these options Royal Mail would retain the ability to carry out the emergency 1p/1p price increase required to ensure protection of the universal service, as well as being able to continue RPI price increases on Category B products. These options would, therefore, deliver Plan revenues.

In order to preserve commercial flexibility through price rebalancing, Royal Mail proposes that the RPI subcaps on every weight step of every product be removed or relaxed to at least RPI+5. This would, for example, allow a 7% increase in Walksort prices to recover costs in the first year of the control, which could be offset by a reduction in Mailsort 120 prices. In addition the price control should provide price mechanisms to permit more fundamental restructuring of prices – such as format-based pricing. All new products would be excluded from the price control. Finally, neither option includes a ‘C factor’ that automatically reduces prices when quality targets are missed, since this represents a clear double jeopardy with the compensation scheme and is entirely unjustified. Both options contain an automatic protection for volume risk.

A rules-based simplified approach also delivers flexibility and downside protection

Royal Mail prefers a simplified approach with flexibility as one way of achieving the objectives for the price control. It would fix prices of every weight step of every product at the start of the period to deliver the 1p/1p price rise that Royal Mail needs. Thereafter, Royal Mail could only change product prices if the net effect were revenue neutral.

To make this test work in practice, rules for demonstrating revenue neutrality would need to be determined in advance since experience suggests that leaving each price change to individual negotiations is a recipe for no flexibility at all. Royal Mail suggests a simple rule whereby proposed price changes in any period would be applied to the product volumes pertaining in the previous period to check for revenue neutrality.

Finally, an automatic “trigger” would allow Royal Mail to increase prices to recover 60% of revenues below Plan revenue outturns so protecting the universal service should Royal Mail’s volume forecasts prove more robust than Postcomm’s. If the level of the control is set with an allowed profit of £400 million per annum, the trigger would occur if the outturn revenue in any year fell below 98% of that in the Plan.

A hybrid average revenue approach delivers pricing flexibility and protects against volume risks

Royal Mail has also defined a hybrid average revenue control which would, like Postcomm’s average revenue control, define the allowed revenue that Royal Mail could earn on a set of products. The control would adjust the level of allowed revenue subject to volume outturn such that Royal Mail could raise prices if volumes were below an agreed level to recover 60% of the lost revenue. This simple “hybrid” mechanism would be designed to protect Royal Mail cash flows from very low volume outturns, so safeguarding the universal service. It would also be a simple, practical way of bridging the huge gap between Royal Mail’s and Postcomm’s volume forecasts.

The control would have the benefits of pricing flexibility that Postcomm recognises in its proposals. Most importantly, it would provide insurance against what Royal Mail considers to be Postcomm’s grossly over-optimistic assumptions about volume losses to competitors over the next three years, and so help in securing the funding Royal Mail needs to deliver the Renewal Plan and maintain the universal service.

Generating a reasonable return for the shareholder will require further price increases

As stated above, even based on Postcomm’s over-optimistic projections of likely traffic and achievable operating expenditure reductions, Royal Mail’s total cashflow over 2003/04-2005/06 is only £46 million at 2000/01 prices. This does not represent anything close to an economic return. There is no mention in Postcomm’s proposals of what it considers might be a reasonable level of profits and how these might be translated into reasonable allowed revenues. Royal Mail’s shareholder might well consider that Royal Mail is being insufficiently aggressive in not demanding a much more generous settlement over this price control period.

In fact, Royal Mail has made to Postcomm a strong case for allowed profits of at least £400 million on efficient costs, which require revenues well in excess of those generated by the emergency 1p/1p price increase that is essential to ensure the survival of the universal service. For example, increases in prices on the major inland mails products in 2004/05 and 2005/06 at the rate of inflation would provide additional investment capabilities to safeguard the universal service without imposing any real price increase on customers.

6. Postcomm's compensation scheme requires important modifications

Royal Mail has sought to work with Postcomm and Postwatch towards the development of a compensation scheme that is fair and reasonable, while protecting its legal rights under the Postal Services Act. However, Postcomm has proposed a scheme to compensate delays and losses of social mail that will incentivise fraud, and has put forward an industry scheme with a punitive compensation level.

Under the social scheme for losses, customers will be able to claim up to 100 times the stamp price – for example £27 for a first class letter – without any proof of purchase. For delays, customers will be able to claim up to £14. These proposed amounts are hugely disproportionate to the price paid by the customer and will incentivise fraud. In addition, the tiered payment structures are too complicated.

The industry compensation scheme forces Royal Mail to reimburse 1% of revenue for each 1% of service shortfall on bulk mail. Given that revenues on bulk mail products exceed £3 billion**,** this exposes Royal Mail to disproportionate and potentially punitive levels of compensation, which could seriously impact its financial position.

Royal Mail has separately proposed alternative arrangements for compensation.

7. Conclusion

Postcomm's price control proposal and downside risks which Postcomm has not taken into consideration add up to substantial financial risks for Royal Mail.

Funding requirements and downside risks to Royal Mail's Renewal Plan,
£ million of funding requirement over 2003/04-2005/06

Funding requirement in Renewal Plan	**465**
Impact of Postcomm's price control proposals	460
Increased National Insurance payments	120
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Direct contribution impact of Postcomm's indicated access prices	250
Impact of having to reprice products	930
Potential total funding requirement after Renewal Plans risks and access	**3,235-3,435**

This price control is critical to the financial viability of Royal Mail and the ongoing provision of the universal service. Postcomm's proposals as they stand are inadequate and would fundamentally weaken Royal Mail and its ability to provide and sustain the universal service. Royal Mail looks forward to completely revised proposals from Postcomm that meet the needs of the industry.

CONTENTS

7. CONCLUSIONS

APPENDICES

1. INTRODUCTION

1.1 Background

1.1 This document is the formal response by Royal Mail (formerly part of Consignia plc) to Postcomm's proposal document entitled "*Review of Consignia plc's Price and Quality Regulations: Proposal for a Second Price Control; A proposal document – A compensation Scheme and A proposal document – Technical Annexes*" (the "October document").

1.2 This price control review is critical to Royal Mail's future given the commercial crisis facing the business, the imminence of aggressive competition and the need to fund a transformation programme that will make Royal Mail fit to compete.

(a) The outlook for Royal Mail's profitability is poor

1.3 As discussed in the Executive Summary, Royal Mail has a recent history of low profits, driven by slowing volume growth, deep-rooted industrial relations sensitivities, and declining prices in real terms over the last ten years, to levels lower than any comparable European postal operator (except for Spain).

1.4 The market for First Class – Royal Mail's most profitable product – is flat. Second class mail loses money – the 19p stamp price is the same today as it was in 1993. Only direct mail has been growing strongly, but has now been hit by the advertising downturn.

1.5 Licensed universal service products lost more than £500 million in 2001/02. The universal service products as a whole lost £166 million in 2001/02 including exceptionals. The licensed universal service products continue to depend on other products, especially non-licensed universal service products, for cross subsidy. Without this cross subsidy, there could be no universal service at today's prices.

(b) Aggressive competition is imminent

1.6 Postcomm's market opening strategy will encourage large overseas operators to enter the UK market. Companies such as DPWN and TPG are major international players with large financial resources protected by statutory domestic monopolies and are actively expanding operations in the UK.

1.7 The top 60 customers in the UK account for a significant part of Royal Mail's marginal contribution, and will be highly vulnerable to competition from January 2003. Without pricing flexibility, Royal Mail risks losing these customers as it will not be able to match well-funded competitors' discounts. And with the potential introduction of access to Royal Mail's network, competitors will immediately be able to establish a high volume position in the market, while building a delivery capability for the medium term – TPG, for example, already has coverage of 80% of UK address points following its acquisition of Circular Distributors. The combination of bulk liberalisation and access to Royal Mail's network provide a barrier-free UK entry strategy to the best players in continental Europe.

(c) Absence of a level playing field

1.8 Royal Mail believes in the principle of increased competition in order to stimulate innovation and efficiency. However, Postcomm's liberalisation programme will promote inefficient competition attracted primarily by cream-skimming opportunities. For example, it is self-evident that:

(i) Competitors will attack profitable products – products whose contribution is essential to Royal Mail's viability and which cross subsidise the social mail products that Royal Mail carries at very low prices

(ii) Uniform national tariffs will encourage competitors to enter the market and bypass Royal Mail in low cost delivery areas and rely on the arrangements provided by downstream access for Royal Mail to deliver in high cost delivery areas.

(iii) Six day a week delivery – required to provide the universal service – will be undercut by operators providing more limited delivery services. This will drive up Royal Mail's unit costs, further undermining its financial viability.

No potential entrant has shown any interest in providing a universal service in the UK.

1.9 This is not competition on a level playing field. Postcomm's price control proposal substantially exacerbates an already risky outlook for Royal Mail by constraining its ability to respond.

(d) Royal Mail has launched an aggressive Renewal Plan to transform the business

1.10 To respond to the commercial crisis it faces, Royal Mail has launched an aggressive Renewal Plan (the "Plan") to transform the business, driving down costs at a speed and to a level that is unprecedented in Royal Mail's history. The Renewal Plan is programmed to deliver £1400 million per annum of gross savings by the end of the three-year period across Royal Mail Group, or £850 million of gross savings in the mails business. (Even if implemented with complete success, however, it would still result in a return to only modest profitability and modestly positive cash flows, albeit with much improved customer service and improved levels of employee satisfaction.) It also involves up to 30,000 job losses and a fundamental transformation in the way the business is run.

1.11 A wide range of projects will transform the mails business under the Renewal Plan. Funding is required from the National Loans Fund to deliver this programmme. This funding must be on a commercial basis and is contingent on cashflows that are not achievable under Postcomm's proposals. Without this funding the plan is on hold.

(e) The financial exposure of the Royal Mail is significant

1.12 Royal Mail published its interim results to September 2002 shortly after Postcomm's publication of its October document. Overall, Royal Mail Group made a trading loss of £147 million before exceptional items for the six months ended 29 September 2002.

1.13 Royal Mail's UK mails business, the largest business unit by far of Royal Mail Group, made a small trading profit before exceptional items of £17 million on external sales of £2,645 million (0.6% margin). Volume remained static reflecting, amongst other factors, the downturn in the economy. Royal Mail believes the impact of competition, which will commence from January 2003 onwards, will have a significant downside impact in the price control period.

1.14 The trading cash outflow for Royal Mail's UK mails (ignoring the inter business impacts) is £5 million for the six month period, which represents an extremely low return.

1.15 Exceptional rationalisation costs relating to Royal Mail's UK mails business in the first half of the 2002-03 financial year were some £350 million. The opening rationalisation provision within the renewal plan was £280 million and will result in future cash costs over the price controlled period of over £600 million as the plan gets underway.

1.16 The financial position of Royal Mail's mails business looking forward over the price control period is summarised in Table 1.1A. Royal Mail developed its Renewal Plan in early 2002. The cash outflow for the Plan over the period of the control is negative £465 million.

1.17 Royal Mail has identified several financial risks to the Plan. Royal Mail raised some of these risks with Postcomm prior to its publication in the context of (a) the risk of volume loss to entrants through cream-skimming and (b) the need for the level of the control to include an allowed profit on the efficient level of expenditure to secure the financial position of the business against downside financial shocks. Postcomm's proposal worsens the cash flow position by a further £460million relative to the Plan.

1.18 Known adverse changes to the cashflow position of the business over the period of the control, relative to that in the Plan, include:

- increased rate of National Insurance contributions payable by employers will cost in the region of £120 million, arising from taxation charges in the Government's Budget 2002;
- the impact of pension deficit and subsequent funding estimated to be £330millon, arising from a fall in the market value of pension funds;
- an increase in the cost of funding, estimates at £280 million.

The potential funding requirement before Renewal Plan risks and access is £1655 million over the three year period of the price control.

Table 1.1A: Funding requirements and downside risks to Royal Mail's Renewal Plan in million of pounds over the period 2003/04 to 2005/06

Funding requirement in Renewal Plan	**465**
Impact of Postcomm's price control proposals	460
Funding requirement under Postcomm's proposal prior to additional costs	**925**
Increased NI payments	120
Additional pension funding requirement	330
Cost of funding	280
Additional costs	**730**
Potential total funding requirement before Renewal Plan risks and access	**1,655**
Risks to Renewal Plan	**400-600**
Direct contribution impact of Postcomm's indicated access prices	250
Impact of having to reprice products on a cost-plus basis	930
Impact of access	**1180**
Potential total funding requirement after Renewal Plans risks and access	**3,235-3,435**

1.19 In addition, Royal Mail faces risks to the Renewal Plan and from the introduction of network access. The risks to the Renewal Plan include:

- an increase in rationalisation spend that may result in up to £200 - £300 million, arising from potential difficulties in delivering the savings, net of redundancy costs, of the Renewal Plan in the period of the control;

- an increase in costs relative to the plan that may have an impact of up to £200 - £300 million, arising from delay in the implementation of the Renewal Plan.

1.20 A range of indicative access prices was sent by Postcomm to Royal Mail in October 2002. Royal Mail estimates the direct contribution impact of Postcomm's central indicative access price to be £250 million. The impact of having to reprice products on the same basis could worsen the cashflow position by a further £930 million.

1.21 The total funding required after Renewal Plan risks and access is £3235-£3435 million over the period of the price control. Postcomm's price control proposal and downside risks which Postcomm has not taken into consideration add up to substantial financial risks for Royal Mail.

1.2 The need for a completely revised proposal

1.22 Given the above this price control review should primarily be about ensuring that Royal Mail can continue to fulfil the universal service obligation while delivering the ambitious efficiencies in the Renewal Plan. It should be able to do so without further recourse to its shareholder or regulator to secure its financial viability over the period of the control.

1.23 Royal Mail is embarking on major change with significant risks. It has set out plans to reduce costs massively over the next three years, a necessary but substantial challenge. In parallel, Postcomm proposes to open the UK postal market to substantially increased competition from 1 January 2003 and to introduce network access. Further, Postwatch has pressed for improved service performance with financial penalties for failure. This is the commercial and regulatory reality facing a business that is struggling to breakeven while offering its customers amongst the lowest postal prices in the world.

1.24 Royal Mail needs to secure funding for the Renewal Plan in order to reduce costs. This funding must be on a commercial basis and is contingent on cashflows that are not achievable under Postcomm's proposal. Without this funding the Renewal Plan is on hold.

1.25 The price control should incorporate three simple guidelines: (i) address the changing market environment; (ii) secure Royal Mail's financial viability and in particular its cashflow position against a broader range of scenarios than is in the proposal document; and (iii) thereby ensure the provision of the universal service for the period of the price control. In particular:

- allowed revenue should be set using the standard regulatory "building block" approach of: (a) an appropriate level of allowed profit for the business; and (b) an appropriate path towards an efficient level of operating cost - to ensure a level of revenue and profit commensurate with the commercial risks of the business.

- the price control should facilitate: (a) price rebalancing and restructuring and changes to product specifications to allow Royal Mail to meet the challenges of competition; and (b) price increases to secure its cashflow against unexpected volume losses in a highly uncetain market.

- to minimise uncertainty the price control should: (a) become significantly more transparent than at present and significantly less reliant on the reopening clause 19.5 in the draft licence condition; (b) use instruments, such as correction factors, to reduce the need for micro-management by the regulator; and (c) ensure that processes and decision criteria are well-defined and predictable.

1.26 Royal Mail is the only universal service provider in the UK. It requires a price control that gives it the opportunity to implement its ambitious plans for service improvement and cost reduction against a backdrop of increasing competition and poor profitability. The present price control and the price control proposed by Postcomm's October 2002 document require fundamental changes to meet these needs and ensure Royal Mail's financial viability.

1.3 Postcomm's and Royal Mail's relative positions on the price control

1.27 This document presents Royal Mail's response to Postcomm's price control proposal, and puts forward two options that could be developed into an acceptable price control for Royal Mail. Table 1.3A summarises Postcomm's price control proposal, Royal Mail's review of that proposal and Royal Mail's alternative approaches to the price control. Royal Mail's two approaches to the price control are further developed in this document (e.g. Chapter 5) and its Appendices. These Appendices set out the detailed principles of the control, without the values of all of the parameters within the control formulae being stated.

1.4 Outline of the response document

1.28 The remainder of this document is structured around six main chapters:

- Chapter 2: Context of the response, with reference to: Postcomm's price control review process; Postcomm's approach to its duties; Postcomm's understanding of the issues; and a fundamental contradiction in Postcomm's proposal.
- Chapter 3: Review of Postcomm's statutory duties of Postcomm; outline of Royal Mail's principles for the price control.
- Chapter 4: Royal Mail's review of Postcomm's October document.
- Chapter 5: Royal Mail's alternative approaches to the price control.
- Chapter 6: Review of Postcomm's proposal for a compensation scheme.
- Chapter 7: Conclusions.

In addition to the main response in Chapters 1 to 7, Royal Mail refers to several appendices. These appendices set out related issues in more detail than in the main response.

Finally, Royal Mail has prepared this response with the assistance of external advisors.

Table 1.3A: A summary of Postcomm's and Royal Mail's relative positions on the price control.

Category	Postcomm proposal	Royal Mail's position on Postcomm's proposal	Royal Mail's alternative approach
1. Coverage	a) The coverage of the revised price control should be determined by a competition based test.	a) It is unacceptable to replace the existing Category A, B and C definitions – which have previously been agreed with Postcomm – with a competition based test	a) The coverage of the revised price control should be based on the existing Category A, Category B and Category C product definitions. The weight ceiling for Category A products, which is currently 350g, should be reduced to 100g in January 2003.
	b) The opening coverage of the revised control (the regulated products) should be the same as the coverage of the present control.	b) It is unacceptable to bring Category B products back under full price control. This represents a considerable tightening of the price control and will cost Royal Mail at least £130m over the price control period Postcomm has no vires over non-USO products, so Presstream must be excluded from the control	b) The opening coverage of the revised control (the regulated products) should be Category A products. Category B products should be subject to RPI caps, as now. Category C products should continue to be unregulated.
	c) Provision should be made to allow Royal Mail to apply to Postcomm after the control is set to remove products from the price control on the basis that competition is established in those areas for the provision of those services.	c) Agreed, though the proposed competition based test is too vague, leaving too much discretion to Postcomm	c) Provision should be made to allow Royal Mail to apply to Postcomm after the control is set to remove products from the price control on the basis of a test with clearly specified criteria on market definition and contestability
	d) New Services developed during the price control period will be included in the price control.	d) It is unacceptable automatically to include new products in the price control. This will stifle innovation and is inconsistent with the regulatory approach in other industries (e.g., telecommunications)	d) New services developed during the price control period should be excluded from the price control, with the exception of network access services which are not contestable and require special treatment within the control.

	e) Whether Royal Mail can reduce service levels (for any service, including non-USO services) requires a Postcomm determination with undefined criteria and of undefined length.	e) It is unacceptable that Royal Mail would have to gain Postcomm's agreement for any change to service specifications on non-USO products. For services that form part of the USO, Postcomm's undefined criteria with no pre-set timescales will restrict Royal Mail's ability to innovate and provide customers with improved services, or to withdraw services not valued by customers.	e) Royal Mail should be able to change service specifications (including removing a service) for any non-USO service without Postcomm's approval For products that form part of the USO: - The approval process should be subject to predefined short timescales that apply to both Postcomm and Postwatch - Postcomm (liasing with Postwatch) should come forward within the pre-agreed timescales with any rationale for blocking a proposed service specification change (based on harm to customers)
2. Structure	a) The structure of the price control should restrict the maximum average price of Royal Mail's regulated products.	a) A pure average revenue control: - Exposes Royal Mail fully to volume risk, unless an automatic mechanism is introduced to reduce volume exposure - Exposes Royal Mail to making unwarranted price changes in the event of product mix shifts, which over the period of the price control are expected to drive average revenue up due to competition impacting bulk mail products, costing Royal Mail £300m - Reduces the incentive for sales growth in higher priced items by forcing Royal Mail to cut prices if high priced products grow more quickly than low priced products	There are two acceptable options for the structure of the control: - The simplified approach with flexibility, which sets initial product prices. It specifies rules that allow Royal Mail to rebalance and restructure prices subject to revenue neutrality criteria, and includes a trigger mechanism that allows Royal Mail to raise prices when revenues fall below a certain level. - The hybrid average revenue control, which restricts the maximum allowed revenue of Royal Mail's regulated products. It reduces Royal Mail's cashflow exposure to volume reductions by including an automatic mechanism allowing Royal Mail to increase prices if volumes fall below an agreed level Of the two approaches Royal Mail prefers the option with the stronger volume growth incentives, termed the “simplified approach with flexibility”.

	b) A correction factor will allow for inaccuracies in setting the level of prices based on forecasting errors.	b) Royal Mail agrees with the principle of a correction factor.	b) A correction factor for the hybrid average revenue control should allow for inaccuracies in setting the level of prices based on forecasting errors and result in lighter touch regulation. A correction factor for simplified approach with flexibility should do likewise for restructuring prices.
	c) Within the overall structure of the average price cap, Royal Mail will be allowed to raise prices on any individual product by no more than the cumulative inflation index.	c) Postcomm's proposed subcaps would severely restrict Royal Mail's freedom to respond commercially to competition by undertaking cost-reflective price rebalancing	c) The RPI subcaps on every weight step of every product be removed or relaxed to at least RPI+5. Royal Mail should also be able to apply for tariff restructurings under a clearly defined ex post revenue neutrality rule.
	d) Royal Mail's only protection against volume risk will be Condition 19(6), which allows for re-opening of the price control in the event of significant risk to financial viability, subject to Postcomm's agreement	d) Given the sensitivity of Royal Mail's cashflows to volume outturns, and the uncertainty over volume projections, it is unacceptable that Postcomm does not propose any automatic protection against volume risk for Royal Mail	d) Royal Mail should be provided some protection against volume risk through an automatic hybrid or trigger mechanism that allows Royal Mail to increase prices to recover 60% of lost revenues when revenues fall below 98% of Plan revenues. The licence should also be modified to include clause that allows Royal Mail to increase prices in the event of cost shocks outside its control (including legislative and tax changes, such as NI changes) and allows sufficient allowed revenue to ensure financial viability with the introduction of third-party network access.
3. Form	The form of the control should be RPI-X.	The RPI is subject to fluctuations in the mortgage interest payments, and there is no evidence that customers compare postal prices with the RPI	RPIX (which excludes the impact of changes in the mortgage rate) should be used to remove uncertainty

4. Duration	The control should last for three years, from 1 April 2003 to 31 March 2006. Postcomm will give consideration to committing publicly that Royal Mail will be able to retain the benefit of a portion of ongoing efficiency savings made in the last year of the current control in the next control period.	Agreed on duration, though this is not reflected in Postcomm's draft licence condition	The control should commence on 1 April 2003 and terminate on 31 March 2006. Postcomm should commit publicly that Royal Mail will be able to retain the benefit of all ongoing efficiency savings made in the last year of the current (short) control in the next control period.
5. Level	a) The level of the revised price control should allow for an immediate increase of over 3% in regulated revenues, representing £170m per year in nominal terms, equivalent to 1p on both the First and Second Class basic weight step products.	a) Royal Mail agrees with the immediate 1p/1p increase, though Royal Mail does not accept Postcomm's approach of ignoring the concept of allowed profit	a) The level of the revised price control should allow for an immediate emergency increase of over 3% in regulated revenues, representing £170 million per year in nominal terms (equivalent to 1p on both the First and Second Class basic weight step products) plus the additional shortfall identified of £460 million. The level of control should also be set consistent with an allowed profit of at least £400 million on efficient costs
	b) Following this immediate increase, maximum average prices should be subject to an annual adjustment equivalent to RPI-2.5%.	b) Royal Mail should not be exposed to the risk of inflation outturns below 2.5%. More importantly, Royal Mail does not accept the principle of setting an X factor that does not take into account the need to provide an economic return to the shareholder	b) The level of allowed revenue in the control should also be set consistent with an allowed profit of at least £400million and the consequential allowed operating/capital expenditure cost.
6. Standards of Service	a) A revised set of service reliability targets should be put in place to complement the price regulation. This should be based on the recommendation from Postwatch and Royal Mail of a package of measures, including increasing the target for First Class mail to 93% (from 92.5%) in 2005/06 and the postcode area targets to 91.5% in 2005/06 (from 90.5% at end March 2004 and 91% at end	a) Agreed	a) Agreed

	March 2005).		
	b) A compensation scheme for "bulk" customers which provides for a rebate of 1% of customers' bills for each 1% underperformance against the relevant service of reliability targets. Non-bulk customers should be compensated upon receipt of a valid claim for individual failures (loss, damage and delay). Compensation for delays for First and Second Class non-bulk mail is at the rate of £3 for a three day delay, increasing by £1 per day thereafter up to a maximum of 15 days.	b) (i) Royal Mail agrees with the principle of there being a compensation scheme for bulk customers. However, Postcomm's proposed compensation level is punitive (ii) Royal Mail agrees with the principle of there being a compensation scheme for social mail customers. However, Postcomm's proposals involve compensation levels that are hugely disproportionate to the price paid by the customer and will incentivise fraud	b) Royal Mail has separately proposed alternative arrangements for compensation.
	c) For products not covered by the automatic bulk compensation scheme, a direct link should be established between the revenue earned from those services and Royal Mail's performance against its service reliability targets. This should be set at a maximum of 1% of the revenue which Royal Mail derives from Stamped and Metered Mail and Standard Parcel revenues.	b) Postcomm's proposed 'C factor' for quality is inappropriate: - It represents a clear double jeopardy with the social mail scheme, and is entirely unjustified - It is asymmetric, providing Royal Mail with no reward for quality improvement - The C factor depends on quality performance in bulk products (which are already compensated under the bulk scheme) as well as social mail	c) There should be no direct link between the revenue earned from Royal Mail's services not covered by the bulk compensation scheme and Royal Mail's performance against its service reliability targets.

2. POSTCOMM'S APPROACH TO THE PRICE CONTROL REVIEW

2.1 Introduction

2.1 Royal Mail's response to Postcomm's October document requires some context. This chapter sets the context with reference to: Postcomm's price control review process; Postcomm's approach to its duties; Postcomm's understanding of the issues and a fundamental contradiction in Postcomm's October document. It concludes that Postcomm has fundamentally mishandled the price control process.

2.2 Postcomm's price control review process

2.2 It is standard practice for a regulator's the proposal document to begin with a foreword that sets out the process that the regulator is following. Since Postcomm's October document does not include such a foreword, Royal Mail summarises the process here.

2.3 In October 2001 Royal Mail announced planned gross savings for Royal Mail Group (formerly Consignia Group) of about £1,400 million per annum over a 3-year period. In November 2001, Postcomm submitted an initial consultation document for the price control review that set out the components that needed to be covered for a standard regulatory approach. Responses to the consultation document were submitted in February 2002, but Postcomm published no summary of these responses at that stage. In fact, no other document on the price control was published from February 2002 until October 2002.

(a) Royal Mail summarises the process in the period between February 2002 and October 2002, as follows:

i. In April 2002, Royal Mail submitted a request for an emergency price increase worth about an additional £170 million per annum for its core inland products (equivalent to a 1p/1p increase on the basic weight step prices with proportionate increases at higher weight steps) to implement its Renewal Plan.

ii. In July 2002, Royal Mail submitted six papers dealing with issues of performance, comparative efficiency, the cost of capital and regulatory asset base for calculation of the allowed profit and volume risk in a non-liberalised and liberalised market as part of the considerations for a standard regulatory approach.

iii. Royal Mail provided detailed figures relating to the Renewal Plan in respect of the regulated business, during the period from July 2002 to September 2002.

iv. During this period Royal Mail sought to take the issues forward with Postcomm. Meetings were held to discuss Postcomm's financial model and the input requirements for that model. However, Postcomm did not engage in any further meetings on the subjects of the six papers or the process for the price control review.

v. In parallel with the above process, Postcomm appointed WS Atkins to undertake an Efficiency Review in July 2001. This review has involved a very large number of meetings between WS Atkins and Royal Mail and over 1100 separate document submissions by Royal Mail.

vi. During the early part of the price control review period to May 2002, Postcomm consulted on and then published a decision document on the opening up of the UK Postal Market to competition. Subsequent to this decision document, Royal Mail has drawn Postcomm's attention formally to flaws in the analysis and the need for the risks arising from the opening of the market to be properly taken into account in the final proposal for the price control.

vii. Finally, in October 2002 (after publication of Postcomm's October document), Postcomm sent an e-mail to Royal Mail which gave a range of prices for network access for third parties and requested that Royal Mail indicate the likely impact of such prices on the cash flow of the regulated business. This request was made by Postcomm despite the prices being hypothetical and having no defined basis and despite Postcomm's October document making no reference to network access.

(b) Royal Mail summarises the process since Postcomm's publication of the October document, as follows:

i. In October, Postcomm wrote to Royal Mail indicating that it was considering a range of alternative approaches to setting the final control proposal. Royal Mail responded by making presentations outlining two approaches that would address its primary concerns namely, (a) the hybrid average revenue approach and (b) the simplified approach with flexibility (both of which are outlined in Chapter 5 of this response).

ii. In addition, Postcomm requested a further presentation on the impact of network access on the two approaches and how the two approaches could be modified to address downstream access. This presentation was made during November 2002.

During these meetings Postcomm raised the possibility of a third approach, namely that of effectively rolling over the existing price control subject to the change in prices requested by Royal Mail in April 2002.

2.4 Postcomm's approach to the price control review has fundamentally changed between its November 2001 and October 2002 documents. In November 2001, it embarked on a standard regulatory approach to a price control review. Indeed this view is reflected in the title of its draft licence condition 19, namely "*long term price control for Consignia*", in the October 2002 document. In direct contrast, however, Postcomm's October document states "*Postcomm sees this price control review as being more akin to an extension of the interim price control imposed by Consignia's licence than to a conventional periodic review of an activity accustomed to operating in a regulatory environment*". (para S9).

2.5 Royal Mail's response to Postcomm's October document is therefore made in the context of the formal proposal in that document but also in the context of developments since that formal proposal, even though these developments have not been made public. The purpose of setting the response in this overall context is to ensure that Postcomm knows the position of Royal Mail when making its final proposal.

2.3 Postcomm's approach to its duties

2.6 Postcomm's primary duty set out in the Act is to "*exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service*"[4]. Moreover, in exercising *any* of its functions in relation to licence holders, Postcomm has to ensure that licence holders are able to finance activities authorised or required by their licences. There is an obligation to ensure the continued financial viability of the licensee. In this regard, and as noted in its October document,

[4] Part 1, paragraph 3.1

Postcomm's regulatory controls "*relate to about 90% of the revenue from Royal Mail's mails business, which in turn accounts for about 70% of Royal Mail plc's revenue*" (para S4).

2.7 The importance of the price control is clear. Any price control proposed by Postcomm must take full account of risks to the financial position of the regulated business over the price control period. Postcomm would be failing its primary statutory duty if, as a consequence of its actions, Royal Mail could not finance its licensed activities.

2.8 In its October document, Postcomm states that

i. "Postcomm's primary duty is to seek to ensure customers continue to be able to enjoy a "universal postal service"(para 1.2);

ii. "Postcomm might need to judge whether there is a trade-off between restricting Consignia's revenue or prices and the promotion of effective competition, particularly given that Consignia is likely to remain the only universal service provider for the foreseeable future" (para S8)

iii. "In principle a price control is based on a regulator's aim to incentivise a regulated company to make greater efficiencies than it might otherwise implement, and ensure the customers reap the benefits of these savings" (6.58);

iv. "Price controls are usually designed to protect customers from paying for inefficiency on the part of monopoly operators" (3.14)

2.9 In its November 2001 consultation document Postcomm devalued the importance of its primary duty to ensure the provision of the universal postal service. It continues to do so in its October document in 2002 by:

i. inserting "to seek" in front of the categorical primary obligation in (i) above;

ii. including a statement that could be read to infer that the financial position of the regulated business should be traded off with one of its secondary obligations, namely that of promoting competition in (ii) above;

iii. focusing on its secondary obligation to promote efficiency and economy without due regard, within the October document, to its primary duty in (iii) and (iv) above.

2.10 Furthermore, Postcomm's statement (ii) above is an acknowledgement by Postcomm that Royal Mail is expected to be the only universal service provider for the duration of the price control. Postcomm therefore has a primary duty to ensure the financial viability of Royal Mail's regulated business. Its proposal does not do so.

2.4 Postcomm's understanding of the issues

2.11 Throughout its October document, there are illustrations of Postcomm's poor understanding of key issues. Most glaringly, the document does not discuss the subject of an allowed profit for the business, nor the question of cream-skimming competitive entry, despite references to these two crucial issues in Royal Mail's February 2002 response to Postcomm's November 2001 consultation document and the submission of detailed papers by Royal Mail on these subjects in July 2002.

2.12 Postcomm's October document also states that: **"***Consignia is broadly content, as the proposals reflect its request for increased revenue via the proposed 1p increase in the price of first and second class stamps. Consignia however is concerned at the way in* *which the proposals would be implemented. In particular Consignia has two specific concerns, namely category B products should continue to be allowed to increase by the rate of inflation and that a change in product mix during the price control could lead to an average price per mail item below that anticipated by Consignia"* (para S29).

2.13 This portrayal of Royal Mail's position is substantially understated. In fact, Postcomm has not adequately engaged with Royal Mail to understand its submissions or concerns. The statement relates only to the specific issue of the level of revenue required for the funding of the Renewal Plan, whereas the regulated business had, prior to publication, communicated to Postcomm a significantly broader range of issues and concerns in the context of the price control against a reasonable range of assumptions about risk factors. These issues are re-emphasised in subsequent chapters of this response

2.5 A fundamental contradiction in Postcomm's proposal

(a) Royal Mail's weak financial position

2.14 For most of its history Royal Mail benefited from a stable, non-competitive environment in which value was created by steady growth in letter volumes and continuous efficiency improvements. Customers benefited from some of the lowest postal prices in Europe. Royal Mail's shareholder, the UK Government, benefited through increasing returns and ultimately UK taxpayers paid less tax.

2.15 Recent history has been different. Overall universal service products in the licensed area, which form the bulk of the products under the existing price control, lost more than £500 million in 2001/02. Business profitability has suffered as prices have declined in real terms over the past 10 years. Among EU countries only Spain (which has lower standards of service) has lower prices for First Class equivalent prices while in Second Class equivalent products the UK is by far the lowest price provider.

2.16 As a result, investment in the core business and especially in capital equipment, has continued to decline leading to infrastructure that, in some places, is struggling to be fit for purpose.

2.17 In its October document, Postcomm states that

- "*This review takes place at a particularly challenging time for Consignia. Consignia's present financial position is relatively weak in the context of its historical performance. Despite volume and revenue growth, Consignia's cost increases have reduced its profitability" (para S4).*

- '*the Government do not expect to take cash out of the business by way of dividends during the three years of the renewal plan*' (*quote in para 6.7 from the Secretary of State for Trade and Industry in the House of Commons 13 June 2002*)

2.18 Postcomm's October document rightly acknowledges that the financial position of the business is weak.

(b) Financial risks facing Royal Mail

2.19 In May 2002, Postcomm set out its decision for a faster and more extensive liberalisation of the UK postal market in the UK from 1 January 2003 than that proposed in Europe:

- bulk mail is being opened to end-to-end competition, with competitors being able to deliver in low cost areas and inject back to Royal Mail for delivery in high-cost areas;

- consolidators will be able to attack First and Second Class, aggregating mail and feeding back to Royal Mail for delivery;

- the reserved threshold across all products is being reduced to 100g in line with the EU Postal Services Directive.

2.20 This liberalisation programme has already provoked many expressions of concern. For example, the National Audit Office has stated that there are risks in introducing competition that could result in breakdown of the universal service at an affordable uniform price.

2.21 In its decision document on promoting effective competition[5], Postcomm stated that "*many of the individual comments received expressed concern about the cumulative effect of competition and other regulatory policies (such as price controls) on the continued provision of the universal postal service*" (S7). In addition, leading academic economists challenge the sustainability of uniform prices and universal services in a world of end-to-end competition and third party access.[6]

2.22 When taken in conjunction with the financial risks described in Chapter 1, it is clear that Royal Mail and Postcomm need to be concerned about the uncertainty facing the business.

(c) Implementation of the Renewal Plan

2.23 In its October document, Postcomm states that

- "*Consignia announced a "renewal plan" committed to returning the business to profitability and reducing its costs by £1.4bn (approximately 15%) over the next three years."(para S4)*;

- "*Postcomm recognises that Consignia's renewal plan represents a significant challenge which if successful will generate benefits to postal users, Consignia and shareholders. Postcomm welcomes this initiative and has taken it into account in developing this price control*." (para S18)

- "*Consignia also faces other challenges. Over the next five years, Postcomm's market opening decision will result in Consignia's monopoly for the delivery of letters weighing less than 350g or costing less then £1 progressively reduced, leading to full opening from 1 April 2007. Customer demands are rapidly evolving with the take up of electronic communication and commerce and an increase in demand for tailor made services*" (para S6);

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[5] "*Promoting Effective Competition in UK Postal Services: A Decision Document*", Postcomm May 2002

[6] *"Reconciling Competition, Downstream Access, Universal Service in Postal Markets", Panzar, John C 2002 in Postal and Delivery Services: Delivering on the Competition, edited by Michael A Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers*.
"Balancing access and the USO", Crew, Michael A., and Paul R. Kliendorfer. 2002 in Postal and Delivery Services: Delivering on the Competition, edited by Michael A Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers.
"Access Pricing and Parcels Delivery", De Donder, Phillippe, Helmuth Cremer and Frank Rodriguez, 2002. in Postal and Delivery Services: Delivering on the Competition, edited by Michael A Crew and Paul R. Kleindorfer. Boston, MA: Kluwer Academic Publishers

2.24 Postcomm's October document rightly acknowledges that its financial position is made more precarious through Postcomm's decision to open the market to competition and the impact of e-substitution. Postcomm's October document also rightly acknowledges that Royal Mail has proposed a challenging Renewal Plan.

2.25 The Renewal Plan is at the heart of Royal Mail's recovery programme. It will transform the business, driving down costs at a speed and to a level that is unprecedented in Royal Mail's history. Operational savings will be greater than those demanded by UK regulators in any other price controlled sectors.

2.26 The Renewal Plan, over a three-year period, maps a return to modest profitability, modestly positive cash flows, improved customer service and improved levels of employee satisfaction. It is about making the business fit to compete. It also involves up to 30,000 job losses and a fundamental transformation in the way the business is run. It plans to deliver £1,400 million per annum of gross savings over three years, and is, by any definition, an extraordinarily challenging programme of change. Postcomm is fully aware of its content, its ambition, and its risks.

2.27 In its October document, Postcomm states that:

- *"….Postcomm believes that it is right that Consignia should be given every incentive to achieve its renewal plan…."* (para S19)

- *"Postcomm believes that a healthy Consignia is central to ensuring the provision of the universal service"* (par S8)

- *"To help position Consignia for the challenges these developments present, the government in its role as sole shareholder has stated that it is increasingly looking to ensure that the mails business is run and financed as a fully commercial business, in line with its public limited company status"* (para S6)

2.28 Postcomm's document rightly acknowledges that Royal Mail should be given every incentive to achieve its renewal plan; that its finances need to be "*healthy*"; and that it should be "*run and financed as a fully commercial business*", separate from dependence of government and the regulator during the period of the price control.

(d) The fundamental contradiction

2.29 There is, however, a fundamental contradiction between Postcomm's statements outlined in (a) to (c) above and its proposal.

i. Postcomm's proposal does not provide sufficient revenue to secure the funding necessary for the Renewal Plan to be implemented. It results in a funding need of £925 million over the period, before the impact of access and other risks to the Renewal Plan.

ii. There is no explicit provision in the proposal to address unexpected revenue shortfalls caused, for example, by the unpredictable development of competition and, potentially, network access. The proposal would continue to rely on Royal Mail applying for a price review under draft licence condition 19.5 (see Appendix 4D) in the event of financial risks. This dependence on a decision by Postcomm is inconsistent with government's objective to ensure that the mails business is run and financed as a fully commercial business i.e., as a business not dependent on the decisions of the regulator or of government during the period of the price control. A fully commercial business that is subject to regulation should not have the vagaries of draft condition 19.5 in its licence. This was recently recognised by the CAA in its proposal to amend the price control for NATS to introduce a mechanism whereby NATS can increase prices by a pre-agreed amount in the event that revenues fall below a certain level[7].

2.6 Conclusions

2.30 Postcomm has refused to engage with Royal Mail a number of key elements of the price control process, including Royal Mail's response to the November 2001 consultation paper, Royal Mail's submission of six papers on the price control in July 2002, and Postcomm's financial model – the final version of which Royal Mail has not received despite expressing deep concerns about its core elements. The results of the 16-month W S Atkins efficiency review still have not been published despite the fact that they underpin Postcomm's arguments on operating costs in their October document, and despite Royal Mail having submitted over one thousand documents during the review. Finally, since publication of its October document Postcomm has communicated to Royal Mail that it is considering alternative options to its proposed average revenue control – including the "simplified approach with flexibility"– but without making any of its thinking public.

2.31 Postcomm's October document dilutes the primary duty of ensuring the provision of the universal service under the Act and treats the need to encourage competition and the need to reduce prices for consumers as of equal importance to the need to maintain the universal service.

2.32 Further, while Postcomm speaks of the 'weakness' of Royal Mail's current financial position - and despite the enormous risks inherent in the Renewal Plan and the liberalisation programme - Postcomm's proposal would worsen the £465 million of negative cash-flows in Royal Mail's Plan by at least a further £460 million, and would offer no protection against very significant downside risks.

[7] "NATS' Application to Reopen the Eurocontrol Charge Control" Consultation on CAA proposals, Civil Aviation Authority, October 2002.

3. ROYAL MAIL'S REVIEW OF THE PRINCIPLES FOR SETTING THE PRICE CONTROL

3.1 Introduction

3.1 Postcomm sets out its objectives for the price control review in paragraphs 3.14 and 3.15 of its October document. Postcomm claims that these objectives flow from its statutory duties, and from good regulatory practice. Royal Mail believes that Postcomm has failed to take account of its duties and its own objectives in developing its proposals, and suggests in this Chapter an alternative set of more precise principles on which to base the price control.

3.2 The price control in the context of Postcomm's duties

(a) The Postal Services Act 2000

3.2 The Postal Services Act 2000 ("the Act") states that Postcomm should "*exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service*"[8] and subsequently defines that universal postal service which includes a uniform charges obligation for the UK. Royal Mail fulfils the universal service obligation in the UK.

3.3 Subject to this duty, the Act states that Postcomm should "*exercise its functions in the manner which it considers is best calculated to further the interests of users of postal services, wherever appropriate by promoting effective competition between postal operators"*[9] and shall have regard to the interests of specified groups of customers.

3.4 Subject to these two duties, the Act states that Postcomm should "*exercise its functions in the manner which it considers is best calculated to promote efficiency and economy on the part of postal operators*."[10]

3.5 In addition, the Act states that "*in exercising any of its functions in relation to licence holders under Part II, the Commission [Postcomm] shall have regard to the need to ensure that such licence holders are able to finance activities authorised or required by their licences*"[11].

3.6 In summary, therefore, Postcomm has a primary duty to ensure the provision of the universal service. There is a requirement in all cases for Postcomm to have regard to the need to ensure the finance of activities authorised or required by licences. Since Postcomm expects the Royal Mail "*to remain the only universal service provider for the foreseeable future*" (S8), in setting the price control for the regulated business of Royal Mail, it must ensure its financial viability. This is a categorical requirement under the Act.

3.7 Postcomm has a secondary duty to promote effective competition where it can be shown to be in the interests of users of the postal service, including disadvantaged customer groups, and a tertiary duty to promote efficiency and economy on the part of postal operators. The Act requires that the application of these secondary and tertiary duties should take place once the financial viability of the universal service provider, Royal Mail, has been secured.

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[8] Part 1, Paragraph 3(1)
[9] Part 1, Paragraph 5(1)
[10] Part 1, Paragraph 5(3)
[11] Part 1, Paragraph 5(4)

3.8 For example, Postcomm has, through its decision document on competition, started to open up the UK postal market to competition from 1 January 2003 at a considerably faster pace than that being followed elsewhere in Europe under the European Postal Services Directive. Fulfilment of its duties under the Act requires Postcomm to ensure the financial viability of Royal Mail, as the sole universal service provider. This needs to be achieved through the setting of the price control.

(b) Competition law

3.9 The Competition Act (1998) seeks to protect customers, competitors and suppliers from companies that are dominant in a market from abuse of that dominance. Where price controls have been removed in other industries, regulators have frequently referred to the Competition Act as a means of providing protection to customers, competitors and suppliers.

(c) Government statements

3.10 Postcomm's October document states that "*the government in its role as sole shareholder has stated that it is increasingly looking to ensure that the mails business is run and financed as a fully commercial business, in line with its public limited company status"* (para S6). Consequently, the price control must enable Royal Mail to be run and financed as a fully commercial business in a manner that best avoids the need for recourse to the regulator or government during the period of the control.

3.3 Royal Mail's licence

3.11 In Royal Mail's current licence the requirement of ensuring the financial viability of the universal service is achieved through the reopening clause of licence condition 19.6 (licence condition 19.5 in the draft licence condition of the October document). Other UK regulators do not use this type of condition because it does not facilitate the running and financing of the regulated business on a commercial basis, separate from the regulator and government decisions during the period of the price control.

3.12 This reopening clause, set within the existing licence or the draft licence in Postcomm's October document, is unacceptable to Royal Mail for the new price control from 1 April 2003. Royal Mail's regulated business should be run and financed on a commercial basis and should operate under a licence that facilitates this requirement.

3.13 This requirement is further emphasised given the market changes brought about by Postcomm's proposal to introduce competition to the UK postal market and the possibility of third party network access. In practice, this means that the price control should be set to minimise reliance on a reopening clause by ensuring that the price control is set using a standard regulatory approach and relevant precedents from other regulated industries.

3.14 A different approach to that used in the current licence is developed further through the remainder of this document and is a fundamental part of Royal Mail's response to Postcomm's October document.

3.4 Principles for setting the price control

3.15 The price control that Postcomm sets for Royal Mail will be critical to the financial viability of the business and, since Royal Mail is the only universal service provider in the UK, to Postcomm meeting its primary statutory duty. It is through the price control that

Postcomm needs to ensure that its proposals and decisions on competition, network access, universal service, compensation and other matters are fully in balance with one another and robust to developments in the market over the period of the price control.

3.16 There are five simple principles that should underpin regulation of Royal Mail. The regulatory framework should:

(i) Ensure that Royal Mail has sufficient baseline profit and cash flow to continue to be able to provide the universal service and to fund the Renewal Programme. This requires at a minimum the emergency 1p/1p price increase on the "Inland 6" products – First Class, Second Class, Mailsort, Walksort, Response and Packetpost – together with price increases at inflation on International, Special Delivery and USO parcels. Any projections of cashflows must be based on reasonable, fact-based analyses of volumes, prices and costs.

(ii) Provide a financial framework for the regulated business that is robust and flexible enough to deal with poor outturn cashflows. Recent examples of inflexible financial frameworks in rail and in air traffic control have left incumbent licence operators with too little cash to meet licence obligations, with extremely damaging consequences.

(iii) Provide a path to allowed profit of at least £400 million per annum on an efficient cost base to provide an economic return to the shareholder. Given the timing of the Renewal Plan, this implies a glidepath to the £400 million in 2005/06.

(iv) Provide strong commercial incentives and flexibility to compete. Royal Mail should not be prevented from responding to competition through rebalancing its prices, introducing new products and modifying the service requirements of the USO, by lengthy regulatory processes as exist today. Royal Mail recognises the significance of its initial market share and agrees that safeguards are required to protect appropriately aggregated customer groups. But these are already in place in Conditions 10 and 11 of its licence and in the provisions of the Competition Act (1998).

(v) Minimise the burden of regulation. Royal Mail is regulated by Postcomm with regard to, amongst other factors, prices and revenues and has a consumer watchdog, Postwatch, that is involved in watching over, amongst other factors, the service performance of the regulated business. The requirements placed on the regulated business are brought together in Royal Mail's licence. The involvement of Postcomm and Postwatch should be eliminated wherever competition is established.

3.5 Conclusion

3.17 This price control review should primarily be about ensuring that Royal Mail can continue to fulfil the universal service obligation while delivering the ambitious efficiencies in the Renewal Plan. It should be able to do so without further recourse to its shareholder or regulator to secure its financial viability over the period of the control.

3.18 Royal Mail has set out core principles that are applied in the remainder of this response to provide a framework both for assessing Postcomm's proposal and for putting forward Royal Mail's alternative approaches.

4. POSTCOMM'S PROPOSAL DOCUMENT FOR THE PRICE CONTROL

4.1 Introduction

4.1 This Chapter reviews in detail Postcomm's October document for the price control in light of the principles developed above in Chapter 3. Postcomm is proposing a price control that allows for an initial 1p/1p price rise on the First and Second Class basic weight step[12], but then caps the average price across all regulated products and all new products for three years. Postcomm's proposal for the main components of the price control and Royal Mail's review of each component is summarised in table 1.1A of Chapter 1. This chapter demonstrates why the proposal is unacceptable.

4.2 Coverage

(a) Inconsistency with stated intentions

4.2 Postcomm's approach to the subject of coverage in its October document is not consistent with its previous decisions or with the principles it lays out.

4.3 In January 2001, Postcomm published a consultation paper on the scope of Royal Mail's Licence and an initial report by its consultants (Andersen) setting out a rationale for the treatment of products inside and outside of the price control.

4.4 In its February 2001 response to that consultation paper, Royal Mail set out the basis for inland letters above 350g or £1, International services, and Parcelforce products being in established competitive markets and outside of the price control. In addition, Royal Mail set out the case for Special Delivery and Presstream products being outside of the control. For the specific case of Presstream, Royal Mail informed Postcomm that it had developed the Presstream product solely for use by customers and businesses who wished to distribute issues of magazines, journals, newsletters and periodicals (including customer magazines but excluding catalogues) in the UK. It showed that the product had (and still has) various competitors within the "Publishing Market", including specialist distributors for business recipients (e.g. Hays) and market participants with alternative distribution channels. Newstrade was (and still is) by far the dominant method of distribution for both consumers and businesses. Royal Mail estimated that its share of the total market share was about 17% over the previous 5 years (recognising the difficulties of providing an accurate assessment).

4.5 In its April 2001 document, Postcomm set out its decision on the subject of coverage for the control. Postcomm's decision separated the products into three categories: products within the reserved area that were not contested were classed as Category A products; products that were contested, but where in practice there was only limited competition or were part of the universal service were classed as Category B products; and products already subject to sufficient competition were classed as Category C products.

4.6 The majority of products were treated as Category A products and are presently subject to the main price control. However, inland letters above 350g or £1, Surface and Airmail Public Tariff letters and packets, Parcelforce Standard Public Tariffs parcels, Special Delivery and Presstream were treated as Category B products, that were outside of the main price control but subject to a supplementary price control (where prices could

[12] With proportionate increases for higher weight steps and other inland products (i.e. Mailsort, Walksort, Response Services and PacketPost) and no price increases for USO international, USO parcels and Special Delivery.

increase in line with RPI inflation). Postcomm's April 2001 document concluded that "*the revised form of price control retains our basic test of relating price controls to the existence or otherwise of competition….*" *(para 3.52)*

4.7 Since these decisions were taken, the UK postal market has become more competitive. At least 20% of the UK postal market is already open to competition. The requirement under the EU Postal Services Directive to open the postal market for above 100g mail from 1 January 2003 increases the share of Royal Mail's inland letter market that is subject to competition to close to 45% by value. Postcomm's decision on competition (May 2002) will increase this by a further 35% to a little under 80% during the period of the price control. No market segment has become less contestable.

4.8 Despite this, Postcomm proposes to include in the coverage of the proposed control all regulated products, including those currently classified as Category B, and all new products. The proposal is inconsistent with Postcomm's own stated intentions, inconsistent with prior practice and inconsistent with regulatory practice in other industries.

(b) Failure to apply a competition test

4.9 In its October document, Postcomm states that:

- "*Postcomm is proposing that the coverage of the price control (i.e. which services are included within it) be determined primarily by a competition test*" (para S10);

- "*In applying this principle, Postcomm is proposing that the coverage of the revised price control should initially include the same products as the present interim control. This includes all products within the current licensed area, where competition is not yet effective. The coverage should also include some products outside the licensed area where competition, although possible, has not developed to the extent where it can be relied upon to protect the interests of customers or ensure that universal services remain affordable"* (para S11);

4.10 Although Postcomm states that a "competition test" should be applied to decide whether a product is inside or outside a control, it simply proposes to put all products that are currently price controlled under the new control, regardless of whether they are category A or B. In other words, products will be covered by the proposed control simply because they are in the current control, not because of any "competition test".

4.11 In fact, Postcomm does not describe a "competition test" in the document and the general guidelines in paragraph 4.23 are inadequate. Lack of a defined "test" or of transparent criteria also raises questions about how products will be removed from the control over time as competition develops.

(c) Identical treatment of categories A and B

4.12 In its October document, Postcomm states that:

- "*Postcomm recognizes Consignia's concern that category B should be treated less stringently in the price control*" (para 4.17)

- "*In particular, the coverage of the proposed price control insofar as it encompasses Category B (e.g. Presstream) products is tighter than the current control and Postcomm would welcome views on this treatment of products*" (para S11);

4.13 Postcomm's October document puts all products that are price controlled under the same control. This is a fundamental and unacceptable change from current practice. In effect, Postcomm proposes to tighten the control on products that are being further exposed to competition and to regulate products and services that are presently outside of the control.

4.14 This is also inconsistent with precedents developed by other regulators such as Oftel. In BT's case, separate controls operate for products that are in "non" competitive and "prospectively" competitive (or contested) markets, while controls are removed from products that are in competitive markets. Postcomm's proposed "test" and licence should make similar distinctions. While the October document notes the issue in paragraphs 4.17 and 4.18, it does not reflect the necessary changes in the draft licence. In fact, since Postcomm applies no competition test, and ignores prior practice and practice in other industries, there would seem to be no basis at all for the proposal.

4.15 Other specific issues of coverage for existing price controlled products, including that of Presstream, are discussed further in Section 5.4.

(d) Unacceptable treatment of new products

4.16 In its October document, Postcomm states that:

- "*Postcomm considers that the licence condition should be framed in a way that means that new products within the regulated area will be included within the control, until Consignia submits an application for their non-inclusion, and Postcomm accepts it*" (para 4.20).

This is not consistent with the approach in the current Licence. Nor is it consistent with the approach developed by other sector regulators such as Oftel. In Oftel's 1997 document[13] it states that "*Oftel believes that it is essential that appropriate incentives are given for the introduction of new services" and "Oftel has concluded that new services should not be included in the price control"* (para 4.11) (adding that there were other means available for dealing with any anti-competitive behaviour by the regulated business). Oftel reconfirmed this position in its 2001 document[14] stating that "*BT will be free to set the charges for Competitive Standard Services and New Standard Services subject to normal competition rules*" (para S11). To encourage innovation and product development new products should, in general, be excluded from the control.

4.17 It is also the European Commission's policy that new postal services do not form part of the universal service, and that regulation should be restricted to services fully within the scope of the universal service.

4.18 In some exceptional cases new products could be introduced into a non-contestable market. An example of such a product is third party network access. Royal Mail would expect such a product to be included within a price control.

[13] *"Pricing of Telecommunications Services from 1997*" Oftel, 1997.

[14] "*Proposals for Network Charge and Retail Price Controls from 2001*." Oftel, February 2001.

4.3 Structure, Form and Duration

4.3.1 Structure

4.19 Postcomm's October document raises, but does not adequately address, the following issues, regarding the proposed structure:

- volume risk
- price flexibility;
- supplementary caps;
- cost shocks
- standards of service
- the regulator's involvement during the control.

These are each discussed in turn below.

a) Volume risk

Royal Mail's volume projection

4.20 In its October document, Postcomm states that:

- "*Postcomm notes the very modest forecast that Consignia has put forward about future business volumes.*" *(para S18);*
- "*Postcomm has seen no evidence to support Consignia's degree of pessimism, although it notes that volume may not be as healthy as in the recent past*" *(para S18);*
- "*Postcomm has seen no evidence to support the view that volumes of mail overall are in decline and does not believe that, in the three years of the price control (when Consignia will still have a considerable degree of protection from competition) Consignia will lose volumes to the extent that it has predicted" (para 6.68).*

4.21 As part of Postcomm's review up to May 2002 for the opening of the UK postal market to competition, Royal Mail provided the models and explanation of the models used for its forecasting of volume[15]. The volume figures in the Renewal Plan were prepared in February 2002. Postcomm asked for these figures in August 2002 but did not seek further explanation at that time.

4.22 Since publication of its October document Postcomm has sought, and Royal Mail has submitted, further information on the volume projection. Royal Mail has modelled the impact of competitors entering the UK postal market and targeting the most profitable streams of mail. This work, set out in its entry pricing model (EPM), considers the impact on Royal Mail's revenues and costs of volume losses arising from liberalisation. The EPM was provided to both Postcomm and Andersen early in 2001 and it was also provided to MMD, Postcomm's lead consultants on modelling for the price control, in the autumn of 2001. It has been widely reviewed not only by Postcomm and its consultants but also, in part or full, by leading academics internationally. Outputs from the EPM, that underpin Royal Mail's Renewal Plan and that are available to Postcomm, suggest that volumes of

[15] Appendix 4A lists the responses made by Royal Mail to Postcomm over the last 3 years on the volume and risk issue associated with Postcomm's approach to competition and the effects on Royal Mail's ability to fund the USO. "Consignia's response to Postcomm's questions on 'Product Mix'" Consignia, 9 October 2002.

bulk mail lost to competitors will be significant. Postcomm is referred to the Royal Mail's submission of 9 October 2002 and Appendix 4A for more detail.

4.23 Finally, as part of Royal Mail's response to the Postcomm's draft proposals for competition (January 2002), Royal Mail submitted information on volume projections by some other international universal service providers. These projections showed a decline in postal volumes. Indeed, the assumptions used in Royal Mail's volume projection in its Plan are more moderate than those used by other international universal service providers (see Appendix 4A for the full list of document references relating to Postcomm's competition review).

Postcomm's volume projections

4.24 In its October document, Postcomm states that:

- "*Postcomm considers that the price control should reflect a realistic view of future business volumes*" (para S19);
- "*Postcomm believes that volumes over the course of the price control period may be significantly higher than Consignia anticipates*" (para 6.41);

4.25 Postcomm's October document uses two other volume forecasts in its cash flow scenarios:

"*The first is broadly consistent with those Postcomm used in developing its market opening decision of May 2002*" and "*the second sensitivity assesses the impact of volume growth in line with historic growth rates*" (Para 6.41).

4.26 As part of its response to Postcomm's competition review, Royal Mail submitted formal responses setting out the flaws in the volume forecasts behind Postcomm's May 2002 decision[16]. These demonstrated that volume figures used by Postcomm and based on analyses undertaken by one of its consultants – Andersen – were flawed. Andersen had not attempted to model explicitly the effects of competition but had made an arbitrary assumption (on the instructions of Postcomm) that Royal Mail would lose 20% of each product group to competitors

4.27 This assumption of equal losses across products, customers, formats, weight steps and geographies is clearly wrong. There are very significant cream-skimming opportunities available to competitors. These are largely caused by the requirement set out in the Postal Services Act that universal service products should be priced uniformly (i.e. geographically averaged). When combined with significant differences in the marginal costs by product, customer type and delivery area this averaging leads to large differences in the profitability of different segments of traffic. Competitors know this very well. For example, TPG has stated: "*let's be realistic - private operators will, at least in the short term, target business customers*".[17]

4.28 The second forecast used by Postcomm in its October document assumes no changes in the market and, in particular, no liberalisation. This is bizarre.

4.29 Together, these two scenarios fail to address the need, as part of Postcomm's requirement to fulfil its primary statutory duty (See Chapters 2 and 3), to assess the potential adverse impact of competition on the financial viability of the regulated business.

[16] For a critique of the Andersen work and the EPM see Royal Mail's responses of April 2002 to Postcomm's consultation paper, "Promoting Effective Competition in UK Postal Services – January 2002" and of August 2002 to "Postcomm' s Decision Document on Promoting Effective Competition in UK Postal Services".
[17] TPG's response to the price control for Consignia plc", TPG May 2002.

4.30 In addition, Postcomm fails to reflect critical conclusions of its own appointed efficiency review consultants (WS Atkins, supported by MMD in this area) regarding volume projections and the impact of competition, which include, in relation to volumes: *"We conclude that Postcomm has no good reason to take its price control decision on a different set of volume projections from those put forward by Consignia in Version 4 of its Strategic Plan";* and in relation to competitive cream-skimming[18]*: "We accordingly recommend that Postcomm takes account in its price control decision of the possibility that competition will have a more serious effect on Consignia's profitability than is predicted in Consignia's interim Strategic Plan[19]"*. These conclusions are in marked contrast to those used by Postcomm in developing its market opening decision of May 2002 and therefore would be a matter of significant public interest. Not only has Postcomm suppressed these conclusions, it also quotes selectively in its October document regarding the Royal Mail's projections in taking its view that volumes would be greater than in the Royal Mail's Plan.

4.31 Postcomm should also consider empirical evidence from other sectors like energy. This evidence supports the (analytically supported, and commonsense) assessment of both Royal Mail and MMD that entrants will target profitable, low cost-to-serve customers. In the gas industry, for example, initially entrants to the domestic market targeted more profitable "Direct Debit" customers rather than more expensive-to-serve "Pre-Payment Meter" customers. Customer churn was initially markedly different between the two groups.

The approach to volume projections in the control

4.32 Royal Mail considers that the outturn level of volume is inherently uncertain. The difference in volume projections between Postcomm's central case on the one hand and those of Royal Mail and Postcomm's consultants MMD on the other hand confirms, strikingly, this inherent uncertainty.

4.33 Throughout the review, therefore, Royal Mail has sought a price control that explicitly addresses volume risk to ensure its financial viability in the event of unexpected volume loss[20]. The structure of the control proposed by Postcomm includes no mechanism to protect against volume shortfalls, despite the very significant uncertainty. The focus of the regulator, regarding volume projections, should not be limited to a single projection or a limited range above the level of volume in Royal Mail's Plan so that the consequential impact on financial viability is fully addressed.

(b) Price flexibility

4.34 In its October document, Postcomm states that:

- "*Postcomm is proposing that the structure of the control be based on a maximum allowed average price per item of mail delivered, subject to its being satisfied that reliable information required for enforcement would be available. This is designed to give Consignia flexibility over its pricing decisions as it moves towards the competitive market with a new commercial focus*" (para S13).

4.35 Postcomm rightly acknowledges that the price control needs to allow the regulated business flexibility over its pricing decisions. Price flexibility is necessary to improve cost reflectivity and to ensure positive product margins in pricing structures. It is also fundamental to enabling Royal Mail to respond to competition. This flexibility needs to

[18] "An Efficiency Study of Consignia's Inland Letters Business" November 2002. WS Atkins Version 17 para 50.
[19] "An Efficiency Study of Consignia's Inland Letters Business" November 2002. WS Atkins Version 17 para 51.
[20] See Consignia's February 2002 response to Postcomm's November 2001 document and Consignia's submission to Postcomm in July 2002.

encompass rebalancing and restructuring of prices and re-specification of products. Mechanisms for flexibility need to be incorporated into the structure of the control and licence in a manner that is fully transparent to ensure they are effective.

(c) Supplementary caps

4.36 In its October document, Postcomm states that:

- "*Postcomm is proposing that this average price control should be supplemented with an additional restriction, preventing an individual product's prices rising by more than the rate of inflation.*" (para S14)

4.37 Having stated the need to provide Royal Mail with price flexibility Postcomm's proposal severely limits flexibility, imposing RPI ceilings on every weight step of every product. These supplementary caps would ensure that some products continue to have negative margins through the price control period and that important examples of necessary price rebalancing could not be carried out. As examples:

- the average price of Second Class services needs to increase by 16% just to recover its costs; and

- as part of Mailsort Re-engineering Walksort prices need to increase by at least 7% to recover costs, which could be offset by a reduction in Mailsort 120 prices.

4.38 Any supplementary cap should be significantly looser than the level proposed in Postcomm's October document to permit effective price rebalancing and restructuring.

(d) Cost shocks

4.39 Postcomm's October document makes no reference to external cost shocks that are out of the control of the management such as changes to taxes and pensions that can impose additional and unforeseen costs on the business. In the October document, Postcomm's proposal would allow Royal Mail to make an application for a change under the draft licence (Condition 19.5) in the event of it being able to demonstrate that it is no longer financially viable. The inadequacy of this approach is set out fully in Appendix 4D.

4.40 Standard regulatory practice is to allow such cost shocks to be recovered through changes to the allowed revenue either during the period of the control or at the end of the control. In addition, standard regulatory practice sets the allowed revenue to include an allowed profit. The allowed profit acts as a cushion for such cost shocks to be absorbed temporarily and potentially allows cost shocks to be recovered in the next control period.

4.41 Postcomm has not defined an allowed profit in setting the control and has not set out how cost shocks are to be recovered by the regulated business, despite describing Royal Mail's financial position as "weak", and having a statutory duty to ensure its viability.

(e) Standards of service

4.42 The automatic bulk compensation scheme proposed by Postcomm is reviewed separately in Chapter 6 of this response. This section focuses specifically on Postcomm's proposal to include a "C-factor" in the licence control for products not covered by the automatic bulk compensation scheme. In this regard, in its October document Postcomm states:

"….a direct link should be established between the revenue earned from those services and Consignia's performance against its service reliability targets. This should be set at a

maximum of about two thirds of 1% of the revenue which Consignia derives from Stamped and Metered Mail and Standard Parcel revenues." (para 2.2)

4.43 The draft licence includes a "C-factor" to make this adjustment to the allowed revenue within Postcomm's proposal for an average revenue control. This raises three issues:

i. the proposed derivation of the C-factor is based on products that are not excluded from the automatic bulk compensation scheme. There is therefore a "double count" amounting to a double penalty on products in the scheme;

ii. quality shortfalls resulting in compensation claims under the proposed social scheme could also result in price reductions – a case of double jeopardy;

iii. the C-factor acts effectively to reduce allowed revenue if service standards fall below target levels, but there is no equivalent increase in allowed revenue if standards are above target levels. Contrary to practice in other regulated industries, the C-factor offers no positive incentive for service improvement.

4.44 Royal Mail does not support the inclusion of the proposed C-factor in the price control.

(f) The regulator's involvement during the control

4.45 In its October document, Postcomm states that:

- "*As Consignia moves towards a competitive market with a more commercial focus it is likely to want to alter its price structure. The review aims to set a framework with a regulatory incentive within which Consignia can make those decisions on its pricing and service quality. It does not seek to set individual prices or the operational details for service performance, or to second-guess management decisions*" (para 1.8)

4.46 Royal Mail welcomes this approach and recognises that it is consistent with the "light touch" regulatory approach advocated by Postcomm in paragraph 5.42 in its October document.

4.47 In paragraph 5.45, Postcomm's October document proposes a correction factor to roll forward any over or under recovery, between actual revenue outturn and allowed revenue outturn, into the next year's allowed revenue. A penalty charge is then applied to any over-recovery to create the incentive for the regulated business to price under the maximum average revenue control. Royal Mail recognises the correction factor and its successful application in other regulated industries. Royal Mail considers that, since it would effectively control the allowed revenue (subject to volume outturn) it should lead to greater freedom for the regulated business in proposing and gaining Postcomm's acceptance for price changes. This would be consistent with a "light touch" regulatory approach advocated by Postcomm in paragraph 5.42 in its document.

4.48 However, when translated into the draft licence modification the information requirements exceed those needed to check compliance with the price control formulae. These modifications suggest that Postcomm's intends to review forecasts of volume changes by product and, if it disagrees with them, to obstruct proposed price changes. This level of review is not necessary given the penalty clauses within the proposed average revenue control if Royal Mail gets its forecasts wrong. It brings into question why Postcomm says one thing in the text of its October document (in this case about light-touch regulation) and proposes something else in the draft licence (in this case, information and checks beyond those required by the price control formulae).

4.49 Royal Mail considers that a lighter touch approach to regulation than that experienced to date is essential to the future operation of the price control in providing scope for the business to prepare for competition.

4.3.2 Form of control

4.50 In its October document, Postcomm states that:

- **"***Postcomm is proposing that the average price cap should change over time in accordance with an RPI-X form of control (RPI being the Retail Price Index).*" (para S15)

4.51 The Retail Prices Index is subject to fluctuations in the mortgage rate. Royal Mail considers that a degree of risk and uncertainty for the regulated business could be removed by using RPIX (i.e. RPI excluding mortgage interest payments which is the government's measure for its inflation target).

4.52 Royal Mail also considers that, as is the practice in other regulated industries, the reference to inflation should be made on the basis of an average over 12 months rather than a single month to avoid the possibility of a distortion from a single month's figure.

4.3.3 Duration

4.53 In its October document, Postcomm states that:

- "*Postcomm is proposing that the revised control should last for three years*." (para. S16);
- *"Postcomm proposes that the duration of the revised price control should be three years (1 April to 31 March 2006)"* (para. 5.40).

4.54 Royal Mail agrees that the price control should be set for three years as set out in paragraph 5.40 of Postcomm's October document. However, the draft licence in the October document does not reflect this view directly as it could result in the price control lasting beyond three years. Royal Mail considers that the licence should be unambiguous and limit the control to three years by setting a termination date within the licence.

4.4 Level of the control

4.55 Postcomm has failed to address the funding needs of Royal Mail in setting the level of the control, putting it in breach of its duties. It has also failed to follow standard regulatory practice by not defining under what circumstances Royal Mail might expect to be allowed to earn an economic return nor what that economic return might be, and its analysis of required operating and capital expenditure over the coming period is deeply flawed. The result is a proposed level for the control that is much too low.

4.4.1 Funding

4.56 Postcomm's October document raises issues, with regard to funding, over the following:

a) funding of the Renewal Plan;
b) the level of funding available; and
c) the future treatment of retained profits.

These are each discussed in turn below.

(a) Funding the Renewal Plan

4.57 In its October document, Postcomm states that:

- **"***Future customers, via unacceptable price rises, should not be the principal source of funding for Consignia's restructuring and part under-investment. This burden should be shared with Consignia and its shareholder*" (para S23);

- **"***If it were assumed that these costs might properly be attributed to Consignia's shareholder with only the on-going costs to be supported by the price control, each of the projected cash flows above would be £257m higher (in 2000/2001 terms)*" (para 6.67).

4.58 Royal Mail's Plan has a cash outflow of £465 million to be funded over the price control period, through a loan from the National Loans Fund. A commercial business frequently borrows to fund re-structuring programmes, but eventually these loans need to be repaid and are repaid through future earnings. The funding should not be out of retained earnings over past years whereby the shareholder would pay.

4.59 In addition, Royal Mail believes it to be erroneous to imply that borrowing should be used to net off restructuring costs for cash flow calculations.

(b) The level of funding available

4.60 In its October document, Postcomm states that:

- **"***The DTI has said that the market investments on Consignia's balance sheet reflect past accumulated External Finance Limit surpluses and cash generated by the business. The Government, acting as shareholder, has stated that the mails business ought to be capable of financing itself independently on a commercial basis and that the cash held as gilts should not be spent to finance operating losses in the mails business, and appears to have framed the financing package with this end in mind*". (Para 6.8)

- **"***Postcomm notes, however, that it may be argued that a significant part of the £1.8 billion characterised as 'surpluses' may in actual fact reflect past under investment in the mails business"* (para 3.11).

4.61 This statement implies that Postcomm does not accept the DTI's statement and believes that retained earnings are available to fund the Renewal Plan and secure the financial viability of the business through the price control period. This interpretation would be consistent with the reliance in Postcomm's October document on using retained earnings beyond that required for the Plan as a means of securing the financial viability of the business rather than additional reliance on the standard regulatory approach of setting the level of allowed profit and revenue and mechanisms to ensure a positive cashflow position for the business (see Section 4.8).

4.62 It is published government policy that the market investments on Royal Mail's balance sheet reflect past surpluses which are not available for the general purposes of Royal Mail.

4.63 To give effect to this, the Government proposes to issue a statutory direction under section 72 of the Postal Services Act which will have the effect of formally ringfencing the whole amount of the investments (and interest earned and to be earned on them) and preventing their use for any purpose other than those purposes expressly specified in the relevant direction. The purposes to be expressed in the direction will relate to the funding of Post Office Limited and will not include the financing of the Renewal Plan or any other requirements of the Mails business (save only that the investments may be deposited with the Treasury as security for Mails' borrowings from the National Loans Fund). In addition to the statutory direction, it will also be an event of default under Mails' borrowings from the Government in the event that any part of the investments is used for any purpose other than those specified. So if any of the investments is used to fund Mails' business the borrowings are liable to become immediately repayable, with drastic effect on Mails' viability. The investments are thus put well and truly beyond the grasp of the Mails business.

4.64 Whereas Postcomm may question whether it agrees with the Government's policy, that does not affect the fact that Royal Mail will simply not have the power to expend the investments for the purpose of its Renewal Plan or to protect the viability of the Mails business. It would not be right for Postcomm to treat Royal Mail as having access to resources which it does not have simply because Postcomm may believe that, for reasons outside Royal Mail's control, it ought to have them.

4.65 In fact, Royal Mail believes that the presence of retained earnings and gilts only influence the terms of debt finance. The retained earnings and gilts are only relevant to the setting of the price control in terms of establishing the level of allowed profit through the cost of debt component within the estimation of the Weighted Average Cost of Capital.

(c) The future retained profits

4.66 In its October document, Postcomm states that:

- "*Should Consignia outperform its proposed efficiencies or retain significant volumes over and above those anticipated, Postcomm believes that Consignia should be allowed to keep the benefits for the period of the price control*" (para S23).

4.67 Postcomm's statement (above) in paragraph S23 of its October document is correct in the sense that the proposed price control is not a profit cap, but it is unclear how Postcomm will treat retained earnings in the next control. The inference is that Postcomm could claw back any surpluses that are made in the next price control period. Greater clarity is needed on this subject from Postcomm for transparency and to ensure that appropriate incentives are retained.

4.4.2 Allowed profit

4.68 Postcomm fails to consider the regulated business's financial requirements in the accepted way that has been adopted by all other regulators in the UK and endorsed by the Competition Commission. Under this so-called "building block" approach, allowed operating costs and allowed profit (based on an allowed return on assets) are used to define the allowed revenue (and cash flow) projections which, in turn, are set subject to financial ratios being satisfied. Such an approach would allow a sound review and most importantly would establish the framework on which future price controls could be set.

4.69 Postcomm's cash-flow based approach in Chapter 6 of its October document does not consider the appropriate return on existing or future assets nor the cash-flows beyond the relatively short timeframe of the three-year price control. There is no attention paid to financial ratios. It does not follow the building block approach of a regulatory asset base, cost of capital and allowed revenues based on operating and capital expenditure assessments.

4.70 For the central case in Postcomm's October document the total cashflow for Royal Mail over 2003/04-2005/06 is only £46 million at 2000/01 prices. This represents a margin of approximately 0.3% averaged over the price control period.

4.71 The inference from the approach in Postcomm's October document is that Postcomm expects any shocks (whether direct or indirect) to be met by further efficiency savings. There is no cushion of allowed profit to absorb cost shocks during the period of the control. (see Section 4.4.6).

4.72 In its October document, Postcomm states that:

- *"Since Consignia has not been the subject of a market-determined flotation there is no clear anchor available to Postcomm for the calculation of Regulated Asset Value (RAV) on which Consignia should earn a rate of return. Nor is it possible to infer a meaningful RAV on the basis of past cash flows to and from the Government. Various arguments may be put forward for the use of RAVs based on differing versions of the value of a company's fixed assets, but none is compelling, particularly in view of the fact that Consignia's fixed asset base is small in comparison with its size" (para 6.12);*

- **"***no specific adjustment or regulation appears necessary at this stage to allow for the effects of government ownership, compared to the usual situation in utility regulation of having private ownership*" (para 5.50).

4.73 In July 2002, Royal Mail submitted two papers[21] to Postcomm in which it sought to establish the allowed profit as one of the main building blocks to be used in determining the reasonable stream of allowed revenues for its regulated business. The papers estimated a regulatory asset base of a little under £4billion (derived by applying TPG's market-to-book value to Royal Mail's asset base) and Weighted Average Cost of Capital of a little over 10%, which yielded an allowed profit of about £400million per annum[22].

4.74 Postcomm could have used this approach and information to ensure that the regulated business was financially viable through the period of the price control without recourse to the shareholder or the regulator. Postcomm's statement in paragraph 6.12 of its document does not take due account of Royal Mail's submission in July 2002 which not only set out the basis for the approach but also explained that this was consistent with the approach used by most other regulators.

4.75 Royal Mail requested meetings with Postcomm to discuss these papers to ensure that Postcomm fully understood them. However, Postcomm ignored those requests. The above statement in Postcomm's October document reflects no understanding of the submission made by Royal Mail and no willingness on the part of Postcomm to seriously consider this matter. Royal Mail considers that the values of the regulatory asset base and cost of capital in themselves are vital for setting the control, and that the multiplication of the two forms an estimate of the allowed profit that should be used as a reference for setting the control.

4.76 Since July 2002, Royal Mail has taken its analysis of the allowed profit further by using comparisons with the mails businesses of TPG and DPWN – the two universal service

[21] "Allowed Profit I: cost of capital - for the UK inland Mails business", Consignia, July 2002 and "Allowed Profit II: regulatory asset base - for the UK inland Mails business", Consignia, July 2002.

[22] This estimate is also consistent with a replacement cost valuation approach. The gross book value of all assets in use in the USO – which provides a floor to the replacement value - is at least £4 billion even before taking into account the value of brand and knowledge.

providers in the Netherlands and Germany respectively. This analysis is included in Appendices 4B and 4C. This confirms Royal Mail's view that the allowed profit of the regulated business is at least £400million per annum on efficient costs (or at least 7% of turnover). Royal Mail considers that these international comparisons are the best available means of assessing the appropriate level of allowed profit for its regulated business.

4.77 Having identified the allowed profit and revenue for a specific volume scenario or reference case (e.g. a pre-liberalisation scenario), Royal Mail considers that the standard regulatory approach would assess the impact on profit and cash flow for changes in volume to test the financial viability of the regulated business under different price control structures and volume projection mechanisms. It could then be shown in the final proposal that the proposed control ensured the financial viability of the regulated business without recourse to the shareholder or regulator.

4.78 Postcomm's October document does not properly assess the level of allowed profit, has no reference case, makes no proper assessment of volume risk and consequently does not demonstrate that the financial viability of the regulated business through the price control period.

4.79 In this context, while the October document states that no specific adjustment has been made for the effects of government ownership, Royal Mail believes that Postcomm's approach to setting the control has been affected by the issue of government ownership and, in particular, the issue of retained earnings. This deviation by Postcomm from the standard regulatory approach should not be made and the standard approach to regulation should be adopted to set a reference case for the regulated business for this price control and future price controls.

4.4.3 Expenditure

4.80 Royal Mail Group is committed to deliver £1,400 million per annum of gross savings over the three years of the control. The six core strands of the expenditure savings in the Renewal Plan for Royal Mail Group and Royal Mail's mails business are shown in Table 4.4A. The expenditure savings for Royal Mail's mails business are £850 million over the three-year period. This translates into real annual operating cost reductions of 6.4% per annum over 2003/04-2005/06.

Table 4.4A: Expenditure savings in the renewal plan for Royal Mail Group and Royal Mail business.

	Core strand	Royal Mail Group savings £million	Royal Mail's mails Business savings £million
1.	Tailored Delivery Service	350	350
2.	Mails Automation	330	330
3.	Restructuring the Parcels business	500	-
4.	Streamlining the Transport Network	100	100
5.	Outsourcing non core activities	70	70
6.	Modernising the Post Office Network	50	-
7.	Total	1400	850

4.81 Each strand entails radically new management methods and substantial job losses. Each is independently stretching. Together, they represent a truly daunting programme of change that would challenge any management team.

4.82 In its October document, Postcomm states that:

- *"The high-level benchmarking indicates that Consignia's projections are not ambitious compared to what WSA considers achievable and in relation to reasonable comparators". (para 6.34);*

- *"Postcomm expects that Consignia will deliver within the period of the price control more cost savings than Consignia currently projects" (para 6.68).*

4.83 In Royal Mail's July 2002 submission, it set out evidence of its performance and efficiency using a "top-down" approach. The evidence submitted by Royal Mail indicated that UK letters have had an excellent track record of price restraint (and by implication efficiency) when compared with other countries, other sectors of the UK economy, particularly the more labour intensive sectors, and even competitive businesses in the same sector [23] (see also Section 4.5.5). Postcomm's October document makes no reference to this benchmarking evidence provided by Royal Mail [24].

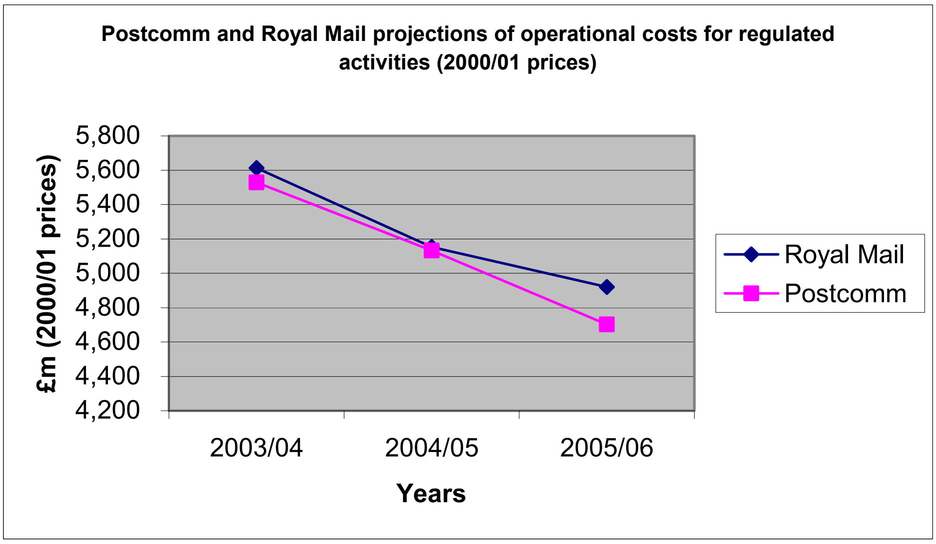
4.84 Postcomm's proposal document, regarding operational and capital expenditure is based on the advice of its consultant W S Atkins. It assumes that Royal Mail will reduce costs by 7.8% per annum over the period of the price control. The difference between Royal Mail and Postcomm projections of operational costs over the full three-year period from 2003/04 to 2005/06 is shown in Table 4.4B and in Figure 4.4B.

Table 4.4B: Postcomm and Royal Mail projections of operational costs for regulated activities (2000/01 prices)

	2003/04	2004/05	2005/06	Total	Annual % change 2003/04-2005/06
Royal Mail	5,613	5,153	4,920	15,686	-6.4%
Postcomm	5,528	5,133	4,703	15,364	-7.8%
Difference	-85	-20	-217	-322	

Figure 4.4B: Postcomm and Royal Mail projections of operational costs for regulated activities (2000/01 prices)

[23] Papers 1&2 of July 2002 submission to Postcomm.
[24] WS Atkins (for Postcomm) makes reference to benchmarking documents in the draft reports that Royal Mail has seen, but WS Atkins does not report on the conclusions of these documents.



4.85 Nearly 70 per cent of Royal Mail's letter service operating costs are labour costs and with a workforce numbering some 170,000, Postcomm's extra savings imply thousands of extra job losses in addition to up to 30,000 already identified and committed to by Royal Mail. Postcomm gives no indication of how these extra savings could be driven out.

4.86 In its October document, Postcomm also states that:

- *Consignia's estimates for the cash implications of selected future operational projects (Tailored Delivery Services, Flats Automation, the rationalisation of Postbox collections and the upstream efficiency opportunities resulting from those projects) were amended to take account of new projections derived from an operational view by Canada Post International Limited (CPIL), part of the WSA consortium; and*

- *A generalised efficiency factor of 1% per year was applied to total operating expenditure from 2003/04 onwards to reflect the additional efficiencies which an efficient operator, incentivised by the new price control regime, could be expected to achieve"* (para 6.30).

4.87 Postcomm's additional cost savings are largely driven by a generalised (and unexplained) efficiency factor of 1% per annum applied to total operating expenditure. Postcomm provides no indication of how or where these savings can be made, and they appear to represent a clear double count with the specific project savings that make up the plan[25]. Postcomm has also made incorrect assumptions about the achievable efficiencies from the Renewal Plan and other identified areas. Royal Mail's estimated savings from these projects are already stretching, and Postcomm's estimates for incremental efficiencies are based on highly flawed analysis and assumptions. A detailed response to the issues raised in paragraph 6.30 of Postcomm's October document and the WS Atkins' report presented to Royal Mail is included in Appendix 4F.

4.88 Postcomm's estimates should not form the basis of setting the price control or analysing cash flow. WS Atkins' report stresses that its operating expenditure targets relate to a "hypothetical efficient operator". It makes no assessment of the achievability of these cost levels by Royal Mail over the period of the price control, nor demonstrates that any postal operator has ever achieved these levels of savings. Royal Mail considers the levels of operational efficiencies in the Renewal Plan to be aggressive and

[25] This double-count arises from an attempt to merge the in-depth "bottom-up" review with that of a "top-down" review, an approach which is spurious and without precedent.

unprecedented. Postcomm's alternative operational efficiency targets are without foundation.

4.4.4 Postcomm's financial scenario analysis

4.89 In its October document, Postcomm states that:

- "*The fact that Consignia's unit operating costs (excluding the effect of provisions release) rise in real terms over the period suggests that Consignia's cost projections are somewhat less ambitious, and therefore more achievable, than it has indicated*" (para 6.31);
- "*Underlying the cost projections above is a set of forecast volumes over the proposed price control period. Consignia regards the consideration of volume changes as crucial, arguing that their cost structure implies that if volumes decrease by 10% their costs decrease only by around 6%".*

4.90 Postcomm's October document sets out financial analysis for a range of volume projections, but this analysis is flawed. It fails to identify that the increase in unit operating costs referred to in paragraph 6.31 of Postcomm's October document is attributable to, amongst other factors, the reduction in volume and impact of cream-skimming entry on the costs of the regulated business. It also fails to calibrate cost (which in Royal Mail included items varying from about 15p to over £5) and therefore makes no allowance for changes in product mix.

4.91 In July 2002, Royal Mail submitted two papers on the subject of volume risk which referred to the impact on cost of cream-skimming. Royal Mail requested meetings with Postcomm to ensure that Postcomm understood the issue of cream-skimming. Postcomm declined to meet. The above two statements in the document and subsequent cash flow analysis in Chapter 6 demonstrate that Postcomm has not understood the impact of cream-skimming on cost and cash flow.

4.92 In Paper 5 of Royal Mail's July 2002 submission, it explained how historically a 10% increase in volume increased costs by about 6% in a non-liberalised market. In Paper 6 of Royal Mail's July 2002 submission, it explained how, in a liberalised market, entrants take volume that has a high contribution to Royal Mail's profit and fixed costs and in Version 4 of the Plan tends to (but need not necessarily) have a low marginal cost. Consequently, with cream-skimming, a volume reduction of 10% would lead to a less than 6% reduction in cost.[26]

4.93 Postcomm's October document estimates operating costs from different levels of volume to those in the Plan based on the relationship between costs and volumes attributed to Royal Mail in 6.36 of Postcomm's October document. This relationship between costs and volumes is not appropriate for the analysis undertaken by Postcomm and leads to results and conclusions that are erroneous.

4.4.5 Postcomm's financial model

4.94 In its October document, Postcomm states that:

[26] For example: for the Inland 6 products (First Class, Second Class, Mailsort, Walksort, Response Services and PacketPost) plus Presstream, given the post-liberalisation costs and volumes in Version 4 of the Strategic Plan, January 2002, the increase in volume to the pre-liberalisation case consistent with the plan is about 15% and the corresponding increase in costs is about 3%. This implies a cost elasticity with regard to volume of about 0.2.

"*Postcomm has provided Consignia (and Postwatch) with analysis and financial modeling, prior to publication of this document, to ensure that it is a fair representation of Consignia's business*." *(para 6.77)*

4.95 The financial model is a fundamental part of setting the level of the control. The regulated business received several versions of Postcomm's financial model during the summer of 2002 but has not received a copy of the final version on which the figures in the document are based. Royal Mail believes that the versions of Postcomm's financial model that it has seen are fundamentally flawed in their structure because: (i) they fail to adequately address the provision release relating to rationalisation in both the cashflow and profit and loss; and (ii) they take no account of product mix changes in setting the average revenue for 2003/04 for the average revenue control. The figures in the document are also fundamentally flawed because of the issues raised in the section above entitled "cream-skimming".

4.5 Related issues

4.96 In addition to the key areas of coverage, structure, form, duration and level, Postcomm's October document makes a number of other points that are discussed in this Section.

4.5.1 Transparency, enforcement, avoidance of perverse incentives

4.97 In its October document, Postcomm states that:

"*In addition to the objectives that flow from Postcomm's statutory duties, the November 2001 document listed a number of other objectives that have been established as good practice and which Postcomm believes are relevant*" (para 3.15)

It proceeds to identify these as transparency, enforcement and avoidance of perverse incentives. These are each discussed below.

(a) Transparency

4.98 In its October document, Postcomm states that:

"*It is important that customers, competitors and Consignia understand the nature of any controls on prices in order to limit market uncertainty and to allow them all to plan ahead under the control with reasonable confidence*" (para 3.15)

4.99 Postcomm rightly acknowledges the need for transparency in the price control. However, Postcomm's proposal does not provide the necessary transparency for a price control in several areas, including (with reference to other sections in this document) the treatment of:

i. the "competition test" used to remove products from the control (see Section 4.2);
ii. volume risk (see Section 4.3.1(a));
iii. cost shocks (see Section 4.3.1(d));
iv. future profits (see Section 4.4.1);
v. changing service specification (see Section 4.5.3);
vi. allowing Royal Mail to proceed with a revised schedule of prices (see Section 4.5.4);
vii. network access (see Section 5.5);
viii. the universal service (see Section 5.6).

4.100 In contrast to its stated objectives of "*good practice*" in paragraph 3.15 of its October document, Postcomm's October document and, in particular, draft licence shows an unwillingness by Postcomm to make the proposal and licence transparent. Most obviously, Postcomm's proposal retains the reopening clause of the existing licence condition 19.6 within the draft licence condition 19.5. This clause:

(i) does not set out a measurable and clear set of criteria to trigger an application for an interim determination and does not set out well-defined guidelines as to how the determination decision will be approached and made;

(ii) uses terms such as 'significant risk', 'competition sufficiently developed', or 'efficient operator' that are not well-defined. These are then open to interpretation and the discretion of the regulator in a manner that is excessive for the interim determination approach;

(iii) does not directly address the uncertainty to Royal Mail's cash flow position that is caused by volume loss to competition.

4.101 Royal Mail discusses the inadequacy and lack of transparency of this clause in more detail in Appendix 4D.

4.102 The price control must be transparent. To achieve this Royal Mail considers that: (i) wherever practically possible the process and decision criteria should be defined and automated; and (ii) wherever it is not practically possible a transparent appeals process should be established.

(b) Enforcement

4.103 In its October document, Postcomm states that:

- "*Any control needs to be practical and enforceable to ensure that customers and Consignia experience in practice what is intended by the price control*" (para 3.15)

4.104 Subsequent to this statement above, in Chapter 5 of the document, Postcomm questions whether some of the options for the structure of the control (e.g. tariff baskets, the average revenue control and the hybrid average revenue control) are enforceable.

4.105 Volume data is generic to all price controls that incorporate price flexibility and price flexibility is a requirement in a competitive environment (see Section 4.3.1). Consequently, the issue of data is generic to all price controls in a competitive environment.

4.106 Royal Mail considers that the issue of enforcement raised by Postcomm is, in practice, an issue of volume data measurement and accuracy:

- In fact, however Royal Mail's current system are adequate to enforce any of the structures Postcomm considers. Royal Mail is currently engaged in initiatives to improve the methods of traffic measurement.

- Royal Mail has informed Postcomm that the level of accuracy improves with data aggregation. It considers that the licence for the price control could be written to ensure that the process of measurement is defined and the most accurate aggregate level of volume, consistent with this process, is used in the control. When disaggregated data is required, the disaggregated data that is consistent

[27] or the simplified approach with flexibility (see Section 5.2).
[28] or hybrid average revenue control (see Section 5.3).

with the aggregated data could be used. Since the aggregated data would be validated by correct application of the process for deriving that data no further validation would be required for the disaggregated data. Consequently, once the method of measurement is identified, procedures can be defined for establishing outturn volumes for the control.

(c) Avoidance of perverse incentives

4.107 In its October document, Postcomm defined this as:

- *"…perverse incentives on Consignia that are not consistent with Postcomm's statutory duties." (para 3.15).*

- ***….“****Postcomm recognises that, if Consignia achieves the full WSA efficiency savings and retains significant market share in a postal services market that resumes its historic pattern of growth, the levels of cash flow which could arise might be greater than warranted. Postcomm would see those enhanced levels of cash flow as being, in part, a due reward to Consignia"* (para 6.70)

4.108 Postcomm's October document rightly acknowledges that the price control must be consistent with Postcomm's statutory duties. The primary duty is to ensure the provision of the universal service and financial viability of Royal Mail's regulated business (see Chapter 2). For the avoidance of doubt, this rules out price controls that do not meet: (i) the revenue requirement of the Renewal Plan and taking account of the appropriate level of allowed profit, (ii) the ability to increase prices in the event that volumes (or revenues) decline below the levels in that plan and (iii) the ability to rebalance prices and change the prices for product restructuring and re-specification to prepare for the competitive market. Once these have been addressed, secondary issues relating to efficiency and economy need to be considered.

4.109 For example, as indicated in paragraph 6.70 of Postcomm's October document, it is desirable for a price control to have the property of increasing cashflow as volumes increase whereby incremental revenue is above the incremental cost. In this regard, the average revenue control reduces volume growth incentives if the allowed average revenue is below the incremental cost.

4.5.2 Service specification

4.110 Royal Mail plans to restructure and re-specify some of its prices and products to prepare for competition. For example, Royal Mail is developing proposals to re-price International and pre-sorted products and to introduce format-based pricing for a broad range of products.

4.111 Though not specifically addressed in the text of the October document, the proposed draft licence states:

- ".. *and any question as to whether the terms other than price on which Controlled Services were offered and provided were more or less beneficial to users on one date as compared with another shall be decided by determination by Postcomm*" (page 43).

4.112 This clause could severely restrict changes to the service specification, yet the Renewal Plan includes major projects that require such changes. In fact, the draft licence would make the implementation of the Plan subject not only to the level of allowed revenue in the final price control proposal (see Chapter 2), but also to the outcome of a determination by Postcomm. Postcomm has set out no process and prepared no criteria for making this determination. This is a recipe for micro management and obstructively "heavy handed" regulation, and results from lack of transparency.

4.113 This has been Royal Mail's experience over the last few years. For example, in the last two years Royal Mail proposed a restructuring of Mailsort prices. Postcomm has still not cleared this change even after several revisions that have significantly diminished its potential impact in the market place.

4.114 The price control must be transparent with regard to service specification. To achieve this Royal Mail considers that (a) wherever practically possible the process and decision criteria should be defined and automated and (b) wherever it is not practically possible a transparent appeals process is established.

4.5.3 Publication of charges

4.115 In its October document, Postcomm states that:

- "..*by 31 December preceding each price control year, Consignia will publish a suggested schedule of charges for the next formula year*". (para 5.43).

4.116 This statement implies that:

i. prices can only be proposed by 31 December in any year for implementation on the 1 April of the subsequent year; and

ii. Royal Mail will need to publish all of its prices three months ahead of implementation.

4.117 Royal Mail considers these restrictions to be excessive and unreasonable as follows:

i. it is unreasonable to limit the ability of Royal Mail to change its prices to once a year, particularly given the need to prepare for the competitive market;

ii. no commercial business in the competitive market should be required to publish all of its prices for competitors to see three months ahead of implementation;

iii. the requirement of the licence should be for Postcomm to ensure that the prices are compliant with the levels allowed in the price control formulae. It should not be the requirement of Royal Mail to consult on price changes for existing products. Only Postcomm need receive the prices before implementation for the purposes of compliance with the price control;

iv. the requirement to receive prices 3 months ahead of implementation is excessive. The period should be consistent with standard industry notice periods.

4.118 This statement again brings into question why Postcomm says one thing in the text of its October document (i.e. it favours light-touch regulation (paragraph 5.42)) and proposes something else in the draft licence (in this case, severe limitations to the number of times Royal Mail can change its prices in any year and a unnecessary and inappropriate requirement to publish and consult on prices).

4.5.4 Unpriced services

4.119 Paragraph 4 of the draft licence condition 19 lists six “unpriced” services. This is a reference that is not in the existing Licence. These services are not provided without significant cost and these costs must be included in estimates of the cost of the universal service obligation that Royal Mail uniquely bears. If Royal Mail is not allowed to recover these costs by charging the sender or recipient, other customers will necessarily have to pay. In other countries in the EU or the UPU some of these services are charged for by the universal service provider, e.g. Poste Restante.

4.120 Furthermore, the item listed in this paragraph and referred to as Pouch Services (bespoke) in fact should only refer to Ministerial Pouches.

4.5.5 Comparison of UK letter prices with those overseas

4.121 Postcomm’s October document summarises postal price trends on page 26. Figure 3.1 in Postcomm’s October document seriously misrepresents the actual position by Postcomm through selective exclusion of comparative prices for Belgium, Luxembourg, Denmark, Sweden, Austria, Finland, Greece, Portugal, New Zealand and Japan, all of which are above that of the UK on a comparable basis.

4.122 Updated comparative figures are shown in Figures 4.5A and 4.5B for First Class below 20g and 20g to 50g respectively and in Figures 4.5C for Second Class below 20g. The UK’s prices are extremely low compared with overseas prices and, at the same time, have a higher service specification than many (i.e. six day delivery with second deliveries for most addresses). The figures show the following:

- the UK basic First Class rate of 27p is very low compared with the equivalent rate charged in other EU countries. In the EU, only Spain, with lower service standards, charges noticeably less than the UK for a First Class 20g letter;

- the UK charges the same First Class rate for up to 60g, while all other EU countries have two or three different tariffs over this weight-band. For letters between 20g and 60g, the UK rate is therefore extremely low compared with other EU countries;

- the UK’s Second Class rate of 19p for a letter up to 20g is, by a very large margin, the lowest amongst EU countries that offer both First Class and Second Class services.

Figure 4.5.A

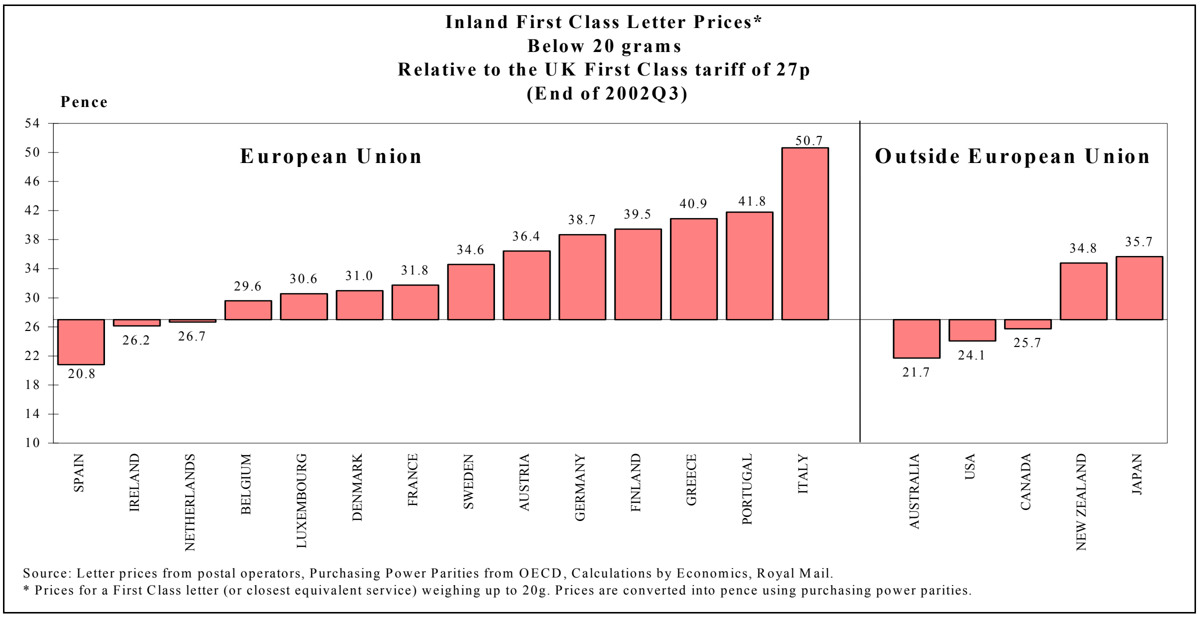


Figure 4.5B

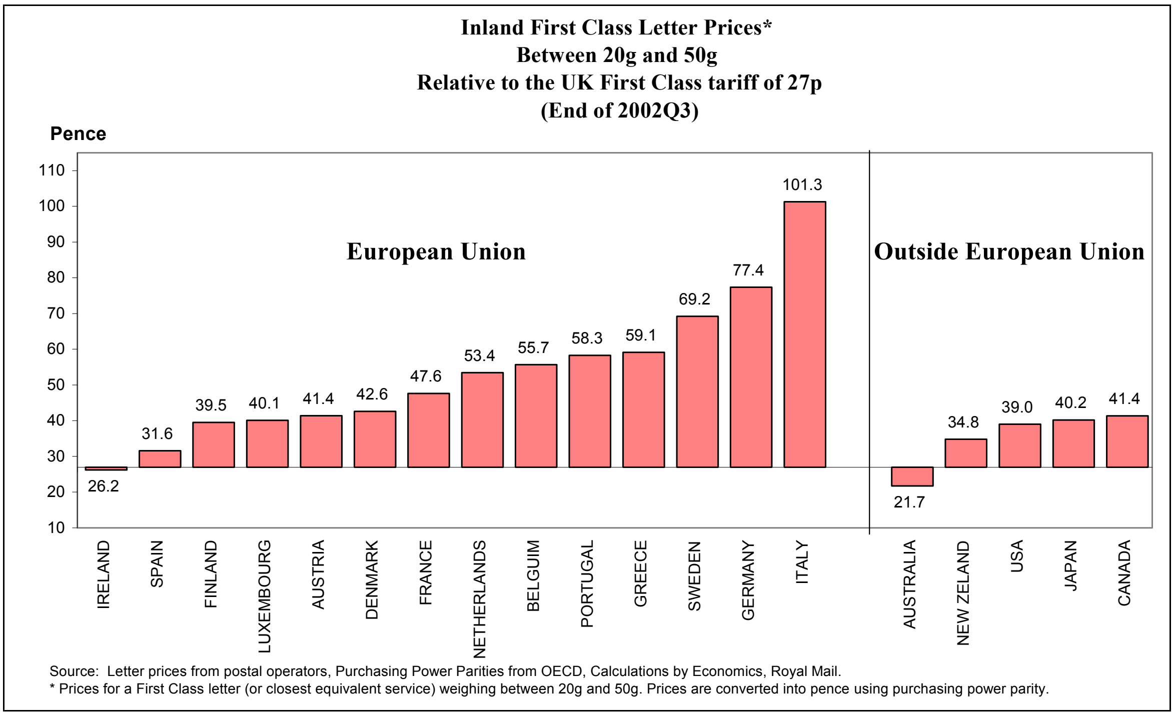
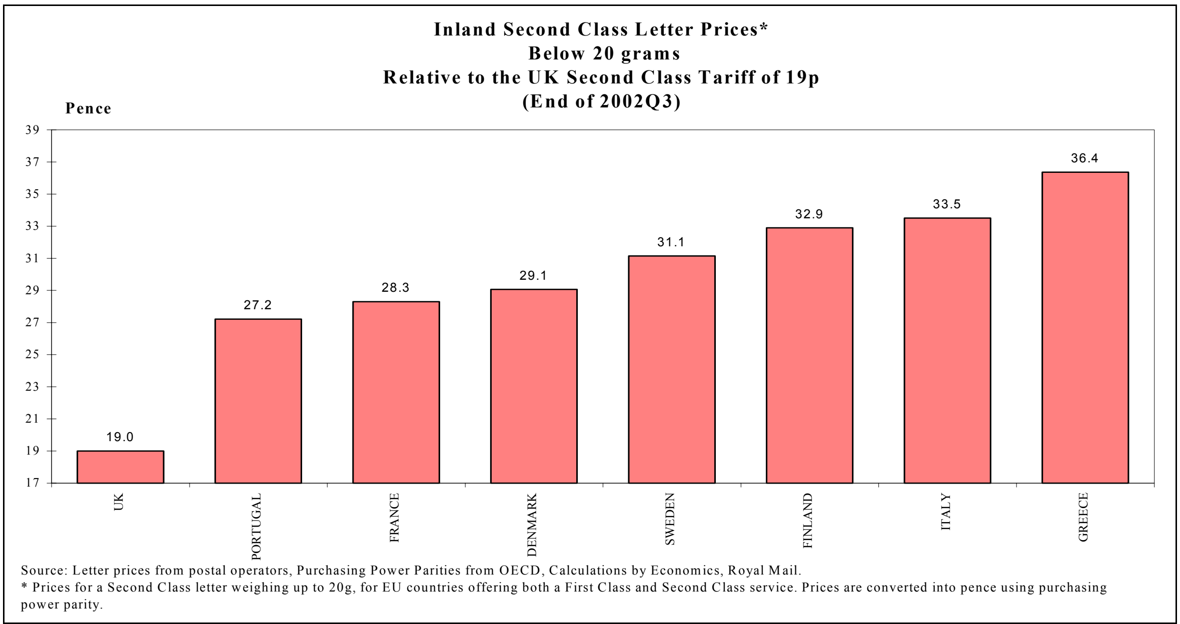


Figure 4.5C



4.5.6 Limitations of information

4.123 In its October document, Postcomm states that:

- "*A particular problem in the current early stages of the new commercial and regulatory regime, which has added to the complexity of this review, is Consignia's lack of quality data and robust management information systems. Much information, necessary for effective regulation and for commercial activities, has not been collected by Consignia or presented in a form suitable for regulatory needs. …Postcomm is currently considering what information should be provided by Consignia on an ongoing basis, to address this issue in time for the next review*" (para S5).

4.124 Postcomm must take responsibility for issuing of information requests during the price control review and for setting out the process for that review. This particular review has been complicated by Postcomm's development of policy during the review with regard to competition and Royal Mail's development of the Renewal Plan.

4.125 Royal Mail has submitted over 1100 documents in response to the Efficiency Review alone. This is a significant achievement and illustrates Royal Mail's willingness to inform Postcomm and facilitate its decision making process.

4.126 A fuller response on information provision is included in Appendix 4F.

4.5.7 Draft licence modification

4.127 The text in this chapter has referred to the draft licence condition 19 that is in Postcomm's October document under: "A proposal document – Technical Annexes". Additional detailed comments on the draft licence condition 19 are included in Appendix 4E.

4.6 Conclusions

4.128 Royal Mail identified five core principles for the price control in Section 3.4. Postcomm's proposal on the price control fails each of the core principles and are unacceptable:

(a) *Postcomm's proposal will cost Royal Mail approximately £460 million over 2003/04-2005/06 beyond the already negative cash flows in its Strategic Plan*

4.129 Postcomm's proposal results in a funding need of £925 million over the period. That is £460 million more than the funding need in Royal Mail's Plan, and £460 million more than Royal Mail's shareholder has agreed to finance. It leaves a black hole in the balance sheet that may make it impossible to continue providing the universal service. The gap is explained by:

- Postcomm proposes to bring back into the price control "Category B" products – International, USO parcels, Special Delivery, Presstream and the core inland products above the licensed threshold (currently 350g, but set to reduce to 100g in January 2003). These products are already exposed to competition and, under the current licence, Royal Mail is able to increase prices in line with inflation. Taking these products back into the control will mean that Category B product prices can no longer be increased at RPI without offsetting price reductions elsewhere. Including these Category B products in the control will cause Royal Mail to undershoot its Strategic Plan by approximately £130 million over the price control period.
- The proposal allows for no adjustment to product mix, which is expected to shift the average price up over time as competition captures share in lower priced Mailsort products. This effect will force Royal Mail to make price reductions on other products to meet the average price cap. Royal Mail estimates that this will cost a further £300 million over the price control period.
- Although Postcomm has declared that the proposals are for a "price freeze" following the initial price change, the decision to set "X" at 2.5% rather than RPI, leaves Royal Mail facing further reductions as, with inflation continuing below 2.5%, Royal Mail consequently faces a further price reduction. This will potentially cost Royal Mail a further £30 million over the price control period.

(b) Postcomm has proposed no automatic protection for the maintenance of the universal service in the event of revenue downside

4.130 Royal Mail's revenue outturns are highly uncertain, given that they are subject to macroeconomic conditions, technological change (e.g., e-substitution) and liberalisation to both full-service competitors and potentially to third parties accessing Royal Mail's network. Moreover, as Postcomm has itself recognised, Royal Mail's cashflows are extremely sensitive to traffic outturn.

4.131 The recent experience at National Air Traffic System (NATS) is illuminating here. The revenue falloff due to September 11th combined with NATS being subject to a pure price control with no automatic protection for volume risk – as Postcomm is proposing for Royal Mail – almost forced NATS into bankruptcy. The CAA has now proposed to introduce a mechanism whereby NATS can increase prices by a pre-agreed amount in the event that revenues fall below a certain level. Royal Mail believes that a similar mechanism is critical for its price control too, given the high degree of uncertainty and sensitivity of cash-flows to volume.

(c) The proposal does not deliver the prospect of an economic return to the shareholder

4.132 The funding requirement in Royal Mail's strategic plan within the three-year price control period is some £465 million, which will be met by a Government-approved finance package from the National Loans Fund upon a satisfactory outcome from the price control consultation. This cash-flow profile does not represent anything close to an economic return over the next three years, yet Postcomm proposes to worsen the cash flows by a further £460 million over the period. Royal Mail has stressed to Postcomm that a target of at least £400 million per annum of profit on efficient costs represents a reasonable return to the shareholder, but Postcomm have refused to engage in discussion.

(d) The proposal will limit Royal Mail's flexibility to compete and reduces commercial incentives

4.133 The average revenue control gives the potential flexibility to rebalance and restructure prices in a manner that is necessary to prepare the business for the new competitive market and make prices more cost reflective. However, this commercial freedom is taken away from the business by excessively tight supplementary caps on individual prices. In addition, the proposed average revenue control reduces the incentive for sales growth in higher priced items by forcing Royal Mail to cut prices if high priced products grow more quickly than low priced products.

(e) The proposal increases the regulatory burden substantially

4.134 Postcomm has stated its intention to reduce the regulatory burden and cites competition as a key enabler. For example, Postcomm's Forward Work Programme (March 2002) it states that, "*Postcomm seeks to be deregulatory and (a) maximise the extent of competition…so that it becomes unnecessary either to control Consignia's prices….*"(part 4and the joint consultation paper (October 2002) and the Memorandum of Understanding between Postcomm and the OFT, states that "*Postcomm has committed to reducing the role of regulation where possible with the intention of deregulating the postal services market*" (para 2.1). In contrast to these statements, existing Category B products are, Postcomm's price control proposals, being brought into a tighter price control. Furthermore all new products are to be included in the control, subject to an undefined competition test

4.135 In addition, while Postcomm's stated intent is for a "light touch" approach to regulation (para 5.42), a lack of transparency within the price control in a several significant areas (including the draft licence condition 19.5) increases the uncertainty facing the regulated business under the proposal.

(f) *Postcomm's proposal puts the universal service at risk*

4.136 Postcomm's primary duty under the Act is to exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service. There is also a requirement in all cases to have regard to the need to ensure the financing activities authorised or required by licences. Both requirements are absolute. Other duties set out in the Act are secondary, including the promotion of effective competition.

4.137 Postcomm, in its proposal, fails in both of these duties by placing undue reliance on a reopening clause (Condition 19.5 in the draft licence condition) that receives no mention in the main text of Postcomm's October document which is a recipe for micro-management and delay

4.138 The combined effect of Postcomm's proposal would be to leave Royal Mail at least £460 million worse off over the price control period than under its own Renewal Plan. Since Royal Mail's Renewal Plan is already very aggressive, and is being used by the DTI to justify continuing funding for the business, this shortfall puts into question Royal Mail's viability as a going concern and, as the sole provider of the universal service, puts the universal service at risk.

5. ROYAL MAIL'S APPROACHES TO SETTING THE PRICE CONTROL

5.1 Introduction

5.1 Following publication of Postcomm's proposal document in October 2002, Postcomm indicated to Royal Mail that it was still reviewing the relative merits of six options for the price control. In response, on 21 and 24 October Royal Mail made separate presentations to Postcomm on two of the alternatives being reviewed by Postcomm, termed the "hybrid average revenue control" and the "simplified approach with flexibility". The presentations were made in the context of Postcomm's proposal and subsequent correspondence, and assumed no network access by third parties. These approaches are outlined in Sections 5.2 and 5.3 and are discussed further (with diagrams) in Appendices 5A and 5B. Both are consistent with the principles for the price control outlined in Chapter 2 of these two approaches. Royal Mail has a preference for the "simplified approach with flexibility" but it recognises that the "hybrid average revenue control" also has many desirable features.

5.2 In October 2002, Postcomm sent an e-mail to Royal Mail which gave a range of prices for network access by third parties and requested that Royal Mail indicate the likely impact of such prices on the cashflow of the regulated business. Postcomm made this request despite the suggested prices being hypothetical and having no clear technical basis and despite Postcomm's October document making no reference to network access.

5.3 On 15 November 2002, Royal Mail made a presentation to Postcomm illustrating the impact of network access. It also illustrated the modifications to the hybrid average revenue control and simplified approach with flexibility required to ensure that the cashflow position of the regulated business does not worsen and thereby secures the financial viability of the universal service in the presence of network access. The general issue of third party network access is outlined in Section 5.4. The modifications required to the hybrid average revenue control and simplified approach with flexibility are illustrated through diagrams in Appendix 5C and then incorporated into the economic briefs of the corresponding draft licence condition 19 in Appendices 5D and 5E.

5.4 Finally, Postcomm has also indicated that it intends to review the universal service shortly. This is discussed briefly in Section 5.5.

5.2 The simplified approach with flexibility

5.2.1 Overview

5.5 Royal Mail's preferred option is the "simplified approach with flexibility". This approach delivers the revenue in the Plan with a 1p/1p increase on the core inland products' basic weight step prices with proportionate increases for higher weight-steps and RPI increases for USO International, Special Delivery and USO parcels. Protection against volume risk would be achieved through a trigger mechanism that, similar to the recent CAA proposal, allows Royal Mail to increase prices by a pre-defined amount in the event that total revenues fall below a trigger level.

5.6 To provide commercial flexibility, there would be a rules based approach to price rebalancing and price changes from product restructuring and re-specification. For rebalancing, an ex-ante rules based approach would apply similar to that of a tariff basket, whereby Royal Mail would have the freedom to rebalance prices provided that the average price, weighted by historic volumes, did not increase. The historic volume data would be by price point and measured each half-year to allow bi-annual price changes. For product restructuring and re-specification, an ex-post rules based approach would apply similar to that of an average price control, whereby the average price after the change would need to be no greater than the average price before the change to avoid a revenue clawback in the subsequent period.

5.2.2 Implementation

5.7 The simplified approach with flexibility with no third party network access defines:

(i) the allowed prices as being those in place on 1 April 2003 in the absence of any price rebalancing, price restructuring or product re-specification;

(ii) the allowed prices would need to satisfy revenue neutrality tests in the presence of any price rebalancing; price restructuring or product re-specification;

(iii) the allowed prices could also be increased to reflect additional revenue allowances arising from: (a) end-to-end revenue or volume falls below the post-liberalisation volume in the plan; (b) any under-recovery of revenue from restructuring prices or re-specifying products.

5.8 To guarantee maximum commercial flexibility in practice, this approach requires the licence to define (i) a revenue neutrality test for the rebalancing of the prices for existing products; (ii) a revenue neutrality test for the restructuring and/or re-specification of the products; and (iii) a test for triggering and defining the additional allowed revenues. These are discussed in turn below.

(i) a revenue neutrality test for the rebalancing of the prices for existing products

A test is required to demonstrate that the prices, if rebalanced, are revenue neutral. For price rebalancing in period t, the regulated business would be required to show that, using t-1 volume data, the expected revenue from the new prices in t does not exceed the out-turn revenue in t-1. This ex-ante test would apply only to the prices of products that existed in both t and t-1. The test would require only historic volume data for t-1.

(ii) a revenue neutrality test for the restructuring of the prices for existing products

The regulated business would be required to satisfy a revenue neutrality test when restructuring its prices. In the case of price restructuring (e.g. format based pricing) the basis for measuring volume changes, so it is not possible for the restructuring of prices to undergo the same test as that for the rebalancing of prices. For a restructuring of the price in period t, the regulated business should be required to show that the outturn average price of the new structured products in t was equal to the outturn average price of the old structured products in t-1. This ex-post test would apply only to the prices of products that were restructured between t-1 and t.

(iii) a test for triggering and defining the additional allowed revenues.

To protect the cashflow position of the regulated business, additional allowed revenues would be allowed should outturn revenues fall below a trigger level. Royal Mail believes that an appropriate balance of risk and reward would be struck by allowing Royal Mail to increase prices to recover 60 per cent of revenues that are lost below 98 per cent of Renewal Plan projections. Given that each percentage point of revenue is approximately £55 million, this gives Royal Mail a strong volume growth incentive, while providing downside protection.

5.9 The control requires outturn volumes for the tests that is disaggregated to the level of product and weightstep (i.e. price point). In addition, it requires aggregated revenue and volume data to test for and implement the additional revenue allowances.

5.10 In the case of the ex-post test for restructuring and product re-specification the correction factor for over and under-recovery would act as an automatic control on the revenue and prices of the regulated business, as the interest rate penalty would penalise overstated prices. The potential penalty and limit on allowed revenue reduces the need for Postcomm to investigate the consequences of any proposed changes on revenue. This would enable Postcomm to have the "light touch" regulatory approach to pricing that is used by other regulators (e.g. Ofgem for the distribution and transmission businesses). This improves the efficiency of the regulator and reduces the uncertainty for the regulated business.

5.11 With volume risk explicitly addressed, the present re-opening condition (i.e. draft licence condition 19.5) would no longer be the primary means of addressing the impact of competition.

5.12 The simplified approach with flexibility is discussed further in Appendices 5B without network access (and 5C with network access) and developed into an economic brief for a draft licence in Appendix 5E.

5.3 The hybrid average revenue approach

5.3.1 Overview

5.13 The hybrid average revenue approach (with no third party network access) is defined such that part of the allowed revenue in any year is set, independent of volume, while the total allowed revenue is the sum of this fixed part and a variable part that depends on volume outturn. Prices are set to recover no more than the allowed revenue with any over or under-recovery in one year leading to a correction to the allowed revenue in the subsequent year. An interest penalty for over-recovery encourages the regulated business to set prices that do not exceed the allowed revenue. Rebalancing and restructuring of prices are automatically permitted but are subject to the limits of allowed revenue.

5.14 This approach is a further development of the average revenue approach in Postcomm's October document. It makes the revenue and cash flow position of the regulated business less sensitive to changes in volume when costs do not change in direct proportion to volume. Costs will not change in direct proportion to volume because of:

a) the presence of fixed costs (primarily universal service network costs)[29]; and

b) the presence of cream-skimming entry in a liberalised market, with competitors capturing high margin market share first.

Papers 5 and 6 in Royal Mail's July 2002 submission to Postcomm set out this in some detail.

[29] as evidenced by the historic cost elasticity with respect to volume in a non-liberalised market being significantly below unity

5.3.2 Implementation

5.15 The hybrid average revenue control defines the allowed revenue over a range of volume outcomes. Allowed revenue is defined by:

- using pre and post liberalisation data on revenues, costs and volumes to define an allowed revenue line consistent with both outcomes; and
- tilting this allowed revenue line about the post- liberalisation point in such a manner as to retain some volume growth incentives, and in a manner that reduces allowed revenue for high volume scenarios and increases allowed revenue for low volume scenarios.

5.16 The control would, in effect, trade off some additional revenue for a high volume outcome to secure the revenue of the Plan or lower volume outcome and thereby ensure the financial viability of the regulated business over a broad range of volume outcomes.

5.17 Under a further variant of this approach, an additional factor could be added to the definition of allowed revenue if outturn volume exceeds that in the Plan. This would improve the cashflow if volume exceeded the level in the Plan and thereby enhance the incentives for volume growth of the control.

5.18 The control requires outturn volume, to derive the allowed revenue, and outturn revenue, to derive any over or under recovery with respect to the allowed revenue. The use of only aggregated data removes the need for disaggregated volume data for the hybrid average revenue control.

5.19 The correction factor for over and under-recovery would act as an automatic control on the revenue and prices of the regulated business, as the interest rate penalty would penalise overstated prices. The potential penalty and limit on allowed revenue reduces the need for Postcomm to investigate the consequences of any proposed changes on revenue. This would enable Postcomm to have the "light touch" regulatory approach to pricing that is used by other regulators (e.g. Ofgem for the distribution and transmission businesses). This improves the efficiency of the regulator and reduces the uncertainty for the regulated business.

5.20 With volume risk explicitly addressed, the present re-opening condition (i.e. draft licence condition 19.5) would no longer be the primary means of addressing the impact of competition.

5.4 Related issues

5.21 Given either the simplified approach with flexibility or the hybrid average revenue control, Royal Mail also requires modifications to Postcomm's proposed approach to secondary caps and to the coverage of the control.

(a) Secondary caps

5.22 Postcomm's October document advocates secondary caps that limit the maximum change in any price between years to RPI. However, Royal Mail considers that:

- since both the simplified approach with flexibility and the hybrid average revenue control effectively limit the overall level of revenue, the secondary caps are not necessary to control the level of revenue. Instead, the caps are primarily used to limit the degree of price rebalancing;

- the limit of RPI would not provide sufficient headroom to enable the regulated business to rebalance its charges to be cost-reflective within the price control period. The degree of rebalancing required for cost-reflective charging could significantly exceed this limit;

- the limit of RPI is arbitrary and has no statutory basis. The secondary cap could be related back to the test of affordability in the Act by allowing prices to change such that they do not exceed the price, in real terms, of the product at the time of the Act coming into effect. An additional allowance of RPI+5% per annum should be applied to provide some additional scope to rebalance prices in preparation for competition.

- though not stated in its October document, Postcomm has expressed the view that the secondary caps act as a means of limiting the extent to which the Royal Mail could reduce some prices in response to competition. That is, by limiting the extent to which some prices increase, Postcomm limits the extent to which prices could fall and still retain the maximum allowed revenue. This is a spurious line of argument for defence of the RPI cap, since it does not directly address the issue of price reductions. If the specific concern of Postcomm is one of potential market abuse through reducing prices then this is addressed directly through the Competition Act (1998) which prohibits anti-competitive behaviour and Postcomm's powers of access to information within the Licence. It is not necessary for the price control to address this issue.

(b) Coverage

5.23 In principle, Royal Mail considers that:

i. products that are not part of a contested market should be in the main price control. These products are referred to as Category A products;

ii. products that are contested, but where in practice there is only limited competition or are part of the universal service should be transferred from the main price control to a supplementary price control. These products are referred to as Category B products;

iii. products that are already in a contested market that becomes competitive should be transferred from the supplementary price control to have no price control. These products are referred to as Category C products;

iv. products that already operate in competitive markets should not be price controlled and should be treated as Category C products.

5.24 As the postal market is opened to competition in this way products should transfer from Category A to Category B and ultimately to Category C with no price control.

5.25 In principle, this should mean that, as the contestable market extends from above 350g to above 100g from 1 January 2003, Inland 6 products in the range of 100g to 350g should be transferred from Category A to Category B.

5.26 For the Inland 6 products, the level of the prices for Category A products below 100g should continue to reflect constant nominal prices while the level of the prices for Category B products above 100g should reflect constant real prices (i.e. indexed by RPIX). Until the earlier of the establishment of the competitive market for a product or 31 March 2006 (the end of the next price control), the prices of the products below 350g should be within the same price control formulae to allow for price rebalancing and price changes for product restructuring and re-specification.

5.27 Furthermore, the existing Category B products of USO International and USO Parcels & Special Delivery should be removed from the main control and given separate controls, the levels of which should reflect constant real prices (i.e. indexed by RPIX). These products have very different growth paths to the core inland mails business products and have average prices significantly greater than the core inland mails business products. Consequently, there would be significant changes in product mix that would affect the average price if the control covered all price-controlled products in a single control.

5.28 More specifically:

(i for Special Delivery and USO parcels the structure of the control should remain an RPI cap, consistent with the present control and the contestable market;

(ii) for USO International, the structure of the control should be a hybrid average revenue control. The Plan includes a restructuring of the prices that could be achieved through some form of hybrid average revenue control. The variable component of the hybrid average revenue should use weight rather than volume as the primary measure of USO international products is through weight (i.e. the weight of freight cargo). The portion of revenue that is set independent of the volume should be about 0.3.

(iii*)* Presstream products should be excluded from the price control*.*

The draft licence modification in Postcomm's proposals requires the Royal Mail to provide for the duration of the price control all the services that it provides on 31 March 2003, subject to approval by Postcomm of a dis-application request. The Act sets Postcomm's primary duty to ensure the provision of the universal service products at uniform and affordable prices for public tariffs.

Presstream is not a universal service product and hence Postcomm is outwith its powers under the Act to require Royal Mail to provide this service through Licence Condition 19. Presstream should be separated from the control of the universal service products.

Postcomm's vires to set a price control for the Presstream products are not from its primary duties under the Act but from its secondary duties to promote efficiency and economy when there is insufficient competition. Presstream faces significant competition from local distributors, primarily within the business sector but also in the domestic sector (see Section 4.2). Consequently, Presstream should be excluded from any price control.

It is also the European Commission's policy that new postal services do not form part of the universal service, and that regulation should be restricted to services fully within the scope of the universal service.

(iv) New products should be excluded from the control to provide incentives to innovate. This should be the case for all new products outside of the USO*.*

In some exceptional cases new products could enter a non-contested market. An example of such a product would be third party network access. Royal Mail would expect such products to be included within a price control, but would expect the price control of other products to be modified to ensure the financial viability of Royal Mail and the provision of the universal service.

5.29 Finally, coverage should reflect the contestability of markets over time. Postcomm has not set out the "test" that would need to be satisfied for the removal of a product from the coverage of the control. Postcomm's final proposal should set out the criteria by which the Royal Mail could effectively seek to remove a product from the control in the licence period and thereby reduce the uncertainty over this application process.

5.30 Royal Mail believes that the "competition test" should follow OFT guidelines on market definition and should set out criteria for assessing contestability of the market. Changes in the market should also be reflected in the changes to the coverage, structure and level of the control. For example, where products are in a market that is opened up to competition, this should be reflected in a less stringent price control.

5.5 Network access

5.31 The opening of Royal Mail's downstream network to competitors has crucial implications for the price control. With access available, competitors can bypass Royal Mail in urban areas (where delivery is cheap) but inject mail into Royal Mail for delivery in rural areas (where delivery is expensive). As such, access makes much more of the market profitable to entrants, and so increases the loss of contribution and worsens the cashflow of Royal Mail. It also makes market entry easier, and so accelerates the pace at which Royal Mail will lose volume. This reinforces the need to have a price control that provides some protection against low revenue outcomes to secure the universal postal service.

5.32 Postcomm is undertaking a review of network access for a determination request by a third party. It has also indicated that it wishes to consider an access code for third party access to the network to commence within the period of the price control. These are not trivial matters and yet, Postcomm's October document says nothing about network access, and makes no assumptions about the impacts Royal Mail will face as a result of opening its network to competitors. In fact, in the context of the price control review, Postcomm has only raised the issue of network access through an e-mail late in the day (in October 2002, after publication of its October document) and referred to a range of hypothetical access prices with no definition of the terms of access (e.g. definition of the access point).

5.33 Postcomm's October e-mail gave Royal Mail a range of prices for third-party access of 11p, 14p and 17p. Royal Mail has undertaken analysis to assess the financial impact of these access prices under two cases where:

A. the effect of the access price is limited to its direct impact on reduced end-to-end volumes and new access volumes; and

B. the effect of the access price includes the direct volume impact of (a) as well as further price reduction in the price levels of other Royal Mail end-to-end products to meet requirements for non-discrimination.

5.34 The results of this analysis are shown in Table 5.5A. For the central access price scenario of 14p, Royal Mail's cashflow position worsens by £250million in case A and £1,170 million in case B over the period of the control. These results show that third party network access will have major and far-reaching implications on Royal Mail and its ability to meet its licence obligations. Volumes, revenues and cash flows will be fundamentally affected. The introduction of network access could have very significant implications for Royal Mail's finances and therefore Royal Mail's ability to fulfil the universal service obligation in the UK.

Table 5.5A: Royal Mail's analysis of the financial impact of third party network access prices of 11p, 14p and 17p on its cashflow in millions of pounds over the three year period of the control.

Case	Access price		
	11p	14p	17p
A	-420	-250	-150
B	-1970	-1170	-1060

5.35 It is imperative that the price control ensures that Royal Mail can fulfil the universal service obligation for the UK both with and without network access. The issue of the impact of network access on the financial viability of Royal Mail needs to be explicitly addressed within the price control and not be subject to the discretion of the regulator during the price control period. The regulated business needs clarity in the licence to minimise uncertainty and risk as it undertakes the Renewal Plan.

5.36 The implications of third-party network access, in the context of the two approaches to the price control set out in Sections 5.3 and 5.4, are illustrated in Appendix 5C. This also outlines the modifications to the two approaches that are necessary to address the cashflow implications of third party network access. In outline the required modifications are as follows:

- for the simplified approach with flexibility an additional revenue allowance for every item with third party network access would need to be defined once the access price is known and the secondary caps would need to be set sufficiently high to enable price changes of other products to attain the additional allowed revenue;

- for the hybrid revenue control the secondary caps would need to be set sufficiently high to enable price changes of other products to attain the allowed revenue with the portion of allowed revenue that is not dependent on volume possibly adjusted to reflect the avoided upstream costs of third party network access.

This is developed further in the economic briefs for licence modifications in Appendices 5D and 5E.

5.37 The Appendices (5C, 5D and 5E) develop an understanding of the mechanisms required to address the impact of access on Royal Mail's cashflow. The extent of the impact will depend on the level of the access price. The ability of the business to increase prices to recover the financial hole left by access will diminish the lower is the access price and higher the increase in the other prices. Royal Mail believes strongly that the level of access price should be based on the price of the corresponding end-to-end product less its avoided costs. This would have the effect of reducing the additional revenue allowances in the price control that would be necessary to enable the business to recover the lost contribution and deterioration in the cashflow from the introduction of access.

5.6 Universal Service

5.38 Postcomm's primary duty, enshrined in the Postal Services Act 2000, is the provision of a universal service. However, the products and services covered by the universal service have not been defined. Postcomm had indicated that, by now (December 2002), it would have issued a consultation paper on the subject. Postcomm has not published such a paper.

5.39 Royal Mail expects Postcomm's paper on the universal service to be published during the price control period. Its findings could have implications for the coverage of the products in the universal service. Postcomm's October document proposes that many of the products that are treated as universal service products in the Regulated Accounts should be price controlled. The price control should allow significant price flexibility and rebalancing for any products that are removed from the uniform price constraint of the universal service obligation.

5.7 Conclusions

5.40 Royal Mail has set out alternative approaches to the price control (under the assumption of no third party network access) that could be developed to address some of its major concerns and requirements for the price control. These approaches are consistent with Royal Mail's principles for the price control set out in Section 3.4. Of the two approaches Royal Mail prefers the option with the stronger volume growth incentives, termed the "simplified approach with flexibility".

5.41 Royal Mail has identified areas of uncertainty, including the access price and the definition of products in the universal service. Royal Mail has undertaken some analysis of the impact on its cashflow using the access prices provided to it by Postcomm. The results show that network access for third parties will have major and far-reaching implications on Royal Mail and its ability to meet its licence obligations. The extent to which cash flow will worsen depends fundamentally on the access price to Royal Mail's network, but based on indicative prices provided by Postcomm to Royal Mail the adverse effect on the cashflow position by (£250 million) to (£1170million) or more over the three-year period. Volumes, revenues and cash flows will be fundamentally affected.

5.42 Consequently, the introduction of network access could have huge implications for Royal Mail's finances and therefore for the viability of the universal service. These changes could require fundamental changes to the price control. Royal Mail has presented to Postcomm alternative approaches to the price control assuming third party network access

5.43 These issues are not addressed in Postcomm's October document. Postcomm's final proposal will need to ensure that the proposed price control addresses these issues to ensure that Royal Mail can fulfil the universal service obligation for the UK without recourse to its shareholder or regulator during the period of the control.

6. POSTCOMM'S PROPOSAL DOCUMENT ON COMPENSATION

6.1 Introduction

6.1 In this Chapter Royal Mail reviews the proposal document on compensation contained within Postcomm's October document. Postcomm's proposal includes separate compensation schemes for retail and bulk services.

6.2 Background

6.2 Royal Mail has had for many years a voluntary compensation scheme. Benchmarking of this scheme during 2001 established that the features of the scheme were at least consistent with, and in some cases surpassed, industry and cross sector benchmarks.

6.3 The provisions of Condition 4 of Royal Mail's Licence which purport to allow Postcomm to determine a standards of service compensation scheme are ultra vires. Royal Mail's liability in tort in respect of loss or damage suffered by any person in connection with the provision of a universal postal service is limited by S. 89 – 92 of the Postal Services Act to proceedings "in respect of relevant loss of, or relevant damage to, an inland packet in respect of which the universal service provider accepts liability … in pursuance of a scheme made under section 89 [of the Postal Services Act]" (S. 91 (1) Postal Services Act). Postcomm is seeking to extend that limited liability which has been conferred by Parliament. Although Postcomm has powers to include conditions in a licence granted under S.11 of the Act, that power cannot be used in such a way as to render nugatory rights which are created by primary legislation – which is what Postcomm is seeking to do by extending the circumstances in which Royal Mail is liable to compensate customers.

6.4 Even if Royal Mail is incorrect in this view, and if Condition 4 were lawful, certain provisions of the draft scheme would be unlawful in the absence of modifications to Conditions 4 and 8, as they go beyond the powers which Condition 4 seeks to impose. Postcomm's proposal itself acknowledges that "compensation for failure to provide Keepsafe and Redirection services, which are not mentioned in the Annex to Condition 4, may be beyond the scope of Postcomm's power of determination" (para. 2.6). Postcomm's legal advisor has also conceded in writing to Royal Mail's legal advisor that the wording of Condition 4 does not cover items which are lost or damaged.

6.5 Furthermore, even if Condition 4 were intra vires Postcomm, the proposed compensation scheme for retail services seeks to impose penalties upon Royal Mail in respect of service failure, rather than determine compensation. It is not permissible for Postcomm to determine a scheme whose provisions impose such a penalty.

6.6 <u>Notwithstanding this, Royal Mail has sought to work with Postcomm and Postwatch towards the development of a new voluntary compensation scheme (not governed by Condition 4 of its Licence) that is fair and reasonable. It continues to be willing to do so, but in a way which protects its legal rights. Details of Royal Mail's proposed new voluntary scheme are set out in a document, which is supplied to Postcomm with this response. Royal Mail believes that its new scheme achieves its aims of offering redress appropriate to the level of service associated with each product whilst meeting users needs. It reflects (and in many ways exceeds) industry and regulatory best practice.</u>

6.3 Postcomm's proposed compensation schemes

6.7 Without prejudice to this legal position, Royal Mail has a number of commercial comments to raise in respect of Postcomm's proposals. Royal Mail's principal objection to the proposed retail scheme for delay and loss is that the amounts proposed are disproportionate to the price paid by the customer and will incentivise fraud, which it will be difficult to detect. In addition, the tiered payment structures are too complicated. Royal Mail also objects to Postcomm's proposals for Special Delivery delay and Keepsafe, again on the ground that payments are disproportionate and outside the industry norm.

6.8 The "bulk" compensation scheme proposed by Postcomm on Postwatch's advice is effectively a penalty scheme or industry subsidy for poor performance, with no credit for good performance and no reflection of customers' actual loss. The scheme does not take account of the level of precision with which performance is measured. The confidence limits for some products are not accurate enough to warrant a compensation payment for a small shortfall. The "bulk" scheme also exposes Royal Mail to disproportionate and potentially punitive levels of "compensation", which could seriously impact on its financial position. This is in contrast to the capping of the quality element for other products within the proposed price control formula.

6.9 Postcomm has failed to take into account the full potential impact of its proposals and the effect that this may have on Royal Mail's ability to provide the universal postal service.

6.10 Appendix 6A sets out Royal Mail's views on the question of Postcomm's vires to determine a compensation scheme and its commercial comments on Postcomm's proposal, which are made without prejudice to its opinions on vires and its legal position.

6.4 Licence Conditions 4 and 8

6.11 Royal Mail's Licence can only be amended with its consent, which consent has not been and is not given, or following a reference to the Competition Commission under S.15 of the Postal Services Act.

6.12 The proposed changes have been drafted by Postcomm and Postwatch without the involvement or agreement of Royal Mail. Nevertheless Postcomm have chosen to include the drafts in the consultation process, simply acknowledging that Royal Mail has serious objections.

6.13 Royal Mail accepts the need to make some changes to Conditions 4 and 8, for example to incorporate any agreed new service standards. However the other proposed changes go far beyond what is required. Moreover, Royal Mail believes that the proposals are an attempt to reintroduce changes that Royal Mail rejected when the original Licence was negotiated, and which there is no new evidence from the operation of its Licence to justify.

6.14 Royal Mail's principal objections to the draft Conditions are:

- Paragraphs 21 and 22 for Condition 4 give Postcomm the power to determine alterations to the agreed scheduled standards of service and compensation scheme, at the behest of Postwatch.
- Paragraphs 10 to 13 of Condition 8 set standards for reductions in mail loss, theft and damage and require Royal Mail to use reasonable endeavours to achieve these reductions. It is also proposed that the estimates of loss etc. are formally audited, although it is not possible to audit estimates of this nature.

6.15 The financial risk to Royal Mail of these proposals is immense. Service performance targets have already been discussed and agreed with Postwatch for 3 years in line with the price control. Non-achievement of these and any new loss reduction targets would expose Royal Mail to enforcement action with consequent potential actions for damages, and penalties. Such targets must be agreed and incorporated in business strategy; they cannot be externally imposed. Moreover, Royal Mail cannot agree to any target reduction on aspects of mail loss and damage that do not lie fully within its control.

6.16 Further serious objections are:

- Paragraphs 10 and 12 of Condition 4 extend Postcomm's ability to determine on compensation to include Loss, Damage, Keepsafe and Redirections. Royal Mail believes that this lies outwith Postcomm's legal powers.
- Paragraphs 7 and 8 of Condition 8 give Postcomm the power to determine alterations to Royal Mail's mail protection procedures, at the behest of Postwatch, who have no legal responsibility and no expertise in this area. This is unnecessary, intrusive and in direct contradiction to Postcomm's own proposals for industry-wide security compliance. There are no such requirements in the Standard Licence for other operators.

6.17 Royal Mail will not consent to these changes. Royal Mail must also put on record its view that any Licence condition (and any determination under it) which was inconsistent with the statutory provisions would be unlawful and unenforceable.

6.18 Appendix 6B sets out Royal Mail's views on the proposed Licence modifications.

6.5 Conclusions

6.19 Royal Mail has sought to work with Postcomm and Postwatch towards the development of a compensation scheme that is fair and reasonable, whilst protecting its legal rights under the Act. However, Postcomm has proposed a scheme to compensate delays and losses of social mail that will incentivise fraud, and has put forward an industry scheme with a punitive compensation level.

6.20 Under the social scheme for losses, customers will be able to claim up to 100 times the stamp price – for example £27 for a first class letter – without any proof of purchase. For delays, customers will be able to claim up to £14. These proposed amounts are hugely disproportionate to the price paid by the customer and will incentivise fraud. In addition, the tiered payment structures are too complicated.

6.21 The industry compensation scheme forces Royal Mail to reimburse 1% of revenue for each 1% of service shortfall on bulk mail. Given that revenues on bulk mail products exceed £3 billion**,** this exposes Royal Mail to disproportionate and potentially punitive levels of compensation, which could seriously impact its financial position.

7. CONCLUSIONS

7.1 This document has presented Royal Mail's response to Postcomm's price control proposal, and has put forward two options that could be developed into an acceptable price control for Royal Mail. Table 7.A summarises Royal Mail's alternative approaches which are further developed into economic briefs for the draft licence condition 19 in Appendices 5D and 5E. (These Appendices set out the detailed principles of the control, without the values of all of the parameters within the control formulae being stated. Of the two approaches Royal Mail prefers the option with the stronger volume growth incentives, termed the "simplified approach with flexibility").

Table 7.A Royal Mail's alternative to the price control.

	Royal Mail's approach
1. Coverage	a) The coverage of the revised price control should be based on the existing Category A, Category B and Category C product definitions. The weight ceiling for Category A products, which is currently 350g, should be reduced to 100g in January 2003.
	b) The opening coverage of the revised control (the regulated products) should be Category A products. Category B products should be subject to RPI caps, as now. Category C products should continue to be unregulated.
	c) Provision should be made to allow Royal Mail to apply to Postcomm after the control is set to remove products from the price control on the basis of a test with clearly specified criteria on market definition and contestability
	d) New services developed during the price control period should be excluded from the price control, with the exception of network access services which are not contestable and require special treatment within the control.
	e) Royal Mail should be able to change service specifications (including removing a service) for any non-USO service without Postcomm's approval. For products that form part of the USO: - The approval process should be subject to predefined short timescales that apply to both Postcomm and Postwatch - Postcomm (liasing with Postwatch) should come forward within the pre-agreed timescales with any rationale for blocking a proposed service specification change (based on harm to customers).
2. Structure	a) There are two acceptable options for the structure of the control: - The simplified approach with flexibility, which sets initial product prices. It specifies rules that allow Royal Mail to rebalance and restructure prices subject to revenue neutrality criteria, and includes a trigger mechanism that allows Royal Mail to raise prices when revenues fall below a certain level. - The hybrid average revenue control, which restricts the maximum allowed revenue of Royal Mail's regulated products. It reduces Royal Mail's cashflow exposure to volume reductions by including an automatic mechanism allowing Royal Mail to increase prices if volumes fall below an agreed level Of the two approaches Royal Mail prefers the option with the stronger volume growth incentives, termed the "simplified approach with flexibility".
	b) A correction factor for the hybrid average revenue control should allow for inaccuracies in setting the level of prices based on forecasting errors and result in lighter touch regulation. A correction factor for the simplified approach with flexibility should do likewise for restructuring prices.

	c) The RPI subcaps on every weight step of every product be removed or relaxed to at least RPI+5. Royal Mail should also be able to apply for tariff restructurings under a clearly defined ex post revenue neutrality rule.
	d) Royal Mail should be provided some protection against volume risk through an automatic hybrid or trigger mechanism that allows Royal Mail to increase prices to recover 60% of lost revenues when revenues fall below 98% of Plan revenues. The licence should also be modified to include clause that allows Royal Mail to increase prices in the event of cost shocks outside its control (including legislative and tax changes, such as NI changes) and allows sufficient allowed revenue to ensure financial viability with the introduction of third-party network access.
3. Form	RPIX (which excludes the impact of changes in the mortgage rate) should be used to remove uncertainty
4. Duration	The control should commence on 1 April 2003 and terminate on 31 March 2006. Postcomm should commit publicly that Royal Mail will be able to retain the benefit of all ongoing efficiency savings made in the last year of the current (short) control in the next control period.
5. Level	a) The level of the revised price control should allow for an immediate emergency increase of over 3% in regulated revenues, representing £170 million per year in nominal terms (equivalent to 1p on both the First and Second Class basic weight step products) plus the additional shortfall identified of £460 million. The level of control should also be set consistent with an allowed profit of at least £400 million on efficient costs
	b) The level of allowed revenue in the control should also be set consistent with an allowed profit of at least £400million and the consequential allowed operating/capital expenditure cost.
6. Standards of Service	a) A revised set of service reliability targets should be put in place to complement the price regulation. This should be based on the recommendation from Postwatch and Royal Mail of a package of measures, including increasing the target for First Class mail to 93% (from 92.5%) in 2005/06 and the postcode area targets to 91.5% in 2005/06 (from 90.5% at end March 2004 and 91% at end March 2005).
	b) Royal Mail has separately proposed alternative arrangements for compensation.
	c) There should be no direct link between the revenue earned from Royal Mail's services not covered by the bulk compensation scheme and Royal Mail's performance against its service reliability targets.

This price control is critical to the financial viability of Royal Mail and the ongoing provision of the universal service. It needs to take into account all of the major regulatory decisions Postcomm is currently considering, particularly the introduction of competition and the pricing of network access. Royal Mail looks forward to completely revised proposals from Postcomm that meet the needs of the industry