

**POSTCOMM'S PROPOSALS FOR PROMOTING EFFECTIVE  
COMPETITION IN UK POSTAL SERVICES: JANUARY 2002.  
RESPONSE BY CONSIGNIA PLC**

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**1. CONSIGNIA'S APPROACH TO COMPETITION**

- 1.1 Consignia believes in the principle of increased competition and supports the gradual and controlled approach to the introduction of competition, accepted across Europe, through progressive reduction in the weight and price limits of the reserved/licensed area.
- 1.2 Under this model the impact of each successive step in the process can be subjected to an assessment of the ability to maintain the Universal Service, before the next step is embarked upon. This approach is acclaimed across Europe and was supported by the UK Government at the Council of Ministers in Autumn 2001. Consignia considers this is the appropriate model for the UK too.
- 1.3 This is particularly relevant to the UK where Government has determined that achievement of essential social obligations e.g. universal service and uniform tariff structure should override the introduction of a fully competitive market.
- 1.4 Consignia believes that competition provides a powerful spur to drive performance, it will lead to innovation, increased customer focus and sustained performance improvement in the eyes of all stakeholders. The key issues for Consignia are the route taken to introduce competition and the pace at which it is introduced.
- 1.5 Consignia believes that its success as a commercial business will depend on providing competitive services at attractive prices supported by a best in class infrastructure delivered by excellent people. It will do this alongside the delivery of essential social obligations – the universal service within a uniform tariff structure. Consignia has demanding plans in place that achieve this successful future – unfortunately it does not have a magic wand to make them happen overnight.

- 1.6 In a competitive market, over time, prices will need to become more cost reflective. Consignia will therefore need the commercial freedom to be able to rebalance its prices as happens in other sectors. Postcomm needs to be explicit in this area with a clear statement of its expectation, so that all parties, operators and end users, can meaningfully contribute to the debate on an informed basis.
- 1.7 Consignia fully accepts that it has an important role in developing competition in the UK by allowing other operators access to its networks. The Postcomm proposals are though silent on the important question of the appropriate basis of access prices. Clarity on this issue is absolutely essential, both so that other operators can plan future business models confidently, but also, essentially, to establish principles to ensure the financing of the Universal Service is safeguarded.
- 1.8 Consignia believes, in line with the principle set out in the draft Postal Services Directive, supported by the EU Commission, all Postal Operators and all Member States governments, as well as by authorities in postal economics, that access prices should be set on the basis of standard public tariffs less the savings made in the long run by Consignia no longer having to supply the service elements being provided by the other licensed operator. In this way only efficient entry is stimulated into the market, the financing of the Universal Service is assured and the principle of the Uniform tariff structure is guaranteed.
- 1.9 As a business Consignia is already keenly aware that customers already have numerous choices on how they communicate. As individuals we now have almost instantaneous written communication through e-mail, and the SMS capability of mobile phones is now a real force being used to keep people in touch with each other. For businesses the same alternatives exist and we are seeing that routine business to business communications and transactions are rapidly going electronic. For example, Consignia's role in supporting its customers' communications with their customers and potential customers brings Consignia's direct mail products into head to head competition with advertising through TV and radio broadcasters, magazines, newspapers and street posters.

Consignia already sees itself firmly in the competitive world and having to change.

- 1.10 The issue now is the manner, extent and pace that competitors should be allowed to enter the part of the communication and distribution market that has traditionally been protected.
- 1.11 It is less than a year since Consignia was established as a PLC, still 100% owned by Government, with its own industry regulator – Postcomm and consumer watchdog – Postwatch. Consignia's strategic plan for the next five years is currently being finalised for agreement with Government and has been based on the regulatory assumption that liberalisation will follow the agreed European path with additional, niche licensing. This plan deals with an increasingly uncertain future with the challenge of increasing e-substitution combined with the urgent need to regain customer confidence and return to profitability and cash neutrality.
- 1.12 Consignia has developed a number of transformational change programmes that are ambitious in scope, extensive in impact and enormously demanding on the stakeholders within our business. They are of a scale that it is unprecedented in Consignia's history.
- 1.13 Postcomm's overriding duty is to ensure the provision of a universal postal service. To minimise the risk to the universal service, competition must be introduced into the postal sector in a gradual and controlled way. Indeed this is a requirement of the 1997 European Postal Directive. It has been accepted at the European level that the best way to achieve this end is a carefully phased reduction in the weight and price limits of the reserved area.
- 1.14 An amendment to the 1997 Directive has been adopted by the European Commission, endorsed by the Telecommunications Council on which the Department of Trade and Industry sits, and has recently been agreed by the European Parliament. This Directive determines a timetabled reduction in weight and price limits for the reserved area. Specifically, that the weight limits for postal monopolies across all EU Member States should be no higher than

100gms after Jan 2003 and no higher than 50gms after Jan 2006.

- 1.15 This new Directive provides for a substantial further step in 2009 but leaves open whether or not this should be full liberalisation subject to a review of the postal sector to take place across the European Union. A decision will then be made on the next step on European wide liberalisation of postal services following a co-decision procedure involving the European Commission, the Telecommunications Council and the European Parliament. No decision has been made at the European level on the liberalisation of postal service beyond the reduction in the weight limit to 50gms in 2006. The Government, through its participation in the Telecommunications Council decision, has endorsed this position.
- 1.16 The present legal framework already allows for the issuing of “defined activity licences”. These, however, have to satisfy two tests, following guidelines issued by the European Court of Justice. Such licensed services should be distinct (i.e. dissociable) from the universal service and should not put in jeopardy the financial viability of the universal postal service.
- 1.17 In Consignia’s view<sup>1</sup> the approach adopted across Europe is the best way to proceed in that it permits increased competition, will provide ongoing assurances for the preservation of the universal service at a uniform tariff and also provides for a harmonised approach across Europe, thereby allowing reciprocal arrangements to be established

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<sup>1</sup> See Promoting Effective Competition in UK Postal Services, CRI, Proceedings 29

for competition between operators from different Member States.

- 1.18 These steps will already result in a substantial loss of profit by Consignia. Introducing competition into the UK postal market using a different approach will substantially increase the risks to universal service as well as placing the UK out of step with the other European Member States.

## **2. EXECUTIVE SUMMARY**

- 2.1 This document responds to Postcomm's Proposals for Promoting Effective Competition in UK Postal Services, published at the end of January 2002.

### **Commitment to the Maintenance of the Universal Postal Service**

- 2.2 The National Audit Office has recently pointed out<sup>2</sup> that there are risks in introducing competition, which could result in a breakdown in the delivery of a universal service at an affordable uniform price. Postcomm's overriding duty is to act in the manner which it considers best calculated to ensure the continued provision of a universal service (which includes the provision of postal services at an affordable and geographically uniform price).

### **Postcomm's Financial Analysis**

- 2.3 Postcomm has used financial analysis to argue that they can liberalise the market fully and meet the universal service obligation but this analysis has not been subject to the scrutiny which can provide assurance that the risk to universal service has been adequately addressed. The data that has been released suggests that this risk may have been seriously underestimated. Neither has Postcomm explained the consequences of their proposals on prices.
- 2.4 In particular, Postcomm admits that its financial analysis is based on an assumption about the extent to which competition will enter the parts of Consignia's market opened to competition. The proportion of the market that will be opened to competition by Postcomm's proposals is significantly underestimated. Further analysis during the consultation period has shown that the extent of the market that will be opened to competition immediately exceeds 50% by volume.

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<sup>2</sup> Opening the Post; Postcomm and postal services – the risks and opportunities. Report by the Comptroller and Auditor General, 24 January 2002.

## **The Pace of Liberalisation**

2.5 Postcomm sees full liberalisation taking place in 2006. In fact, there will be full liberalisation in 2004 - in the sense that their proposals would enable any mailer to find an alternative end to end letter delivery service from that time if the planned review of the restrictions in Large Mailing licences preventing them from accepting consolidated mail were relaxed. This is two years earlier than Postcomm's own planned schedule and five years ahead of the EU's timetable for change.

## **Financial Impact of Postcomm's Proposals**

- 2.6 Postcomm's proposals, if implemented, will reduce Consignia's profits (Earnings Before Interest and Tax) significantly, in the medium term, making continued provision of the universal service in its present form impossible. Consignia has already incorporated into its plans a profit reduction of more than £500m pa by 2006 from the impact of European liberalisation and the continuation of "defined activity" licences. Postcomm has been separately provided with information which shows that their proposals will increase this challenge by over £250m.<sup>3</sup> This profit will be creamed off by postal operators that have no obligation to provide a universal service throughout the UK.
- 2.7 In their financial analysis Andersen calculates an NPV of Consignia at £11.6bn which is too high and gives too great a weight to profits over the very long term. Postcomm also take inadequate account of very significant risks from outside developments such as labour market pressures and the threat to mail volumes from e- substitution.
- 2.8 Andersen makes an 'arbitrary' assumption that 20% of each product group will switch to entrants. However, Andersen and Postcomm provide no evidence to support this. Andersen's assessment is incomplete in that it does not include estimates of the financial impact of upstream liberalisation, 'defined activity' licences and existing licences

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<sup>3</sup> These estimates assume that access pricing is based on the avoided cost approach required by the draft EU Directive. An approach to pricing access based on a lower access price would give rise to a significantly greater profit impact.

and has understated the impact of Postcomm's proposals for bulk mail liberalisation by underestimating mailings above its 4,000 item threshold.

- 2.9 It will not be possible to include meaningful estimates of the financial impact of upstream liberalisation until finalisation of the access price to Consignia's network which is due later in 2002.
- 2.10 Consignia has developed alternative base cases allowing for the prospects for volume decline over the longer term. The combined financial impact of these cases and Postcomm's proposals for liberalisation lead to NPVs for Consignia which are well below Postcomm's threshold value.
- 2.11 Postcomm has separately issued a consultation document on price control<sup>4</sup>. Postcomm link their competition proposals to the price control review for they see this as their key policy lever. It is important that Postcomm's price control review takes account fully of the effect of competition and its own assertion that this policy lever can be used to ensure the financial viability of Consignia to deliver universal postal service at a uniform affordable tariff. Postcomm has not said how big an increase in price they believe may be necessary to continue to provide financial viability for the universal service nor have they yet formulated a price control structure which takes due account of volume risk to this viability.
- 2.12 Postcomm has failed, therefore, to address adequately the possible financial consequences of their proposals on everyday consumers of mail services, which is material to their general statements about competition benefiting consumers. Whether the price control mechanism, can, under full liberalisation, ensure the financial viability of the universal service depends on the effectiveness of price increases in raising revenue with significant entry. Andersen assumes that the responsiveness of demand to price changes (price elasticities) is unchanged in a fully liberalised market. However, as competition increases demand will become more price responsive and price increases less capable of increasing revenue.

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<sup>4</sup> Price Control Review for Consignia plc, November 2001, A Consultation Document.

2.13 Postcomm's price control policy lever could produce higher prices to many more consumers than it is prepared to acknowledge in its proposals document and could also provide insufficient revenue to meet Postcomm's 'threshold value' test for Consignia. Even if the overall price elasticity of demand for Consignia's services were to remain unaffected by competition price increases of at least 5% per annum would be required to secure the threshold value of NPV. A modest increase in the price elasticity would lead to a need to increase prices by 6% to 8% per annum. Price increases in the region of 10% per annum may be necessary. If the postal market becomes highly competitive, which is Postcomm's intention, price increases alone would be insufficient to ensure financial viability. Additional, policy instruments would be required, for example, greater price differentiation, reducing the service specification, taxing entrants, or maintaining the reserved area.

### **Future of the Universal Service**

2.14 Postcomm state that they will be consulting on the extent of the universal service later in the year. They have got the process the wrong way around. The restrictions on competition are designed to protect the universal service. Whereas they are proposing to introduce competition and then decide what the universal service should be. If competition bites harder than they expect Postcomm's only response, other than allowing an increase in the price to consumers, is to reduce the scope of the universal service so that they can continue to say that it is not in jeopardy. This is not in the interests of users.

### **Evidence from International Experiences**

2.15 Precedents overseas do not support Postcomm's arguments on the viability of the universal service with full market liberalisation. Sweden is often quoted as an example of how it is possible for a commercial postal operator to continue to provide a universal postal service in a fully liberalised postal market. However, should liberalisation have an impact on letter prices in the UK similar to that in Sweden, then, discounting for the imposition of VAT – which has been

applied to postal services in Sweden since liberalisation, in the interests of creating a level playing field –the First Class price of 27p would rise to more than 33p.

- 2.16 If VAT were to be introduced at 17.5% the First Class price would rise to 39p. Full liberalisation of postal services may have to lead to the introduction of VAT, as in Sweden, in order allow competition to occur on a fair basis. Postcomm has not indicated how high they see the consumer price having to increase to preserve the universal service although they have made an assumption about this in their analysis of some of the possible outcomes of their liberalisation proposals.

### **New Entrants offer no Guarantee for the Universal Service**

- 2.17 Postcomm is proposing to open up the UK postal market to major international players, which have large financial resources protected by domestic monopolies, such as TPG and DPWN. They will be able to enter and take a substantial foothold in the UK market without reciprocal opportunities being made available to Consignia in their markets.

### **The Consultation Process**

- 2.18 Postcomm originally allowed a wholly insufficient period of six weeks for substantive representations on its proposals particularly given that key information requested from Postcomm has not been provided on a timely basis.
- 2.19 Consignia believes that this process is being undertaken with undue haste and that even with the additional period allowed for responses it does not reflect the best interests of its considerable number of stakeholders.

### **Postcomm's confidence is misplaced**

- 2.20 Postcomm's confidence in the benefits arising from a rapid and unprecedented opening up of the market is misplaced, especially as it readily admits that once liberalisation has been achieved EU competition policy would preclude any return to pre-existing market conditions, however chaotic and unsatisfactory the resulting situation might be. Postcomm

also argue that the risk should be borne by the “shareholder”. Since Consignia is a plc which is 100% owned by the Government, the costs of failure would be borne by the taxpayer in the form of an indefinite subsidy to ensure the continued provision of a universal service at a uniform and affordable price. Such a subsidy would be uncertain in extent and duration and dependent fundamentally on Postcomm’s handling of the price control review. Postcomm has a duty to ensure that any licensee is able to finance activities authorised or required by their licences without recourse to public funds.

### 3. The Wider Context of Consultation

- 3.1 This document is a response by Consignia to Postcomm's Proposals for Promoting Effective Competition in UK Postal Services, published at the end of January 2002. Only six weeks were originally allowed for representations on the proposals. Six weeks is not sufficient to respond substantively to this report given that key information has not been provided on a timely basis by Postcomm. Postcomm's own procedures document sets a minimum consultation period of 8 to 12 weeks for complex issues.
- 3.2 Postcomm state in their proposals document that their primary duty is to act in such a way as to ensure the continued provision of a universal service at an affordable and geographically uniform price. In fact, the duty is an overriding or paramount duty rather than a primary duty. Postcomm's other statutory duties can only be carried out subject to the duty to "exercise its functions in the manner which it considers is best calculated to ensure the provision of a universal postal service"<sup>5</sup>. Postcomm, on the other hand, does not have a "duty" to promote effective competition. It is only required to "exercise its functions in the manner which it considers is best calculated to further the interests of postal users, *wherever appropriate* by promoting effective competition between postal operators." The phrase "wherever appropriate" has been italicised in this quotation from the Act since it has been translated in the proposals document into "*wherever possible*" (for example, in paragraph 1.3). This is a misinterpretation from which Postcomm derives its need to strike a balance between its "primary duty" to ensure customers continue to enjoy a universal service and its "other key duty" of furthering the interests of users of postal services wherever possible by promoting effective competition. There is no question of balancing the two duties. It is clearly stated in the Act that the duty to further the interests of users of postal services is strictly subordinate to the universal postal service duty. Additionally the Act only provides that the promotion of effective competition between postal operators is merely a

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<sup>5</sup> Postal Services Act, 2000, part 1, section 3.

means by which Postcomm might further the interests of users but only “wherever appropriate”.

- 3.3 Postcomm dismisses any claims that the universal service might present an impediment to the benefits of competition, arguing that competition itself will be sufficient protection. Nowhere is any evidence provided to support this claim. In fact at no less than 50 places in the text beliefs, claims and assertions are made about how Postcomm sees the postal market evolving after liberalisation without supporting evidence being supplied. Nevertheless, Postcomm has sufficient confidence in its beliefs that it is proposing a rapid opening up of the market to an extent, at a pace and in a manner which is unprecedented.
- 3.4 Postcomm also admit that once the postal market is liberalised it will not be possible to rewind and put the clock back. Under EU competition policy it is not possible to “remonopolise” competitive activities. Once liberalised, however chaotic and unsatisfactory the resulting situation might be, it will not be possible to ensure universal service by partially restricting competition.
- 3.5 Moreover, Postcomm states that its vision is of, “a range of reliable innovative and efficient postal services, including a universal postal service, valued by customers and delivered through a competitive postal market” (para 3.7). But, also that this vision, “will be dependent on Consignia successfully improving its performance”, (para 3.8), this despite the UK postal customer already benefiting from amongst the lowest postal prices throughout Europe. Whilst Postcomm may have a vision, its paramount *duty* set out in legislation requires an approach that ensures the provision of a universal postal service and not be dependent on the actions of a third party (Consignia).
- 3.6 The National Audit Office has pointed out that there are risks in introducing competition, which could result in a breakdown in the delivery of a universal service at a reasonable uniform price. Postcomm have not demonstrated that they have undertaken sufficiently robust financial and market analysis to ensure that this risk has been adequately addressed. Postcomm also argue that the risk should be borne by the

“shareholder”. Since Consignia is a plc which is 100% owned by the Government, the costs of failure would be borne by the taxpayer in the form of an indefinite subsidy to ensure the continued provision of a universal service at a uniform and affordable price. Such a subsidy would be uncertain in extent and duration and dependent fundamentally on Postcomm’s handling of the price control review. Postcomm has a duty to ensure that any licensee is able to finance activities authorised or required by their licences and not be dependent on subsidy.

#### **4. Postcomms' Proposals.**

- 4.1 Postcomm describes a three phase approach to the introduction of competition based on the issuing of licences of three different kinds: large mailing licences, consolidation licences and defined activity licences.
- 4.2 In Phase I (originally April of this year until March 2004) large mailing licences will be granted to allow competitors to deliver mailings from customers where the individual mailing exceeds 4000 items, and consolidators will only be able to give their consolidated mailings to Consignia to deliver. Postcomm do not say whether a single operator would be able to hold both a consolidator and a large mailing licence at the same time. In Phase II (April 2004 until March 2006) the threshold mailing size that will enable a competitor to deliver the mailing will be reduced to below 1000 items and consolidators may be permitted to use other operators than Consignia to deliver their mail.
- 4.3 In April 2006, the market will be "fully liberalised" through "light touch" regulation. Postcomm states that approximately 30% of the market by value and 40% by volume will be open to competition in 2002 and two thirds in 2004, followed by full liberalisation in 2006. In fact on the basis of Postcomm's detailed proposals more than one half of the market, measured by volume, will be open to competition immediately (in Phase I) and the market will be fully open in April 2004 in the sense that their proposals would enable any mailer to find an alternative end to end letter delivery service if the planned review of the restrictions in Large Mailing licences preventing them from accepting consolidated mail were relaxed.

#### **In Phase I:**

- 4.4 In estimating the scope of large mailing licences, Postcomm have used the volumes of mail that make use of Consignia's "bulk" customer workshare mail products where the entry requirement is a minimum of 4,000 items (Mail sort 120, Mail sort 1400, Mail sort 700, Flatsort 3 and Walksort). However, this substantially underestimates the amount of mail that is or could be mailed in volumes exceeding 4000

items. Firstly, many companies mail large volumes without accessing the workshare products listed. Such mailings will pay the full public tariff but through a contractual arrangement (known as Standard Tariff Letters (STL)). Secondly, mailings for the standard workshare contracts all have to be of the same class (first or second). Many companies mail large quantities of mail on a daily basis which are a mixture of classes, some of which will currently be paid for, for example, by postage meters as well as STL arrangements.

- 4.5 Including STL items in the estimates increases the volumes exposed to competition in Phase I to 52%, and increases the exposed revenue to 41% (c. £2 billions). Similar, considerations apply to the other volume thresholds listed in Table 6.1 of the Postcomm paper. During the course of their consultation period Consignia has undertaken a special exercise to identify the full extent to which postings exceeding 4000 items are made and supplementary information has been provided to Postcomm. A corrected version of this table is listed here (the figures in brackets are Postcomm's figures taken from Table 6.1):

<b>Number of items in single mailing</b>	<b>Market opening as a % of inland letter volumes 2000/01</b>	<b>Market opening as a % of inland letter revenue 2000/01</b>
10,000	44 (7)	34 (4)
4,000	52 (40)	41 (29)
2,000	53 (42)	43 (30)
1,000	55 (42)	45 (30)

- 4.6 Secondly, Postcomm have not included in their assessment the market share loss or the loss of revenues due to the other licensed activities: consolidation licences and defined activity licences. The volume and revenue losses due to defined activity licences clearly cannot be assessed precisely by Consignia because there is as yet no understanding of the kinds of licences which will be sought and granted. The impact of consolidation licences would depend very

significantly on the access price. Postcomm give no indication in their paper of what position they will take on the access price but they say in a number of places that they will use constraints on Consignia's pricing as an enabler to allow competition to become established. It must be the intention, therefore, to encourage substantial competitive entry through access, an approach which is supported by respondents to the previous consultation papers such as the DMA and MUA, but this has not been taken into account by Postcomm in the assessment of the proportion of the Consignia revenues which will be open to competition.

### **In Phase II:**

- 4.7 It is stated in the competition proposals paper that the volume threshold for large mailings will be reduced to a figure between 500 and 1000 items and that this level will be adjusted in order that a further 30% of the market by revenue will be opened to competition. It is also proposed to review the restrictions on Large Mailing licences to allow holders of consolidator licences to hand their mail over to large mailer licence holders for delivery by the recipient. This means that any mailer, with as little as a single item to post, would, in principle, have an alternative to using the Consignia network – they would be able to hand their mail to a consolidator who would then be able to consolidate this mail with that of others and pass it on to an operator with a large mailing licence to deliver.
- 4.8 The holders of large mailing licences would be able to use consolidators as sub-contractors to collect mail from smaller mailers to be amalgamated into their mailings from large posters so that they would be offering a full alternative postal service. Consequently, no matter to what level the threshold is reduced, with the relaxation of the condition which prevents consolidators passing their mail to large mailer licence holders proposed for Phase I, in Phase II there would be an alternative provider for every mailer and therefore 100% of the market would be liberalised; not the 60% that Postcomm have expressly intended. The result is that the market would be fully liberalised two years in advance of the schedule which Postcomm have themselves specified.

## In Phase III:

4.9 Postcomm proposes that the market should be fully liberalised by 31st March 2006 at the latest but that a review of the timing of the end date should take place during Phase II with a view to bringing it forward. It has been pointed out that the proposals for Phase II, may create a *de facto* fully liberalised market from April 2004. The new European Postal Directive, about to be ratified, contains an Article which requires the European Commission to prepare a study which will assess, for each Member State, the impact on universal service of a further opening of the postal market beyond that already agreed at the European level. This will include an assessment of the impact on universal service of full market opening. The European Commission is required to complete this study and submit proposals to the European Parliament and the Council by the 31<sup>st</sup> December 2006. It would be prudent for Postcomm to delay any decision on a further opening of the postal market in the UK until the results of this exercise are known.

4.10 The Postcomm proposals will lead to a fragmentation of the postal market with a vast set of complex and expensive contractual arrangements between companies being set up. This will:

- lead to confusion on the part of customers when seeking recompense or alternative arrangements in the case of service failures (In the case of misdeliveries or “gone-aways”, for example, it will no longer be possible to simply readdress a letter and place in a letter box in the expectation that the letter will reach its intended recipient).
- substantially increase overall industry costs. This will arise from two sources (a) The need to provide for facilities to provide information and answer customer queries as a result of the complexity of the new arrangements (call volumes rose by some 40% in the regulated energy industry as a direct result of the introduction of competition and an initial estimate of the cost to Consignia of a similar rise in workload over two years is in the region of £50m) and (b) the additional

facilities required at the handover between different operators when “consolidators” hand mail to “deliverers” to deliver. Elements of increased cost of this kind are: revenue protection costs, costs of handover procedures to ensure service quality and customer complaint handling costs.

- 4.11 Finally, Postcomm has not factored in to their calculations the loss of volume and revenue which will occur in any case from the competition which will result from the European wide liberalisation proposals soon to be finally ratified.

## **5. Financial Estimates**

- 5.1 Postcomm's proposals document is underpinned by the financial analysis prepared by Andersen. In brief, Postcomm's case is that the market can be liberalised in full by 1 April 2006 because the risk that Consignia will no longer be financially viable in this situation, whilst continuing to provide a universal service at a uniform and affordable tariff, is very small.
- 5.2 Andersen's modelling is the basis for Postcomm's assessment. It is stated in section A1.14 of Postcomm's document that "Consignia has indicated that it considers Andersen's modelling approach to be sound and the Base Case (before competition) modelled by Andersen to be a reasonable representation [of] its business, subject to some specific comments set out in Andersen's report".
- 5.3 In fact, Consignia made clear to Postcomm that, as an accounting model, the model prepared by Andersen appeared sound from a provisional review. This is separate to the modelling of liberalisation effects. No conclusions regarding Postcomm's general approach to modelling liberalisation scenarios or the results produced by it were provided to Postcomm by Consignia.
- 5.4 Various assumptions are made to generate liberalisation impacts, most notably the assumption that entry occurs evenly across all products. The NPV of the business is calculated under that set of proposals. Consignia is assumed to maintain the same set of services and the uniform tariff. The NPVs for a number of sensitivities to the Base Case liberalisation estimates are reported also in Table A1-3 of the proposals document.
- 5.5 The only sensitivities reported are estimates for downsides for efficiency and that Postcomm has an effective 'policy lever' of easing its, still to be developed and agreed, price control framework. The conclusion drawn is that even in alleged "worst case" scenarios, the NPV is either above or sufficiently close to the threshold value of £2.2bn. Consequently, Postcomm suggests that there is a comfort

margin in Postcomm's proposals and only a small risk of Consignia failing to be financially viable.

5.6 It is important and indeed fundamental that Andersen's analysis and its conclusions are fully tested as part of the consultation process on Postcomm's proposals. There are a number of significant areas that should be examined and financial modelling undertaken in order to perform this process to a level capable of giving assurance to the public. These areas include,;

- Andersen has underestimated the effect of cream skimming. They do not use the main outputs from Consignia's Entry Pricing (EP) model, which indicates relatively greater entry on more profitable routes and where they refer to Entry Pricing output it is only a partial application of the model's results.
- As indicated above Postcomm has underestimated the market share that is liberalised by the proposed bulk mailing licences. It is likely that full application of the EP results and the use of the correct market share would produce a significantly larger impact on NPVs than those reported by Andersen.
- Andersen has not been able to provide any estimates of the financial impact of downstream access and defined activity licences. They will not be in a position to confirm estimates of the financial impact of this until the finalisation of the access price due later in 2002 and Andersen's state they have not done modeling work on consolidation licences because of this. Since Postcomm has no financial assessment and identification of risk this fails their own test of justifying their proposal on consolidation licences. They should defer issuing these until they have assessed the risk.
- Postcomm have not put to external test and scrutiny the effectiveness of their policy levers. Their claim in Section A1.31 of the document that their policy lever (here, the price control and allowing Consignia to raise prices) can significantly increase NPV is fundamental to their argument but has not been subject to scrutiny. Given this

very explicit claim that they have policy levers to ensure financial viability, Postcomm have not provided any information about the price control, which is the subject of a separate on-going process, nor what provisions in the control will tackle these issues. However, it seems unlikely that the necessary improvement in Consignia's finances through the use of the price control mechanism could be achieved without a significant increase in at least some prices akin to the experience in Sweden.

- Other key assumptions in Andersen's modelling are long term traffic growth and wage inflation. The robustness of the results to these key assumptions, acknowledging more clearly the e-substitution risk, should have been undertaken and included in the assessment of the financial risk of Postcomm's proposals.

5.7 A critique of Andersen's work is provided in Appendix 1 to this report. In summary, Andersen projects the level of NPV of the free cash flows (FCFs) of Consignia at £11.6bn. This is based on a rising profile of FCFs to £1.3bn in 2010/11 which is then assumed to continue at that annual level in perpetuity. This NPV is too high and gives too great a weight to profits over the very long term, which become increasingly and highly uncertain, and too little to short to medium term circumstances.

5.8 Postcomm asserts that the main risks to Consignia's financial viability are those surrounding efficiency. However, there are very significant risks from outside developments including labour market pressures and the threat to mail volumes from e- substitution Postcomm largely ignores risks other than those linked to efficiency. Under Postcomm's 'no competition' cases these risks can be handled through the use of 'policy levers'. Postcomm emphasises the use of the price control framework for this purpose, allowing postal prices to rise.

5.9 Andersen do not attempt to model explicitly the effect of competition but rather make an 'arbitrary' assumption that 20% of each product group will switch to entrants. It then projects the financial impact on Consignia of this assumption using its financial model of Consignia.

- 5.10 However, Andersen and Postcomm provide no evidence to support this assumption and while Postcomm point to lower levels of entry than 20% in other countries the circumstances elsewhere are different to those Postcomm envisages in the UK. Andersen's assessment is incomplete in that it does not include estimates of the financial impact of upstream liberalisation, 'defined activity' licences and existing licences and has understated the impact of Postcomm's proposals for bulk mail liberalisation by not including PPI and meter mailings above its 4,000 item threshold. It will not be possible to include meaningful estimates of the financial impact of upstream liberalisation until finalisation of the access price to Consignia's network which is due later in 2002.
- 5.11 Using Andersen's base case and applying instead the results from Consignia's entry pricing model (after replication of part of Andersen's financial model) produces an NPV close to Postcomm's 'threshold value' for the business as a whole of about £2bn. This threshold value is used by Postcomm to benchmark an appropriate minimum NPV since below this, Postcomm explains, ".....Consignia would potentially maximise shareholder value by ceasing operations and selling the assets, rather than continuing operation". Consignia has developed alternative base cases. The combined financial impact of these cases and Postcomm's proposals for liberalisation lead to NPVs for Consignia which are well below Postcomm's threshold value. The main difference with Andersen's base case is in allowing for the prospects of volume decline over the longer term.
- 5.12 Whether under full liberalisation Postcomm's main policy lever, namely the price control mechanism, can meet its obligations to ensure the financial viability of the USO provider depends not only on the extent to which liberalisation pushes the NPV of Consignia below Postcomm's threshold value but also critically on the effectiveness of price to raise revenue in a fully liberalised environment with significant entry.
- 5.13 Andersen assumes that the responsiveness of demand to price changes (price elasticities) is unchanged in a fully liberalised market. However, as competition increases

demand will become more price responsive and price increases less capable of increasing revenue. If this change is significant, as it is likely to be, Postcomm's price control policy lever would produce higher prices to many more consumers than it is prepared to acknowledge in its proposals document and could also provide insufficient revenue to meet Postcomm's 'threshold value' test for Consignia.

- 5.14 Using the framework of Andersen's financial model, results are reported by Consignia which show that the extent to which prices need to rise and indeed whether such increases are capable of meeting the requirements for financial viability are sensitive to the price elasticities that emerge in a fully liberalised market.
- 5.15 On quite cautious assumptions applied to Andersen's modelling framework, price increases well in excess of the rate of inflation seem likely to be necessary for Consignia to achieve Postcomm's threshold value. Even if the overall price elasticity of demand for Consignia's services were to remain unaffected by competition price increases of at least 5% per annum would be required to secure the threshold value of NPV. A modest increase in the price elasticity would lead to a need to increase prices by 6% to 8% per annum. Price increases in the region of 10% per annum may be necessary.
- 5.16 If the postal market becomes highly competitive, which is Postcomm's intention, price increases alone would be insufficient to ensure financial viability. Additional policy instruments would be required, for example, greater price differentiation, reducing the service specification, taxing entrants, or maintaining the reserved area.
- 5.17 Postcomm is currently undertaking a price control review to come in to effect in April 2003. The relationship between the liberalisation of the postal market and the price control review is a fundamental one, not least because Postcomm views the price control as its main policy lever. Its significance is reinforced by Consignia's analysis using the framework of Andersen's financial model. It is important that Postcomm's price control review takes account fully of the

effect of competition and its own assertion, which Consignia's analysis challenges, that this policy lever can be used to ensure the financial viability of Consignia to deliver universal postal service at a uniform, affordable tariff.

- 5.18 Prior to the completion of its price control review, Postcomm has put forward its proposals for the introduction of effective competition. Consignia has tested these within the framework of Andersen's model to check that Postcomm's statutory obligations could be satisfied after liberalisation. Consignia has undertaken these tests in the same framework as that used by Postcomm but using alternative, reasonable and appropriate assumptions. Consignia has concluded that these tests are not satisfied and, consequently, that if these proposals are implemented Postcomm will be unable to meet its statutory obligations.

## 6. Protection of universal service

- 6.1 Postcomm is proposing to open up the UK postal market to major international players, which have large financial resources protected by statutory domestic monopolies, such as TPG and DPWN. These operators will be able to enter and take a substantial foothold in the UK market without reciprocal opportunities being made available to Consignia in their markets.
- 6.2 At the same time Postcomm recognises that Consignia is likely to remain the sole provider of the universal service in the UK for some time. To date none of the potential entrants to the market have shown any interest in providing universal service in the UK.
- 6.3 Since this is not the most profitable service (it being clearly more advantageous to “cream-skim”) and since it is clear from Postcomm’s scheme that no incentive or regulatory imperative will be used to encourage universal service by competitors, Postcomm can have no reason to suppose that alternative universal service providers will arise.
- 6.4 Alternative postal providers will not necessarily provide safeguards for the universal service, particularly if they pass to Consignia all mail destined for rural and other relatively non-profitable recipients as they will be able to do by demanding an access agreement with Consignia.
- 6.5 Postcomm’s consultation paper sets out their view as to how the universal service is to be maintained.
- 6.5.1 **Postcomm states that Consignia will become more efficient and innovative and therefore protect itself from competition and thus safeguard the universal service.**

This view does not appear to have any basis in calculation of the levels of efficiency Consignia could practicably achieve, nor indeed have the levels of efficiency Consignia currently has to achieve to return to profitability- even under the current regime - been assessed. Postcomm has not yet published any of the work of WS Atkins (work which has not been completed so far during the consultation period). This is

part of the separate consultation on price control the results of which will not be known until after Postcomm propose to make their decision on competition. We have announced plans to increase efficiency and Andersen's central view is in line with our targets.

Postcomm should be aware that there is a risk that these targets will not be achieved in full, with or without their proposals, and that with more rather than less competition they need to have policy levers in place to contain this financial risk. Postcomm does not explain how it will manage to achieve its primary duty if Consignia is unable to improve its performance to the very considerable extent now required by these proposals, which is without precedent.

#### **6.5.2 Postcomm believe that over time rival, universal service providers could emerge.**

Postcomm has not looked at the question of whether the establishment of simultaneous, rival networks is actually viable, and whether, if rival networks do emerge, there is a risk that the infrastructure would lead to the collapse of one, before it is fully replaceable by the other.

#### **6.5.3 Consignia may be allowed more commercial flexibility (principally in pricing) in its provision of the universal service. Flexibility will be increased as market share is lost.**

Since Consignia is dominant in the provision of many postal services and will remain so for some time, even if market share is lost in line with Postcomm's ambitions, Consignia will still be subject to the competition rules applicable to a dominant operator. The Postal Service Act and Consignia's licence also limit Consignia's freedom to price.

Pricing flexibility, which is sufficient to guarantee the finances to provide universal service, may not in fact be possible within the law. As has been said above, competitive pricing tends to increase prices substantially for consumers. It is for these reasons that exemptions from the competition rules, e.g. by allowing for the existence of a monopoly, have been

permitted for the providers of services of general economic interest.

#### **6.5.4 Possible external sources of funding can be used.**

These are of two kinds:

- **A Universal Service Support Fund contributed to by competitors in the licensed area.**

Postcomm do not believe that this is necessary in the short term and will keep it under review. Consignia, repeating a consensus view, has argued, in previous consultations, that the Compensation Fund approach is, in any case, impractical to operate in the postal sector.

- **Funding through general taxation. Postcomm express the view that the “risk” that the universal service cannot be financed after the liberalisation of the market should be borne by the “shareholder”.**

As the shareholder is the Government this means in effect the use of general taxation as a means of directly subsidising loss making universal services. It is very doubtful whether, even if the Government was willing to do this in a fully competitive environment, such state aid would be permitted, particularly as there is already an agreed structure for the support of universal postal services provided under the Postal Directive. Moreover, the duty to ensure the continued provision of a universal service is clearly Postcomm’s under the Postal Services Act. It is not open to Postcomm to pass this back to Government.

- 6.6 Postcomm propose that there should be review of the products and services which constitute the universal service. This consultation is to take place in Summer 2002. Postcomm express the view that their expectation is that the outcome of this review will be that the range of services that are considered as providing universal service will be “narrower” than at present. Fewer services would therefore be subject to the requirement for universal delivery and a geographically uniform tariff.

- 6.7 Postcomm are intending to consult on the extent of the universal service later in the year, that is *after* they have decided on the extent, manner and pace of the introduction of competition. The restrictions on competition are designed to protect the universal service whereas Postcomm are proposing to decide on the introduction of competition first and then decide what the universal service should be. If competition bites harder than expected, Postcomm's only response, other to increase prices to consumers, can be to reduce the scope of the universal service rather than restrict competition to ensure its continued provision.
- 6.8 In addition to the narrowing of the range of services and products which are designated as fulfilling the universal service the proposed consultation should also review other ways in which the current universal service provision exceeds the legal requirements laid down in the Postal Services Act and the European Directive
- 6.9 Postcomm also has the power to designate the addresses, which may not need to have a daily delivery due to remoteness or other access difficulties.

## 7. International Comparisons

- 7.1 There is a widespread but false perception, shared it would seem by Postcomm, that there has been extensive liberalisation of postal services across Europe and elsewhere around the globe. In fact there is very little experience of full postal liberalisation.
- 7.2 Many of the examples frequently quoted have not been liberalised to the extent proposed in this paper. Excluding the Argentinian Post Office from the analysis (since, although it is a liberalised postal market, the Post Office is not financially viable, and the whole Argentinian economy is in crisis) and the Finnish Post Office (the Finnish market is technically liberalised but due to a high “entry tax” for the Universal Service Support Fund no competitors have in fact emerged) there are only two examples of countries with fully liberalised postal markets which can be used as a source of evidence. These two countries are Sweden and New Zealand.
- 7.3 **Sweden** is often quoted as an example of how it is possible for a commercial postal operator to continue to provide a universal postal service in a fully liberalised postal market. However, there has been a 72% increase in the postal tariff in Sweden since liberalisation in 1993 – partly the result of the imposition of VAT. For business mailers in Sweden price changes pre and post liberalisation in Sweden varied substantially across the various types of mail but computer addressed mail prices fell by 43% in nominal terms between 1991 and 2000, versus a 60% increase in Office Mail prices over the same period<sup>6</sup>. For business mailers price cuts have averaged 20% and zonal pricing has been introduced. Should liberalisation have an impact on letter prices in the UK similar to that in Sweden, then, for instance, the First Class price of 27p would rise to 39p (33p excluding VAT). Sweden Post has had to resort to very aggressive pricing strategies to protect its viability and indeed there have been 100 cases of pricing abuse against SwedenPost reported to the regulators and Courts in Sweden.

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<sup>6</sup> Promoting Effective Competition in the UK, CRI, Proceedings 29.

7.4 Table 1 below show the price trends in Sweden and UK for comparison purposes.

Table 1

	Tariffs as of the end of the calendar year (20g)		
	(SEK) Sweden public tariff 1C	(UK pence) UK public tariff 1C	(UK pence) UK Public tariff 2C
1993	2.9	25	19
1994	3.2	25	19
1995	3.7	25	19
1996	3.85	26	20
1997	5	26	20
1998	5	26	20
1999	5	26	19
2000	5	27	19
2001	5	27	19
% change 93-01	72.4	8.0	0.0

Source: Consignia.

7.5 In very recent years SwedenPost has started to make operating losses, in part attributable to liberalisation. In comparison with the UK, quality of service in Sweden is high (95.6% for Jan-Jun 2001). However, the service specification is lower than in the UK: one delivery a day in Sweden with no deliveries or collections on Saturdays and one collection on Sunday. In the UK, in many areas currently there are two deliveries a day Monday to Friday and one on Saturday with collections both on Saturdays and Sundays at selected locations. In Sweden, delivery times range from 09:30 to 13:00 in urban areas and from 09:30 to 15:30 in rural areas.

7.6 The **New Zealand** postal market was liberalised in 1998. However, in New Zealand there is no sector regulator tasked with introducing competition and competition law there is very weak in comparisons with the provisions of the 1998 Competition Act and the Treaty of Rome. New Zealand Post has applied a very aggressive pricing strategy which has had the effect of leading to the withdrawal of some market entrants.

7.7 Postal markets that have been partially liberalised to a greater extent than is the current position in the UK, but to a lesser extent than the proposals in the competition paper, are The Netherlands, Germany, Spain and the United States.

- In **The Netherlands** there has been a 100 gm weight limit since 1998 (this is the weight threshold which will apply to all European member states from January 2003) and the delivery of printed paper is outside the Dutch monopoly. The Dutch Post Office (TPG) does not however allow access to the network or offer discounts for worksharing.
- In **Germany** a 200 gm weight limit applies to letter mail although direct mail can be delivered by competitors at weights down to 50 gms. The German regulator can also licence “fringe” activities in certain well defined ways. It was the original intention of the German Government to allow full liberalisation of postal services in 2003, however this legislation was revoked when it became clear that full liberalisation would not be taking place across the rest of Europe.
- In **Spain** neither direct mail nor local to local mail is reserved and private sector mail companies have existed for over 20 years. The market share of the Spanish post office (Correos Y Telegrafos) is approximately 80%. Postal prices in Spain are the lowest in Europe, but below cost. Recent developments in Spain have led to the removal of subsidies in line with other Spanish state owned companies and which are now being scrutinised for profitability. This will lead to prices rising to cover costs.
- In the **USA** a form of downstream access has been in operation for many years based on an access price determined by the costs saved for the USPS by the upstream consolidators. The USPS is not subject to the American anti-trust laws but its pricing is controlled by the US Postal Rate Commission. The Postal Rate Commission does not specify the level of revenue that the USPS is allowed to recover but only how the recovery of those revenues is allocated across the different classes of mail. The USPS has an absolute monopoly on the

delivery of items posted through letter boxes. The USPS was reporting significant financial problems before the events of September 11<sup>th</sup>.

- 7.8 The price of a stamp in the UK is amongst the cheapest in the developed world. Table 1 and Chart 1 in Appendix 2 show comparative prices at the lowest three weight steps across a number of countries.

**Consignia plc**  
**April 2002**

**Andersen's Assessment of the Financial Impact of Competition on Consignia: A Response by Consignia**

**A1.1 Summary**

**A1.1a Introduction**

A1.1.1 In its proposals document, Postcomm concludes that after it opens the UK postal market fully to competitors, Consignia will be able to continue to provide universal postal service at a uniform, affordable tariff and remain financially viable. These conclusions are underpinned by the results of the financial analysis undertaken for Postcomm by Andersen. Consignia has reviewed Andersen's analysis and concluded that it is ill-founded in a number of respects, which, when corrected for, lead to starkly different conclusions. Consignia concludes that Postcomm's proposals are contrary to its statutory obligations. The basis of this conclusion is summarised in section A1 and detailed in subsequent sections of Appendix 1.

A1.1.2 This is the first stage of Consignia's response to Andersen's analysis. Since Consignia received a copy of Andersen's full report (dated 5 March) from Postcomm only a few days before the end of the consultation period on 12 April it reserves the right to respond at a later stage on other aspects of Andersen's assessment and on the other consultants' reports summarised in Andersen's full report.

**A1.1b Background**

A1.1.3 Andersen has developed a financial model of Consignia and undertaken a free cash flow (FCF) analysis under a number of modelling assumptions and distinct cases and market liberalisation scenarios.

- For its base case prior to liberalisation, the FCFs are projected to 2010/11 and then the FCF in that year is assumed to continue in perpetuity. The

net present value (NPV) of these FCFs is £11.6bn.

- For its 'downside' case prior to liberalisation the 'base' case is amended to take account of lower levels of improvement in efficiency. This has the effect of reducing the NPV.
- In the event that the NPV falls below a threshold value, taken to be £2.2bn, 'policy levers' are applied, such as increasing prices, to ensure that the NPV of FCFs exceeds the threshold value and thereby maintain the financial viability of the company.

A1.1.4 This exercise is then repeated for the liberalisation proposed by Postcomm. One of the key results is the extent to which prices need to increase to retain financial viability. Andersen reports results which show that the application of policy levers, primarily allowing prices to rise at RPI rather than being frozen in nominal terms, allows the achievement of financial viability in nearly all of the cases it considered.

A1.1.5 This result is fundamental to Postcomm's stance on the effects of competition. Even in its worst-case scenario, Andersen's projections appear to provide comfort to Postcomm that it always has the price control at hand to allow financial viability to be secured. Hence, there is only an extremely small risk that Consignia will not be financially viable in meeting the universal service obligation of universal postal service at a uniform, affordable tariff. Postcomm's assessment is that it has policy levers, principally the price control, to ensure Consignia's financial viability although the corollary of this is that some consumers, at least, will face higher prices to fund the loss of profitability due to entrants coming into the market.

## **A1.1c Consignia's Response: Weaknesses in Andersen's Assessment**

- A1.1.6 Andersen's assessment of the financial impact of competition on Consignia is ill founded in a number of respects as summarised below.
- A1.1.7 For its base case prior to liberalisation, Andersen projects the NPV of the FCFs at £11.6bn. This is based on a rising profile of FCFs to £1.3bn in 2010/11 that is then assumed to continue at that annual level in perpetuity. The NPV calculation uses a discount factor that reflects Andersen's cost of capital estimate for a price control period of up to 5 years. Since the analysis extends in perpetuity, the forecasting errors and financial risks are significantly increased and this would be reflected in a higher cost of capital and discount factor. Andersen, therefore, overstates the base NPV against which to assess the impact of competition on Consignia's profitability and financial viability.
- A1.1.8 Postcomm asserts that the main risks to Consignia's financial viability are those surrounding efficiency and focuses on these almost entirely in Appendix 1 of its proposals document in its 'downside' cases. However, there are very significant risks from outside developments including labour market pressures and, in particular, the long term threat of declining mail volumes as a result of e-substitution. Similarly, the current financial position of Consignia is less robust than depicted in Andersen's base case. Postcomm largely ignores risks other than those linked to efficiency. Andersen, therefore, further overstates the base NPV against which to assess the impact of competition on Consignia's profitability.
- A1.1.9 Andersen does not attempt to model explicitly where and to what extent entry will occur and thereby capture the full impact of cream-skimming entry in the presence of Consignia's uniform tariff. It adopts in its central case an assumption provided to it by Postcomm, which Andersen describes as 'arbitrary', that 20% of

each product group will switch to entrants. It then projects the financial impact on Consignia of this assumption using its financial model of Consignia. However, Andersen and Postcomm provide no evidence to support this assumption for their central case which is, in fact, completely counter to evidence of cream-skimming entry in other countries and the licence applications it has received and while Postcomm point to lower levels of entry than 20% in other countries the circumstances elsewhere are different to those Postcomm envisages and proposes in the UK. Andersen, therefore, understates the impact of competition on Consignia's profitability.

- A1.1.10 Andersen's assessment is incomplete in that it does not include estimates of the financial impact of upstream liberalisation, 'defined activity' licences and existing licences and has understated the impact of Postcomm's proposals for bulk mail liberalisation by not including mailings above its 4,000 item threshold which include PPI and meter traffic. It will not be possible to include meaningful estimates of the financial impact of upstream liberalisation until Postcomm's determination of the access price to Consignia's network which is due later in 2002. Andersen, therefore, further understates the impact of competition on the profitability of Consignia.
- A1.1.11 Andersen assumes in the results it reports in the 'policy levers' cases that the responsiveness of demand to price changes (price elasticities) is unchanged in a fully liberalised market. However, as competition increases demand will become more price responsive and price increases less capable of increasing revenue. If this change is significant, as it is likely to be, Postcomm's price control policy lever would produce higher prices to many more consumers than it has prepared to acknowledge in its proposals document and could also provide insufficient revenue to meet Postcomm's 'threshold value' test for Consignia. Andersen, therefore, understates the extent to which prices will need to rise to offset the impact of a competition on the profitability of Consignia.

## **A1.1d Consignia's Response: Consignia's Assessment using Andersen's Framework**

- A1.1.12 Consignia presents its alternative assessment in the same form as that presented by Andersen. To do so Consignia has replicated parts of Andersen's model retaining as much data and assumptions as possible from that model. This enables the main issues and risks to be identified within the framework developed by Andersen for Postcomm with which Postcomm is familiar.
- A1.1.13 The correction for the discount factor reduces the NPV from £11.6bn to £5.1bn, which is further reduced to £1.4bn having amended the assumptions for efficiency, volume and real wage inflation. Consignia, therefore, has corrected for Andersen's overstatement of the base NPV against which to assess the impact of competition on Consignia's profitability and financial viability.
- A1.1.14 Applying the framework of Andersen's financial model and making use of reasonable and appropriate assumptions, price increases well in excess of the rate of inflation seem likely to be necessary for Consignia to achieve Postcomm's 'threshold value'. Consignia, therefore, estimates that significantly greater price increases than implied by Andersen's assessment are required to offset the impact on competition on Consignia's profitability.
- A1.1.15 Consignia estimates using the Andersen's financial model framework that under Postcomm's proposals, even if the overall price elasticity of demand for Consignia's inland mail services were to remain unaffected by competition (at the current estimate of about  $-0.2$ ), across-the-board increases of at least 5% per annum would be required in inland mail prices to secure the threshold value of NPV. If this elasticity were to increase modestly (in absolute terms) to about  $-0.5$  price increases of 6% to 8% per annum would be implied while at  $-0.8$  this increase would be in the region of 10% per annum. Consignia, therefore,

concludes that Postcomm's proposals imply the need for prices to rise at well above RPI inflation to offset the impact of competition on Consignia's profitability

- A1.1.16 If, as Postcomm proposes, the postal market becomes highly competitive and the price elasticity for Consignia's services rises clearly above  $-1$  (in absolute terms), even very significant price increases alone might become insufficient to secure financial viability. Price changes would then be only a partially effective policy lever. In such circumstances, Postcomm would require additional instruments to fund the financial deficit created by entry. Policy levers might include allowing greater price differentiation (subject to the obligation of uniform and affordable tariffs), reducing the service specification, taxing entrants (a compensation fund) or maintaining a reserved area. The latter approach is that being followed by the European Union (EU) and is supported by Consignia. Consignia, therefore, has identified the risk that price increases alone may be insufficient to offset the impact of competition on the profitability of Consignia.
- A1.1.17 In addition to the impact of Postcomm's proposals, Consignia also analyses the impact of the EU proposals for liberalisation which envisage a reduction in the weight limit to 100g on 1 January 2003 and to 50g on 1 January 2006. Consignia, therefore, has identified the extent to which Postcomm's proposals are likely to result in higher prices than those of the EU.
- A1.1.18 Consignia estimates that these price increases are significantly higher than those implied by the EU's proposals. The EU proposals suggest the need for across-the-board price increases of 3% or 4% per annum compared to the 6% to 8% plus case for Postcomm's proposals. Consignia, therefore, concludes that if Postcomm's proposals succeed in attracting a great degree of entry into the market, so implying a higher price elasticity, its proposals will result in average price increases for Consignia customers at least twice those under the EU's proposals.

**A1.1e      Consignia's Response: Assessment of Postcomm's Proposals**

A1.1.19      Postcomm is currently undertaking a price control review to come in to effect in April 2003. The relationship between the liberalisation of the postal market and the price control review is a fundamental one not least because Postcomm views the price control as its main policy lever. Its significance is reinforced by Consignia's analysis using the framework of Andersen's financial model. It is important that Postcomm's price control review takes account fully of the effect of competition and its own assertion, which Consignia's analysis challenges, that this policy lever can be used to ensure the financial viability of Consignia to deliver universal postal service at a uniform, affordable tariff.

A1.1.20      Prior to the completion of its price control review, Postcomm has put forward its proposals for the introduction of effective competition. Consignia has tested these within the framework of Andersen's model to check that Postcomm's statutory obligations could be satisfied after liberalisation. Consignia has undertaken these tests in the same framework as that used by Postcomm but using alternative reasonable and appropriate assumptions. Consignia has concluded that these tests are not satisfied and, consequently, that the proposals are contrary to Postcomm's statutory obligations.

## **Andersen's Assessment of the Financial Impact of Competition on Consignia: A Response by Consignia**

### **A1.2 Context**

A1.2.1 'Postcomm's Proposals for Promoting Effective Competition in UK Postal Services' was published by Postcomm on 31 January 2002 with a consultation period set by Postcomm to end on 15 March<sup>7</sup>. Underpinning Postcomm's document is an assessment of the impact of competition on Consignia prepared by Andersen, one of the consultants employed by Postcomm on this area of Postcomm's work. A summary of the main points from Andersen's assessment is reported at Appendix 1 of Postcomm's proposals document and further published detail is contained in a summary report written by Andersen<sup>8</sup>. The purpose of this current document is to provide Consignia's response to Andersen's assessment and it is part of Consignia's overall response to Postcomm's proposals document.

A1.2.2 Consignia requested that Postcomm provide certain pieces of information in preparing its response to Andersen's work. A formal request was made by Consignia on 1 February for a copy of the full report referred to by Andersen in its summary report. A further formal request was made on 6 February for the full report and detailed tables for nine of the 20 cases in table A.1-3 of Postcomm's proposals document. Previously Postcomm had provided some output, in hard copy, on 8 January prior to the publication of the proposals document on 31 January. However, that output was incomplete and provisional. Earlier requests for a copy of the electronic version of Andersen's model were rejected by Postcomm. One of the sets of tables was provided in hard copy on 11 February and the remaining eight sets, also in hard

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<sup>7</sup> 'Postcomm's Proposals for Promoting Effective Competition in UK Postal Services', Postal Services Commission, January 2002.

<sup>8</sup> 'Sensitivity Analysis of the Impact of Liberalisation on the Financial Performance of Consignia and its Business Segments: A Summary Report prepared on behalf of Postcomm', Andersen, 31 January 2002.

copy, on 28 February some two weeks before the end of the consultation period.

A1.2.3 Postcomm offered meetings between Andersen and Consignia so that Andersen could provide answers to questions from Consignia about Andersen's model and its use. One meeting was held on 8 March and Andersen's answers were direct and clear. At the meeting Andersen confirmed that they had prepared a full report for Postcomm on its work. Following Andersen's confirmation of a full report, Consignia made a further formal request to Postcomm on 15 March that it should be provided with a copy of Andersen's full report. On 2 April, after Postcomm had extended the consultation period from 15 March to 12 April, Postcomm provided Consignia with a copy of Andersen's full report<sup>9</sup>. The report is dated 5 March and is in two volumes. It details not only the key features of Andersen's work on the impact of liberalisation, which commenced in the Autumn of 2000, but also Andersen's interpretation and application of outputs from a number of other studies commissioned by Postcomm from other consultants during this period. This represents a substantial programme of work, the overall cost of which runs well into seven figures.

A1.2.4 The response below has made use of the information provided by Postcomm. In order to develop its response, and given the lack of the electronic version of Andersen's model, Consignia has replicated a part of that model and tested it against the detailed output on the nine cases. The purpose of this was twofold: to understand more fully the internal logic and impact of assumptions in Andersen's model and to allow alternative cases and scenarios to be run. Detailed work on replication of Andersen's financial model was only able to start after receipt from Postcomm of the main set of outputs from the model on 28 February. Parts of the model have not been replicated in full so

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<sup>9</sup> 'Sensitivity Analysis of the Impact of Liberalisation on the Financial Performance of Consignia and its Business Segments: a Report prepared on behalf of Postcomm.' Andersen, 5 March 2002. Two volumes: Vol.1 Report, Vol 2 Appendices.

that results prepared by Consignia may be somewhat approximate in some respects but still sufficiently well founded overall to allow the running of alternative scenarios. Andersen provided further information on the detailed treatment of specific parts of its model on 14 March.

A1.2.5 Consignia considers the issues raised by the proposals and its response to be of utmost importance. Consequently, it submits this part of its response in accordance with the closing date for the consultation period of 12 April. However, Consignia has had only a few days to respond to Andersen's full report and the studies which, in turn, underpin some of Andersen's own key assumptions. Of the studies cited there, Consignia has prepared a response on Frontier Economics' report for Postcomm on liberalisation which is used by Andersen and Postcomm to support their views on the links between liberalisation and efficiency<sup>10</sup>. This report by Frontier was placed on Postcomm's website at the end of January. However, there are a number of other studies as well as the full detail of Andersen's own report where the period for response, a few working days between 2 and 12 April, has been completely inadequate. Consignia reserves the right to respond at a later date on both the detail of Andersen's full report and these other studies. Since this situation is of Postcomm's own making, where no comment has been made to this material in Consignia's response for 12 April Postcomm cannot interpret the absence of comment at this stage as in anyway representing acceptance by Consignia of the output from these studies or the detail of Andersen's full report of 5 March.

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<sup>10</sup> 'The Impact of Liberalisation on Efficiency: A survey,' Frontier Economics, January 2002

A1.2.6 The structure of this part of Consignia's response on the proposals document is as follows:

- A1.3: background: overall summary of Postcomm's position based on Andersen's assessment;
- A1.4: given this, Consignia's overall approach in its response to Andersen's assessment;
- A1.5: Consignia's assessment of its financial position in the postal market environment prior to liberalisation;
- A1.6: Consignia's assessment of its financial position after liberalisation;
- A1.7: a comparison of the Andersen and Consignia assessments;
- A1.8: wider implications and conclusion.

**A1.3 Background: Overall Summary of Postcomm's Position based on Andersen's assessment.**

A1.3.1 From its stance in the proposals document Postcomm believes that after it opens the UK postal market fully to competitors, Consignia will be able to continue to both provide a universal postal service at a uniform, affordable tariff and remain financially viable. The basis for this position is the financial analysis undertaken for Postcomm by Andersen. The results Postcomm report from this work are set out in table A1.3 of its proposals document where they are expressed in the form of an index. For ease of reference, the main results from that table are reproduced in table A1.1 but re-expressed in billions of pounds.

A1.3.2 Andersen has developed a financial model and constructed a base case from data provided by Consignia and various assumptions. The starting point for its analysis is the base case with 'no competition' in the first column of table A1.1. Its financial model presents a year-by-year financial profile of Consignia up to 2010/11 and identifies the free cash flow (FCF) under these assumptions in each of these financial years. Thereafter, the FCF in 2010/11 is assumed to

continue in perpetuity. The FCFs are discounted back to April 2002 using a discount rate equivalent to a cost of capital of 8.7%. In Andersen's base case with no competition the NPV is £11.6bn. This is compared to a 'threshold value' which is used by Postcomm to benchmark an appropriate minimum NPV for below this, Postcomm explains, '.....Consignia would potentially maximise shareholder value by ceasing operations and selling the assets, rather than continuing operations'<sup>11</sup>. The NPV of Andersen's base case under no competition is well above this threshold value, reported by Andersen to be £2.2bn, and hence the report concludes that the business is financially viable and worth keeping open rather than closing down<sup>12</sup>.

Table A1.1

**Andersen's Estimates of Level of NPV for Consignia: Main Results  
(Discounted to April 2002 at 8.7%, £bn)**

	No Competition	Postcomm's Proposed Transition to Full Competition <sup>1</sup>
Base Case	11.6	7.7 (4.3) <sup>2</sup>
Combined "downside" from lower efficiency than Base <sup>3</sup>	-2.2	-6.0 (-10.1)
Combined downside plus 'policy levers' <sup>4</sup>	5.6	1.9 (-2.1)

Source: Postcomm proposals document Postcomm, page 106 re-expressed in £bns

1. Andersen do not provide financial estimates of the effects of upstream liberalisation, 'defined activity' and existing licences
2. Figures in brackets are a variant using some but not all outputs from Consignia's entry pricing model (EPM)
3. One-off efficiency of 5% in 2002/03 and annual efficiencies of 0% pa. thereafter (compared with 15% and 2.5% respectively in the Base Case). Andersen's full report contains more than one combined 'downside' case. The results above relate to that contained in Chapter 11 of Andersen's full report.
4. Primarily price increases as part of the price control mechanism with prices allowed to rise in line with RPI inflation over time.

**A1.3.3** If the postal market were not to be liberalised there would still be risks to the financial viability of Consignia. The only risk Postcomm addresses in its proposals document using Andersen's financial model is that of lower efficiency compared with the base; namely a one-off efficiency of 5% in 2002/03 (compared with

<sup>11</sup> Proposals document, page 100

<sup>12</sup> The 'threshold value' '.....reflects a market based value of Consignia's assets that are required for the on-going commercial operation of the business. This comprises principally the value of property and other tangible assets'. Andersen summary report p 6. Andersen report a rising threshold value over time as it projects growth in Consignia's business and hence asset base.

15% in the base) and annual efficiency improvement of 0% per annum (compared with 2.5% in the base)<sup>13</sup>. Under these circumstances, Andersen's model and assumptions produce an NPV of -£2.2bn implying that the business is not financially viable.

A1.3.4 As it explains in Appendix 1 of its proposals document, Postcomm has 'policy levers' which it can use to maintain the financial viability of Consignia. In particular, it can agree increases in prices via its price control framework and hence in the amount of revenue raised by Consignia. In the first column of table A1.1 with no competition prices of inland mail are allowed to rise in line with RPI inflation rather than be frozen in nominal terms<sup>14</sup>. This increases the projected NPV in Andersen's model from -£2.2bn to £5.6bn which is more than enough to satisfy the test used for financial viability. The conclusion Postcomm draws from these projections is that, if Consignia meets and follows the assumptions in Andersen's model, Consignia starts from a very strong base (£11.6bn of NPV) and even if efficiency improvements are low Postcomm can stabilise the financial situation of the business by very modest increases in prices.

A1.3.5 In contrast to the no competition case in the first column of table A1.1, the second column of table A1.1 sets out Andersen's projections of the financial impact of Postcomm liberalising the postal market in the manner set out in the main part of the proposals document. NPVs for these cases are reported on two bases: the main Postcomm assumption under which entrants take a 20% market share of each product opened up to entry with these losses being at the average revenues and costs of each individual product; and an alternative which uses some of the outputs from Consignia's entry pricing model (EPM). Applying these assumptions for the Andersen's base case, Andersen

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<sup>13</sup> In the information provided to Consignia annual efficiency for inland mail (the sector to be liberalised), international mail and parcels is 3.2% per annum in the Base Case and 0.7% in the 'downside'.

<sup>14</sup> Additionally, in this case Postcomm excludes the impact of overseas and non postal operations but the effect of this lever is much less than that arising from allowing prices to rise in line with RPI inflation.

project that full liberalisation still allows Consignia to be financially viable by some considerable margin (NPVs of £7.7bn and £4.3bn relative to the threshold value of £2.2bn). In the 'downside' case, which combines low efficiency improvements with full liberalisation, these NPVs become highly negative. However, by use of its policy levers (here, again, primarily allowing prices to rise at RPI rather than being frozen in nominal terms) financial viability is just about achieved in Postcomm's main case. The EPM variant is about £4bn short of the threshold value and would require prices to rise in real terms.

A1.3.6 The results of the last two cases are fundamental to Postcomm's stance on the effects of competition. Even in its worst-case scenario, Andersen's projections appear to provide comfort to Postcomm that it always has the price control at hand to allow financial viability to be secured. Hence, there is only an extremely small risk that Consignia will not be financially viable in meeting the universal service obligation of universal postal service at a uniform, affordable tariff. Postcomm's assessment is that it has policy levers, principally the price control, to ensure Consignia's financial viability although the corollary of this is that some consumers, at least, will face higher prices to fund the loss of profitability due to entrants coming into the market.

#### **A1.4 Overall Approach Followed in Consignia's Response to Andersen's Assessment**

A1.4.1 Consignia presents its response to Andersen's assessment in the same form as that presented in table A1.1. To do so, Consignia has replicated parts of Andersen's model retaining as much data and assumptions as possible from that model. This enables the main issues and risks to be identified within the framework developed by Andersen for Postcomm with which Postcomm is familiar<sup>15</sup>.

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<sup>15</sup> The data and assumptions used in Consignia's analysis do not represent Consignia's view of parameter values in respect of the current price control review for 2003. This is the subject of a separate consultation exercise by Postcomm.

A1.4.2 Consignia's response begins with issues relating to Andersen's 'base case, no competition'. It then develops an 'alternative base case 1' and an 'alternative base case 2' for Consignia in the pre-liberalisation environment and applies 'policy levers' to these cases. These issues are discussed in section A1.5. Section A1.6 then sets out Consignia's response with regard to Postcomm's assessment of the impact of competition and the use of policy levers in the post-liberalisation environment. For the analysis in sections A1.5 and A1.6, Consignia uses changes to key assumptions which it considers to be reasonable and appropriate for such an analysis.

A1.4.3 A comparison of the Andersen and Consignia assessments and a statement of wider implications are set out in sections A1.7 and A1.8. Consignia reaches conclusions which are much less sanguine about the scale of the risks from Postcomm's proposals on two main counts. The first is with regard to the continued provision of universal postal service at a uniform, affordable tariff and its financial viability even with the active use of policy levers; and the second is on the scale of price increases that would be in prospect for customers to fund the effect of entry on Consignia's profitability as a result of Postcomm's proposals.

## **A1.5 Consignia's Assessment of its Financial Position in the Postal Market Environment Pre-Liberalisation**

### **A1.5a Andersen's Base Case**

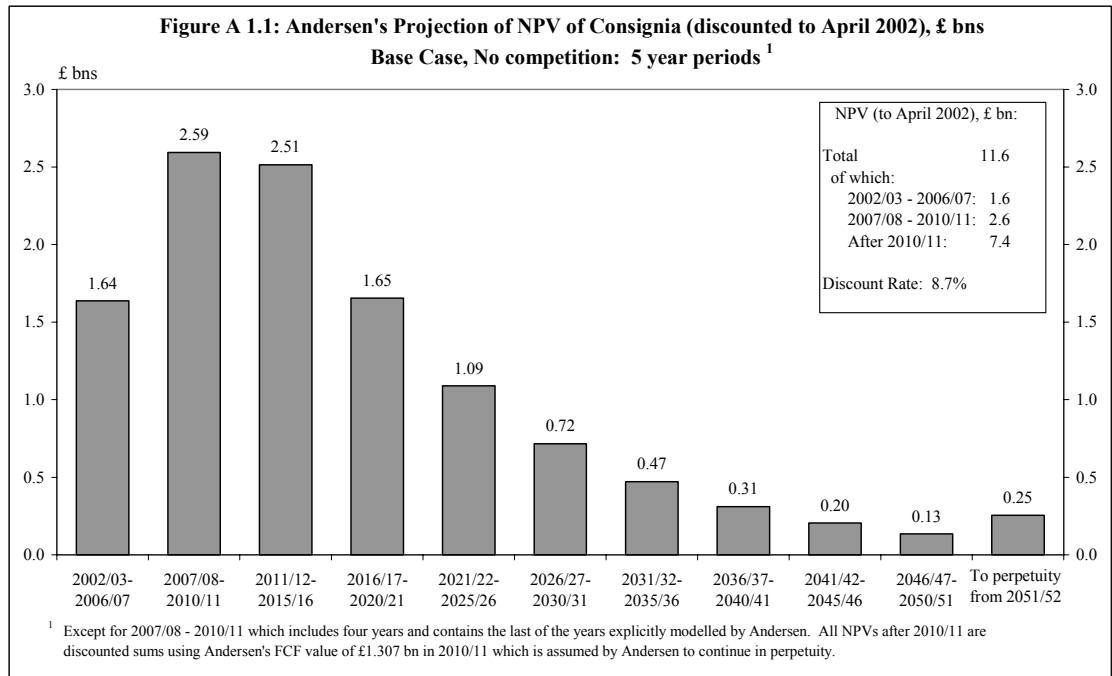
#### **Background**

A1.5.1 The 'base case, no competition' NPV of £11.6bn is calculated by Andersen from its projected FCFs. These are discounted back to April 2002 using Andersen's weighted average cost of capital (WACC) estimate of 8.7% as the discount rate. The FCFs in turn are built up using a number of key assumptions

and parameter values as set out in detail in Andersen's full report. The following are of particular importance:

- a base year of FY 2000/01 using information provided by Consignia;
- projections forward on volumes using information from (but not the same as) Consignia's 2001 Strategic Plan;
- an efficiency profile which includes a 15% improvement in efficiency in 2002/03 followed by annual improvements of 3.2% per annum for inland mail, international mail and parcels;
- a separation of costs by labour/non-labour and by fixed and variable components. All components of costs improve efficiency to the profile described above. Variable costs rise pro rata with the growth in volumes while fixed costs are unchanged (other than by the efficiency improvement and inflation);
- price and wage inflation are assumed to equal RPI in all years (2.5% per annum);
- a 10 year projection culminating in a value of the FCF in 2010/11 which is then assumed to continue at the same annual rate in perpetuity. This value is £1.307bn based on a pre-tax operating profit of £1.901bn.

A1.5.2 The annual FCF profile of Andersen’s financial projection for the ‘base case’ discounted back to April 2002 is shown in figure A1.1. Of the £11.6bn, £4.2bn arises from the FCFs of the years up to 2010/11, the



period which is explicitly modelled by Andersen. In turn, of this £4.2bn, £1.6bn is earned between 2002/03 and 2006/07 (the period covered in Consignia’s 2002 Strategic Plan) and £2.6bn over the four-year period from 2007/08 to 2010/11. The remaining £7.4bn (nearly two thirds of the £11.6bn) arises from the NPV of the value of FCF of 2010/11 projected in perpetuity. In the five-year period from 2011/12 to 2015/16, the NPV is £2.5bn. By 2046/47 to 2051/52, the NPV has declined to £0.13bn. The NPV of the years from 2051/52 onwards is £0.25bn.

### Cost of Capital

A1.5.3 As Appendix 1 of the proposals document points out, the NPV calculated by Andersen is neither a standard valuation of Consignia nor does this value measure the regulatory asset base or RAB of the business. If this NPV were to be interpreted as a valuation of the company, it is clearly out of line with valuations focussing on the NPV for a finite period such as 5 or 10 years for which figures are reported above and with

those using multiples of earnings given the current low level of Consignia's profit. Similarly reference to market comparators of broadly equivalent postal companies would lead to the conclusion that the valuation of Consignia was significantly less than the Andersen valuation. Standard valuation or the RAB would both need to take account of prices being reset at the start of each price control period with an allowed return as measured by the cost of capital on the RAB for each period. Traditionally, the period of price control of regulated industries is up to 5 years and the allowed return reflects the risk over that period. Andersen's model discounts the FCF value in 2010/2011 in perpetuity but it does not take into consideration the effect on risk and return of extending the period to perpetuity which, in turn, has implications for the assumed discount rate.

A1.5.4 The NPV from 2051/52 to perpetuity is calculated as £0.25bn. Given that the technique Andersen uses is the standard one for the valuation of companies, it is relevant to ask the following question: would a private investor be willing to pay such a sum today for the stream of FCFs from Consignia after that date even assuming that the investor shares in full the assumptions that Andersen make in their projection? The further ahead one goes, the greater the uncertainty surrounding any expected value in the future. A key uncertainty relates to letter volumes many years ahead. The range of expectations five years hence would be narrower than ten years hence while by 50 or 100 years into the future, the range encompassing an investor's expectation would be very large indeed. As uncertainty increases so too will the risk premium that an investor will require to take up an investment opportunity and as this rises so in turn will the cost of capital and the appropriate discount rate for discounting back the expected values of FCFs. Consequently, an investor would not value the NPV from 2052, for example, as high as £0.25bn.

A1.5.5 Consignia has commissioned OXERA Consulting Ltd (“OXERA”), which is a consultancy specialising in regulatory finance and economics, to model the impacts on the cost of capital of the effect of this increase in uncertainty over time<sup>16</sup>. The focus of OXERA’s modelling has been on uncertainty relating to volume growth and its impact on FCFs. Two cases have been considered by OXERA. In the first case, the range of possible traffic levels widens by  $\pm 1\%$  per annum for 100 years while the second is a case where the range of volume levels widens more rapidly at  $\pm 2\%$  per annum for 50 years. For both of these cases, Monte Carlo simulations have been undertaken using the standard assumption that 95% of sampled observations are taken from a Normal distribution which has an increasing range around the expected value of the FCF of £1.307bn from 2010/11 onwards. In both cases results are compared with the standard regulatory practice of resetting the allowed revenue such that the expected rate of return is equal to the allowed cost of capital at the beginning of each price control period.

A1.5.6 The result of these simulations is that the standard deviation of returns to an investor is much higher in the case where there is no periodic resetting of price. This can then be converted, using the standard approach of the capital asset pricing model and Andersen’s assumptions on the various elements for calculating the WACC, into new values for the WACC reflecting the higher risk premium in these cases. The case of the range of uncertainty widening by  $\pm 1\%$  per annum for 100 years implies a cost of capital of 20.0 % while that of  $\pm 2\%$  per annum for 50 years results in a WACC of 15.5%. Section A1.7, which sets out Consignia’s results, uses a discount rate of 16% which is set at the low and conservative end of this range<sup>17</sup>.

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<sup>16</sup> ‘Deriving a Base Case NPV for Consignia’, OXERA, March 2002

<sup>17</sup> These values for the rate of widening of these ranges were taken as reasonable cases to examine. Investors’ expectations might widen at a rate different to these amounts but the results reported indicate the significance of this factor in assessing the appropriate cost of capital.

## **A1.5b Consignia's Alternative Base Cases**

A1.5.7 Postcomm's 'downside' risk case focuses on Consignia achieving a lower level of efficiency than in Andersen's base case. However, in addition to efficiency considerations there are other risks faced by Consignia most notably in its product and input markets. Consignia has developed two alternative base cases which combine the risks in these areas with a revised efficiency profile. The purpose of these alternatives is to test the robustness of Andersen and Postcomm conclusions under reasonable and appropriate, but nevertheless conservative, assumptions about the future. Aspects of these cases use assumptions from Consignia's draft 2002 Strategic Plan for the years up to 2006/07 but apart from the three areas outlined below Consignia's alternative base cases otherwise follow Andersen's base case and are set in full within the framework of Andersen's financial model. This exercise does not provide a representation of the full impact of the draft 2002 Strategic Plan nor does it take account of risks such as those relating to pensions. Together these other considerations could be expected to result in lower NPVs than the cases reported later in the current document.

### **Volume**

A1.5.8 The first major risk incorporated and difference to Andersen's base case relates to the long-term prospects for mail volumes, particularly letter mail. The impact of e-substitution is difficult to estimate and even more difficult to project. However, one assessment, which is perhaps that held by the majority of informed observers, is that over a very long term horizon mail volumes will decline in the face of a number of developments including e-substitution, internet based transactions and the facility and familiarity of the young for electronic communication. Recent work in Finland, which is one of the most advanced countries in the world in terms of e-substitution, points to such a

decline<sup>18</sup>. DPWN, TPG and USPS have reached a similar assessment and are planning for declining volumes in the longer term<sup>19</sup>. The point here is not to say that mail volumes will fall in the short term but rather that they are likely to do so within a finite time horizon.

A1.5.9 The volume growth assumptions used by Andersen are based on the 2001 Strategic Plan for years up to 2005/06. Andersen assumes 2.7% per annum average growth to 2010/11 and then the constant value of the FCF Andersen adopts can be interpreted as being consistent with volumes remaining unchanged in perpetuity. By contrast with the sources quoted above in para A1.5.8, Andersen does not include in its base case the prospect of declining mail volumes over the long term. It cites a conclusion from Frontier Economics' review of Consignia's inland letter traffic model and projections that 'Frontier Economics considered that Consignia's econometric functional form adequately captured the prospect of e-substitution without the additional overlay' where the overlay referred to is Consignia's assessment of the prospect for e-substitution over and above that which has occurred in the past<sup>20</sup>. Consignia does not accept Frontier Economics' conclusion as reported by Andersen for Consignia's model uses historical time series data and cannot therefore anticipate significant shifts and new trends in demand from technological changes that will occur in the future. E-substitution is a technological change of this type. Accordingly, Consignia does not share Andersen's assumption that,

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<sup>18</sup> 'Demand Models for Letter Mail in the Competitive Targeted Communication Market', Heikki Nikali, Paper to 2<sup>nd</sup> Conference in 'Competition and Universal Service in the Postal Sector', University of Toulouse, 6 December, 2001

<sup>19</sup> The growing importance of privately owned mail companies has led to growing interest among stockmarkets of the volume prospects for mail and a financial market view of this key variable. This also tends to take a cautious line about such prospects. For example, DKWR notes: 'Our underlying forecasts are that the mail market as a whole shows no growth in 2002 and explicitly that mail is a 0% growth in perpetuity operation. This is due to technology causing substitution of mail. This longer term view frames our valuation of the individual mail operations of the European postal operators'

<sup>20</sup> Andersen's full report (page 62). Andersen's summary of Frontier Economics' 'An Evaluation of Consignia's Letter Volume Forecasts, October 2001' raises a number of issues which Consignia will wish to respond to separately.

as a base case view, volumes will not decline over the long term.

A1.5.10 In Consignia's alternative base cases the projections of inland volume growth are as follows:

- in 'alternative base case 1':
  - the central projection by product from the draft 2002 Strategic Plan which covers the years up to 2006/07;
  - after 2006/07, a slowing in the rate of volume growth to 0% in 2010/11 in line with the view implicit in FCF value in 2010/11 used by Andersen in perpetuity;
  - from 2011/12 an absolute decline in volumes consistent with the FCF in that year falling thereafter by 2% per annum.
- in 'alternative base case 2' to reflect a slightly less optimistic view of the effect of e-substitution:
  - up to and including 2002/03 as in 'alternative base case 1';
  - growth rate in 2003/04 reduced by ¼% compared with 'alternative base case 1', 2004/05 by ½% compared with 'alternative base case 1' and so on by increasing steps of ¼% to 2010/11 implying declining volumes from about 2009;
  - from 2011/12 onwards a decline in volume consistent with the FCF in that year falling thereafter by 20% per annum<sup>21</sup>.

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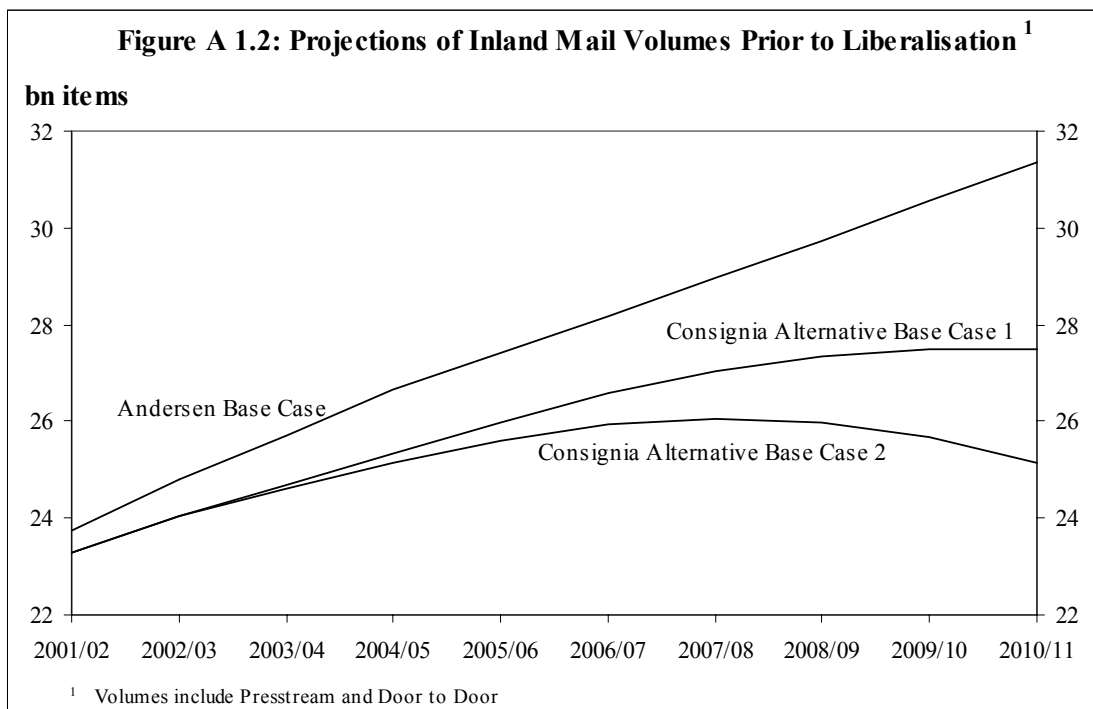
<sup>21</sup> FCFs fall by around -10% in 2009/10 and -30% in 2010/11 in 'alternative base case 2' prior to liberalisation. Over the very long term, FCFs are highly responsive to changes in volumes and, in fact, can become negative on very plausible assumptions. The assumption of a percentage rather than cumulative absolute decline in the FCF prevents this outcome and so tends to boost the overall NPV.

A1.5.11 These two sets of assumptions imply that mail volumes drop below their current 2002 levels only after 2020 in 'alternative base case 1' and after 2010 in 'alternative base case 2'. It is arguable whether these outcomes reflect fully the risk from lower volumes which could quite plausibly fall at a faster rate over the long term. Consignia's projections are shown in figure A1.2 together with that in Andersen's base case for the years up to 2010/11.

### Labour Costs

A1.5.12 The second major source of outside risk is that arising from labour market pressures. Over the last ten years the earnings of operational postal grades have increased in line with male manual earnings as recorded by the New Earnings Survey, that is, at about RPI +1% per annum. Andersen assumes wage inflation at RPI + 0% per annum (with an RPI of 2.5% per annum) which is below the historical average.

A1.5.13 In terms of the labour market itself unemployment, which is the key indicator of the state of this market, has halved over the last decade with there now being full



employment in many parts of the South East. Consignia's alternative base cases both use an

assumption of RPI +1% for wage inflation although again it is arguable whether issues of recruitment and retention might not put greater upward pressure on this element of costs.

### **Efficiency**

A1.5.14 The third area addressed by Consignia's alternative base cases is the efficiency profile in Andersen's projection of 15% in 2002/03 and 3.2% per annum thereafter to 2010/11. For the purpose of modelling Consignia's 'alternative base case 1' within the framework of Andersen's financial model the 2002/03 efficiency improvement has been set at 10% and the 3.2% figure has been set at 2.5%. In 'alternative base case 2' the efficiency improvement profile for 2002/03, 2003/04 and 2004/05 has been averaged and each year has been set at 5%, consistent with a renewal programme over three years. The longer term efficiency improvement is set at 2.5% as in 'alternative base case 1'. To the extent that Postcomm's less optimistic 'downside' assessment (refers A1.3.3) proves to be justified so too will the risk be greater than that contained in Consignia's alternative base cases.

### **A1.5c Alternative Base Cases with Policy Levers**

A1.5.15 As in the approach followed by Postcomm, where the 'policy levers' are applied to the Postcomm's 'downside' case to form the 'policy levers' case, the policy levers are applied to both of Consignia's alternative base cases. The Andersen 'base' and 'downside' cases assume a nominal price freeze for Category A products<sup>22</sup> and that other products rise in line with RPI inflation (2.5% per annum). An additional policy lever used in this case by Postcomm is to disregard the impact of those sectors outside the price control (eg. overseas operations). As discussed in para A1.3.4 Postcomm relaxes the nominal freeze and allows the price of inland mail products to rise in line with RPI, converting an NPV of -£2.2bn into a positive

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<sup>22</sup> As set out in Condition 19 of Consignia's licence

one of £5.6bn. This relaxation, strictly, is more than is required by Andersen's threshold value test as the NPV secured needs to be raised only to £2.2bn or so.

A1.5.16 Consignia notes that the 'threshold value' reflects an estimate by Andersen of the tangible fixed asset value of Consignia. The market value reflects both tangible and intangible values below which it would be worth 'selling' the company. Though still in the public sector, the market value of Consignia would be significantly greater than the fixed asset value of £2.2bn. Consignia considers that the market value should have been used as the 'threshold value' with Andersen's analysis. Nevertheless, for the purpose of this response, Consignia also assumes a 'threshold value' of £2.2bn. Consequently, Consignia's results and conclusions in this response are more conservative than those that would arise from a 'threshold value' that reflects the market value.

A1.5.17 In Consignia's application of the 'policy levers' case there is an across-the-board rise in prices for inland mail so that the NPV in this case rises to £2.2bn. This is then reported in the form of an annual percentage increase in prices. Note that for this purpose the volume impact (and hence revenue and cost implications of the change in price) is derived from the own and cross price elasticities in Andersen's model. These were provided by Consignia to Andersen and were estimated, using econometric techniques, on time series data between 1976 and 1999 and hence in conditions of limited competition in the UK inland mail market<sup>23</sup>.

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<sup>23</sup> 'Disaggregated Letter Traffic Demand in the UK', John Nankervis, Sophie Richard, Soterios Soteri and Frank Rodriguez in 'Postal Services: Pricing, Productivity, Regulation and Strategy' edited by Michael Crew and Paul Kleindorfer, 2002, Kluwer Academic Publishers

## **A1.6 Consignia's Assessment of its Financial Position After Liberalisation**

### **A1.6a Against Base Case**

A1.6.1 This section of Consignia's response again follows the approach used by Postcomm and highlights the way Consignia's estimates of the effects of liberalisation have been incorporated into the corresponding cases prior to liberalisation. For each alternative base case, Consignia considers the impact of liberalisation as proposed by the EU and liberalisation as proposed by Postcomm. These estimates have been prepared using Consignia's entry pricing model (EPM)<sup>24</sup>. Electronic copies of the original and current versions of the model were provided to Postcomm and Andersen early in 2001.

A1.6.2 Andersen's main case for including the effect of liberalisation assumes that full liberalisation results in an equal across-the-board switch of 20% of volumes from Consignia to entrants. As Andersen makes clear, in its own words this is an 'arbitrary' assumption and there is no attempt by Andersen to model explicitly the extent of entry under full liberalisation<sup>25</sup>. Andersen were provided with this assumption by Postcomm and it is not supported either by analysis or modelling. Andersen has then projected the impact of the assumed degree of entry on Consignia's financial position using its financial model. While modelling of the impact of liberalisation is inherently uncertain, Consignia's position is that Postcomm's approach is less than adequate. It is important to assess the financial impact on Consignia of its losing a certain percentage of traffic and whether it would be likely to remain financially viable in such circumstances. However, it is as important, if not more so, to have a means of assessing how much traffic, both overall and within product groups, would be lost in the first place.

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<sup>24</sup> 'Liberalisation of the Postal Market and the Cost of the Universal Service Obligation: Some Estimates for the UK', Richard Robinson and Frank Rodriguez in 'Current Directions in Postal Reform' edited by Michael Crew and Paul Kleindorfer, 2000, Kluwer Academic Publishers

<sup>25</sup> Andersen's summary report (page 28).

Andersen's financial model to some extent tackles the first of these two questions but does not address the second.

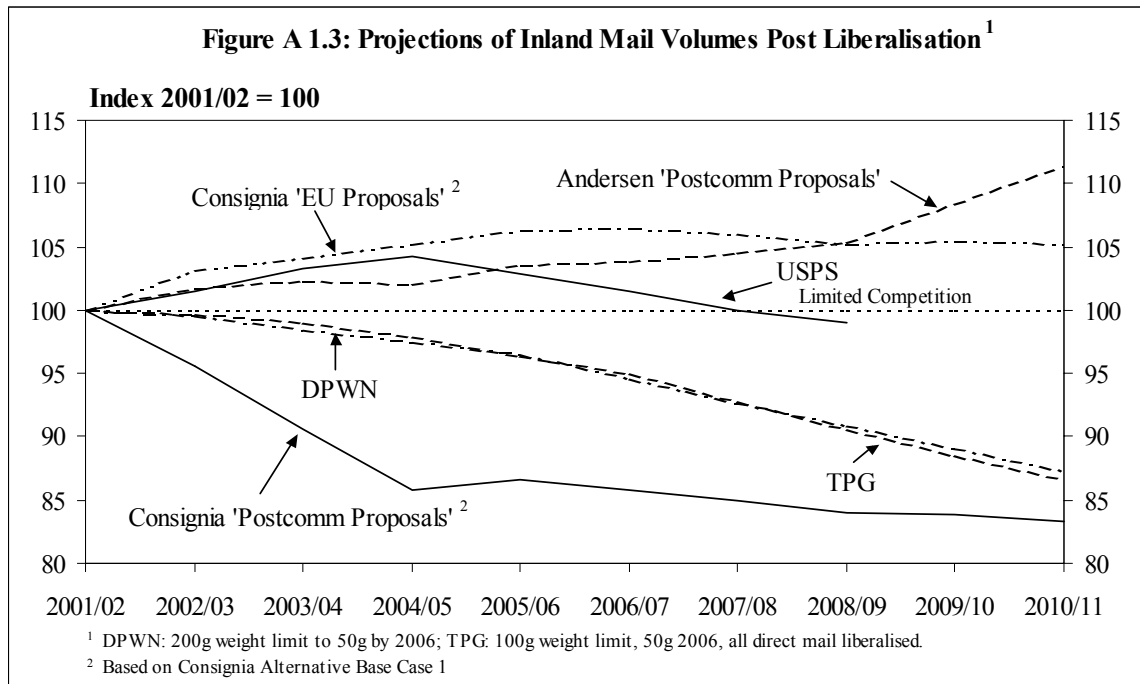
A1.6.3 By contrast, the EPM explicitly considers how much entry is likely to occur under a particular liberalisation scenario and produces an estimate of the financial impact of entry. This modelling indicates that entry is likely to be uneven across products and segments of the market in contrast to Postcomm's assumption of equal losses to all types of traffic. In particular, entry is projected to be greatest into those products and sectors which have the highest profit margin and are the most price sensitive with entrants taking advantage of the cream-skimming opportunities created by the uniform tariff. In terms of products, the largest impact is likely to be on the bulk mail products and the least effect on public tariff streams. Entry is greater for segments of the market covering delivery to businesses in urban areas, where costs are relatively low and profit margins against the uniform tariff relatively high, and less for delivery to households particularly in suburbs and rural areas where costs are relatively high and profit margins relatively low. Evidence from liberalisation abroad suggests that entry patterns of this type have been the likeliest to develop<sup>26</sup> while applications for licences from Postcomm have not been spread evenly across all types of traffic but, counter to Postcomm's assumption, have tended to be cream-skimming in character and concentrated on those segments of traffic identified by the EPM<sup>27</sup>.

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<sup>26</sup> 'Deregulation and Internet: New Challenges to Postal Services in Sweden' Peter Andersson, 2001, Linköping University Press

<sup>27</sup> Andersen notes in its full report: 'The EP model assumes 'cream-skimming' of most profitable routes within products and weight bands which our (Andersen's) procedure does not capture' (page 108). Although Andersen makes use of some of the output from the EPM to overcome this important limitation in its model, it does so in an incomplete and less than satisfactory way. This issue will be addressed by Consignia separately.

A1.6.4 Figure A1.3 compares the Andersen and Consignia projections of volumes after incorporating respective alternative assessments of the effects of Postcomm's proposals for liberalisation on volumes and Consignia's



projection of volume incorporating its assessment of the EU's proposals for liberalisation<sup>28</sup>. Also shown are projections from DPWN, TPG and USPS which incorporate those companies assessments of mail volume prospects after taking into account the effects of the more gradual introduction of liberalisation expected in their own countries in line with the EU proposals. These projections are indexed to (2001/02=100). Consignia's projections, using 'alternative base case1' can be seen to be significantly above those of other universal service providers while Andersen's projection is far in excess of those of leading postal operators in other major countries.

A1.6.5 There are two other issues relating to the NPV of Postcomm's proposals for the transition to full liberalisation. Both of these are addressed more fully elsewhere in Consignia's response to the proposals document. First, mailings above Postcomm's 4,000 item threshold which includes PPI and meter traffic, have been omitted from Andersen's estimates of the

<sup>28</sup> Reduction in weight limit to 100g in January 2003 and 50g in January 2006.

NPV of Postcomm's proposals and these estimates are therefore understated by the extent of this effect. Secondly, as Andersen explains in both its summary and full reports, the financial impact of upstream liberalisation and 'defined activity' licences have not been included in its estimates<sup>29</sup>. The main point here relates to upstream liberalisation, the effects of which cannot be modelled effectively until there is an access price for the use of Consignia's mail network. Postcomm has stated that this will be the subject of a determination by Postcomm later in 2002. Accordingly, the prospective impact of this element has not been included in either Andersen's or Consignia's estimates of the financial impact of Postcomm's proposals.

**A1.6b Against Consignia's Alternative Base Cases**

A1.6.6 The EPM results as described above have been applied to Consignia's alternative base cases set out in section A1.5b of this response.

**A1.6c Against Consignia's Alternative Base Case with Policy Levers**

A1.6.7 Consignia's analysis in these cases is based on an across-the-board rise in the price of all inland mail products to a degree sufficient to meet the threshold value of £2.2bn. This is then expressed in the form of an annual percentage price increase.

A1.6.8 In the 'policy levers' case there is a significant change to the assumptions on price elasticity between the competition and no competition cases which has not been incorporated into Andersen's assessment. In its analysis of this case, Andersen uses the same price elasticities as in the 'no competition' case. As noted in section A1.5c, these price elasticities were estimated in a situation of very limited competition. In a fully liberalised market, where Postcomm assumes 20% of traffic will switch to entrants, the effect of Consignia increasing prices will be different to one where there is

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<sup>29</sup> Andersen full report (page 101)

very limited competition. Traffic will switch to other postal operators as well as being deterred by the rise in price. Own price elasticities will be higher (in absolute terms) in a fully liberalised market compared with the estimates used by Andersen<sup>30</sup>.

A1.6.9 There is limited direct evidence available on the extent to which Consignia's price elasticities are likely to increase in the market environment envisaged by Postcomm. However, it is rational to expect that the effect will be greater where entry is greater. Given the limitations of published evidence on this key risk, Consignia has evaluated its 'alternative base with policy levers' cases using a number of sets of price elasticities. These sets reflect the likelihood of an overall own price elasticity for inland mail rising from the econometrically estimated value provided by Consignia to Andersen of  $-0.2$ . The cases evaluated are for the following overall own price elasticity values:  $-0.5$ ,  $-0.8$ ,  $-1.0$ ,  $-1.2$  and  $-1.5$ .

## **A1.7 A Comparison of Andersen and Consignia Assessments**

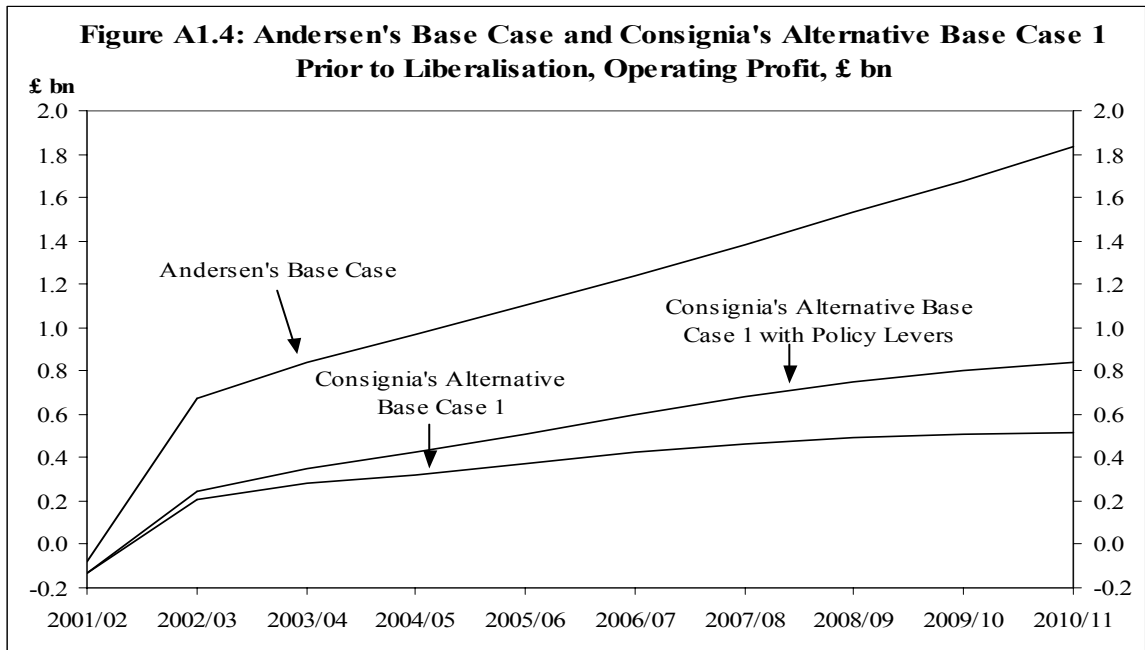
A1.7.1 The results from Consignia's analysis using its partial replication of Andersen's financial model are reported in table A1.2. Under the 'Andersen base case' which uses Andersen's projections but discounted at 16% (refers section A1.5a) the NPV is £5.1bn<sup>31</sup>, less than half of the corresponding value in Andersen's assessment. The 'alternative base case 1' lowers the NPV to £1.4bn and 'alternative base case 2' to £0.5bn, both below the Postcomm threshold value for financial viability (£2.2bn) (refers section A1.5b). Application of the policy lever in the form of an across-the-board increase in inland letter prices (refers section A1.5c) requires a rise in prices of 0.8% per annum to raise sufficient revenue to increase the NPV back to £2.2bn

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<sup>30</sup> All references to 'higher' values of own price elasticities in this response refer to higher absolute value as own price elasticities are negatively signed.

<sup>31</sup> The value of £5.1bn also includes an impact of about £0.2bn from correcting Andersen's treatment of terminal dues payments where it includes, erroneously, an efficiency improvement

in 'case 1' and 2.2% per annum in 'case 2'. Figure A1.4 shows operating profit for the Andersen and Consignia 'case 1' cases up to 2010/11. In the 'Andersen base case', annual operating profit rises to about £1.8bn (after correcting for the treatment of terminal dues payments) by that year compared with about £500m in 'alternative base case1' and a little over £800m after adding the impact of the rise in prices.



A1.7.2 The second column in table A1.2 reports the effect of Postcomm's proposed transition to full competition evaluated using Consignia's EPM (refers section A1.6a). The proposals reduce the NPV in 'Andersen's base case' to £1.4bn, compared with £7.7bn in Andersen's assessment and below the threshold value for financial viability. The EPM impact against 'alternative base case 1' (refers section A1.6b) lowers this NPV further to -£2.5bn with operating profit falling to about -£350m per annum by about 2006 and remaining roughly at that level up to the end of the modelled period in 2010/2011. 'Alternative base case 2' results in a lower NPV of -£2.9bn. The third column of table A1.2 reports the effect of the EU proposals for liberalisation, again evaluated using Consignia's EPM. In 'Andersen's base case' the NPV falls to £3.1bn which, unlike

Postcomm's proposals in column 2, is above the threshold value applied by Andersen to reflect financial viability. Under Consignia's 'alternative base case 1' the NPV is -£0.5bn, significantly above the NPV of -£2.5bn under Postcomm's proposals in column 2, while the corresponding figures for 'alternative base case 2' are -£1.3bn and -£2.9bn.

A1.7.3 In the EPM, cost savings from volume reduction are calculated from estimates of the long run marginal cost (LRMC) for individual products. Consignia has estimated that the LRMC factor on average is about 0.6. While revenues will be lost in step with the loss in volumes, two factors in addition to volume are of importance in determining the effect of entry on costs and hence loss of profitability. First, entrants will be attracted to the most profitable segments of the market where costs are relatively low. Consequently, cream-skimming entry of this type will result in cost savings which are less than this overall cost elasticity. Secondly, as shown in figure A1.3, Consignia estimates that there will be an absolute decline in its volumes as a result of Postcomm's proposals rather than a reduction in the rate of increase of inland traffic. In these circumstances the 0.6 factor, as built into the EPM results, may be more difficult to achieve than if growth were to continue. To the extent that this is the case, the EPM results would understate the loss of profitability due to entry.

Table A1.2

**Consignia's Estimates of Level of NPV for Consignia: Main Results  
(Discounted to April 2002 at 16%, £bn)**

	No Competition	Liberalisation Scenario:	
		Postcomm's Proposed Transition to Full Competition <sup>1</sup>	EU Proposals
Andersen's base case	5.1	1.4	3.1
Consignia's alternative base cases:			
Case 1 <sup>2</sup>	1.4	-2.5	-0.5
Case 2 <sup>3</sup>	0.5	-2.9	-1.3

Consignia's alternative base case plus 'policy levers' – annual percentage price increase <sup>4</sup> :			
Case 1	0.8%	See table A1.3	2.8%
Case 2	2.2%		4.4%
Source: Consignia			
1. Excludes effects of upstream liberalisation.			
2. All assumptions as in Andersen's base case except as follows: volume growth to 2006/07 as in draft 2002 Strategic Plan declining to 0% by 2010/11; wage inflation at RPI +1%; efficiency of 10% 2002/03, 2.5% per annum to 2010/11; value of FCF declining by 2% per annum after 2010/11 implying volumes falling at rather less than this rate.			
3. All assumptions as in 'alternative base case 1' except as follows: volume growth reduction by ¼% in 2003/04, ½% in 2004/05 and ¼% increasing steps to 2010/11; efficiency of 5% for each of three years 2002/03 to 2004/05; value of FCF declining by 20% per annum after 2010/11.			
4. Annual price increase in inland mail products (excluding Presstream and Door to Door) required to achieve NPV of £2.2bn.(Postcomm's threshold value for financial viability).			

**A1.7.4** Given that the NPVs of Consignia under liberalisation are below the threshold value of £2.2bn, policy levers are then required so that the universal service obligation is met on a continuing basis and the financial viability of Consignia is maintained to ensure this. In the case of the EU proposals, table A1.2 reports annual price increases of 2.8% for 'alternative base case 1' and 4.4% under 'alternative base case 2'. With a sizeable reserved area still in place, the overall price elasticity would be likely to be close to that prior to liberalisation. However, in the fully liberalised environment proposed by Postcomm volumes are likely to be more responsive to increases in prices (refers section A1.6c).

**A1.7.5** Table A1.3 reports the results of applying the policy lever of across-the-board price increases to Consignia's alternative base cases under different assumptions for own price elasticities given Postcomm's proposed transition to full competition. The results for 'alternative base case 1' are reported in the upper half of the table and for 'alternative base case 2' in the lower half. In the first row, the 'no competition' overall elasticity is applied as a benchmark. Annual nominal price increases of

about 5% per annum (or about 2½% above the assumed rate of RPI inflation) are required up to 2010/11 to achieve Postcomm's threshold value of £2.2bn<sup>32</sup>. Successive rows of the table show the impact of greater degrees of effective competition, measured by a higher price elasticity, on these

Table A1.3

**Consignia's Estimates of Level of NPV for Consignia:  
'Alternative Base Case plus Policy Levers' under Postcomm's Proposals  
(Discounted to April 2002 at 16%, £bn)**

	<b>Overall Own Price Elasticity</b>	<b>NPV Achieved<sup>1</sup></b>	<b>Annual Price Increase Required to Achieve NPV<sup>2</sup></b>	<b>Shortfall in NPV Expressed as an Annual Equivalent, £m<sup>3</sup></b>
<b>Alternative Base Case 1</b>				
(i)	-0.2	2.2	5.0	0
(ii)	-0.5	2.2	6.1	0
(iii)	-0.8	2.2	8.7	0
(iv)	-1.0	2.2	13.2	0
(v)	-1.2	2.2	41.7	0
(vi)	-1.5	-1.3	7.9	560
<b>Alternative Base Case 2</b>				
(i)	-0.2	2.2	6.8	0
(ii)	-0.5	2.2	8.4	0
(iii)	-0.8	2.2	12.6	0
(iv)	-1.0	2.2	22.3	0
(v)	-1.2	2.2	50.5	0
(vi)	-1.5	-1.9	8.1	660

Source: Consignia

1. Either Postcomm's threshold value of £2.2bn if achieved or projected NPV if lower when price increase unable to secure sufficient increase in profitability to reach threshold value.
2. Annual price increase in each year applied across the board to all inland mail products (excluding Presstream and Door to Door).
3. At 16% discount rate.

<sup>32</sup> From 2011/12 onwards, Andersen's model applies a constant value for the FCF (reduced at 2% per annum in the Consignia cases) so that price increases thereafter are not incorporated into its modelling framework.

indicators. If the overall price elasticity were to rise to  $-0.5$ , the annual price increase required to achieve the threshold value would rise to about 6% per annum while at  $-0.8$  it would be about 9% per annum and at  $-1.0$  about 13%. Under 'alternative base case 2' the annual price increases required would be higher and range from 7% or so at the 'no competition' elasticity of  $-0.2$  to over 20% at an elasticity of  $-1.0$ .

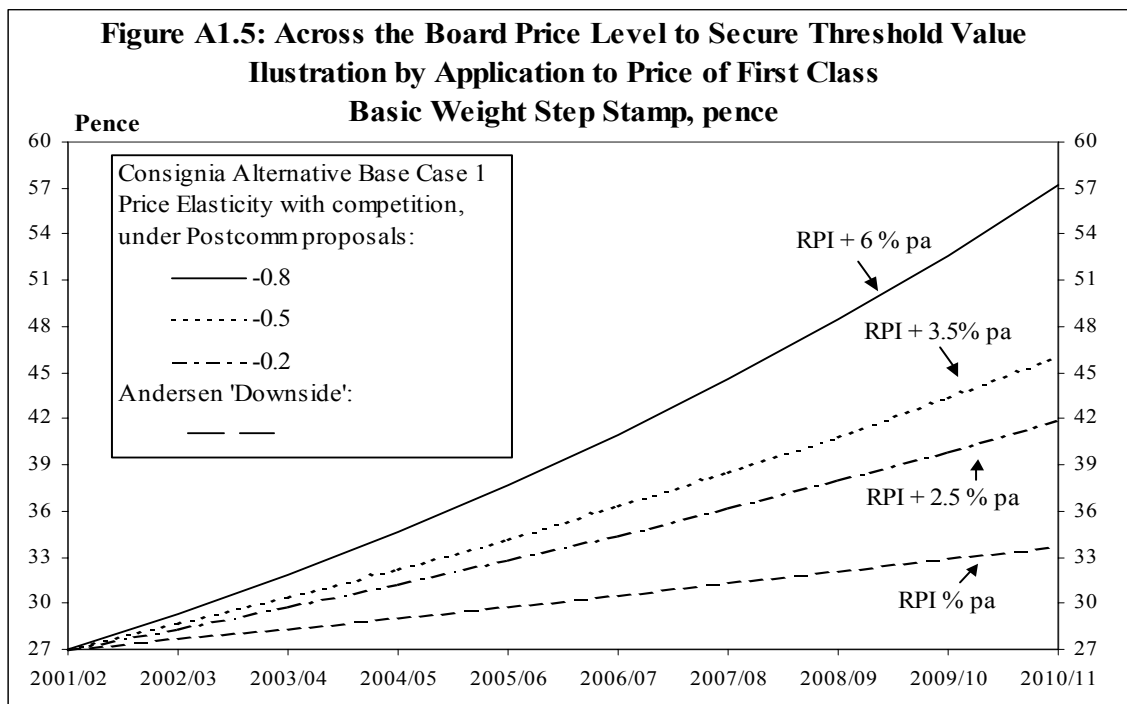
A1.7.6 However, if the new environment were to result in demand becoming clearly price elastic (absolute value significantly above  $-1$ ) then in Consignia's alternative base cases price increases would need to become very high and, if the price elasticity were to rise even further, such increases alone would be insufficient to allow achievement of the threshold value of £2.2bn. With a threshold value higher than Postcomm assumes, the prospect of this outcome would be greater. In addition, table A1.3 reports a significant shortfall in NPV in both cases if the elasticity were to be above about  $-1.2$ . In this situation the NPV shortfall can be expressed as an annual equivalent sum implying that additional sources of funding would be necessary to ensure the sustainability of universal service provision.

A1.7.7 This issue is discussed further in the final section of this part of the response. However, it is worth noting at this point that Andersen acknowledges this possibility: "This (a significantly higher NPV) assumes that the real price freeze could be imposed in the context of competition. To the extent that competition was effective for some products or customers, the real price freeze might not increase profits. Thus, the effectiveness of the policy lever would be reduced, or alternatively price increases would have to fall on products where Consignia retained a degree of market power" (Andersen full report footnote 60, page 117).

Although this risk is stated by Andersen, it reports no analysis of Postcomm's proposals in a situation where the policy lever of price increases becomes partly or wholly ineffective.

A1.7.8 The main difference between the EU and Postcomm proposals, as shown by comparing tables A1.2 and A1.3 is that the price increases required to offset the impact of entry on profitability are significantly higher under Postcomm’s proposals. Price increases are higher under Postcomm’s proposals in part because the impact on Consignia’s profitability is greater and also because of the additional effect from the expected rise in market competitiveness and hence the need to raise price further to achieve a given level of profitability.

A1.7.9 Figure A1.5 provides an example for one product of the prices required under Postcomm’s proposals to achieve



Postcomm’s threshold value as reported in table A1.3 where the price elasticity is assumed to remain inelastic. These prices are included for cases where the full liberalisation price elasticities are at values between  $-0.2$  and  $-0.8$  and so price increases alone would be sufficient to achieve the threshold value of £2.2bn. As the price increases are across-the-board in nature, the price levels implied by these different cases can be illustrated, as in figure A1.5, for the price of one

product. The figure shows the price of a First Class stamp at the basic weight step which at present is 27p. As an example in 'Andersen's downside with policy levers case' the implied price rises by 2.5% per annum leading, by annual increases, to a price of about 34p in 2010/11.

- 1.7.10 Andersen assumes that the overall price elasticity of Consignia's inland mail products remains at  $-0.2$  as estimated from data on the postal market with limited competition. In the Consignia benchmark reported in table A1.3 an increase of about 5% per annum, or RPI +2.5, is required in this case - over 1p in the first year of 2002/03 and reaching a price of about 42p by 2010/11. If the elasticity were actually to rise to  $-0.5$  in the fully liberalised market, these increases would start at about 1½p per annum with a First Class basic weight step price of about 46p in 2010/11. The corresponding figure at an elasticity of  $-0.8$  would be over 2p in the first year reaching about 57p by 2010/11. All other inland mail products would need to rise by equivalent percentage amounts to achieve the threshold value of £2.2bn. Under 'alternative base case 2' these figures would be a little higher in 2010/11 at an elasticity of  $-0.2$  (about 49p) but appreciably so at one of  $-0.8$  (about 78p).
- 1.7.11 The price increases arising from the EU proposals are significantly less as reported in table A1.2. The results reported there would imply a First Class basic weight step tariff under 'alternative base case 1' of about 35p in 2010/11 and a little below 40p under 'alternative base case 2.'
- 1.7.12 Table A1.4 provides an overview comparing Andersen's and Consignia's assessment of Postcomm's proposals set in the framework of Andersen's financial model. Each box sets out the main differences between the two sets of assessments with the NPV from Andersen's assessment in the top left hand corner and that from Consignia's in the bottom right hand corner. As set out by Postcomm in the discussion in its proposals document, the results

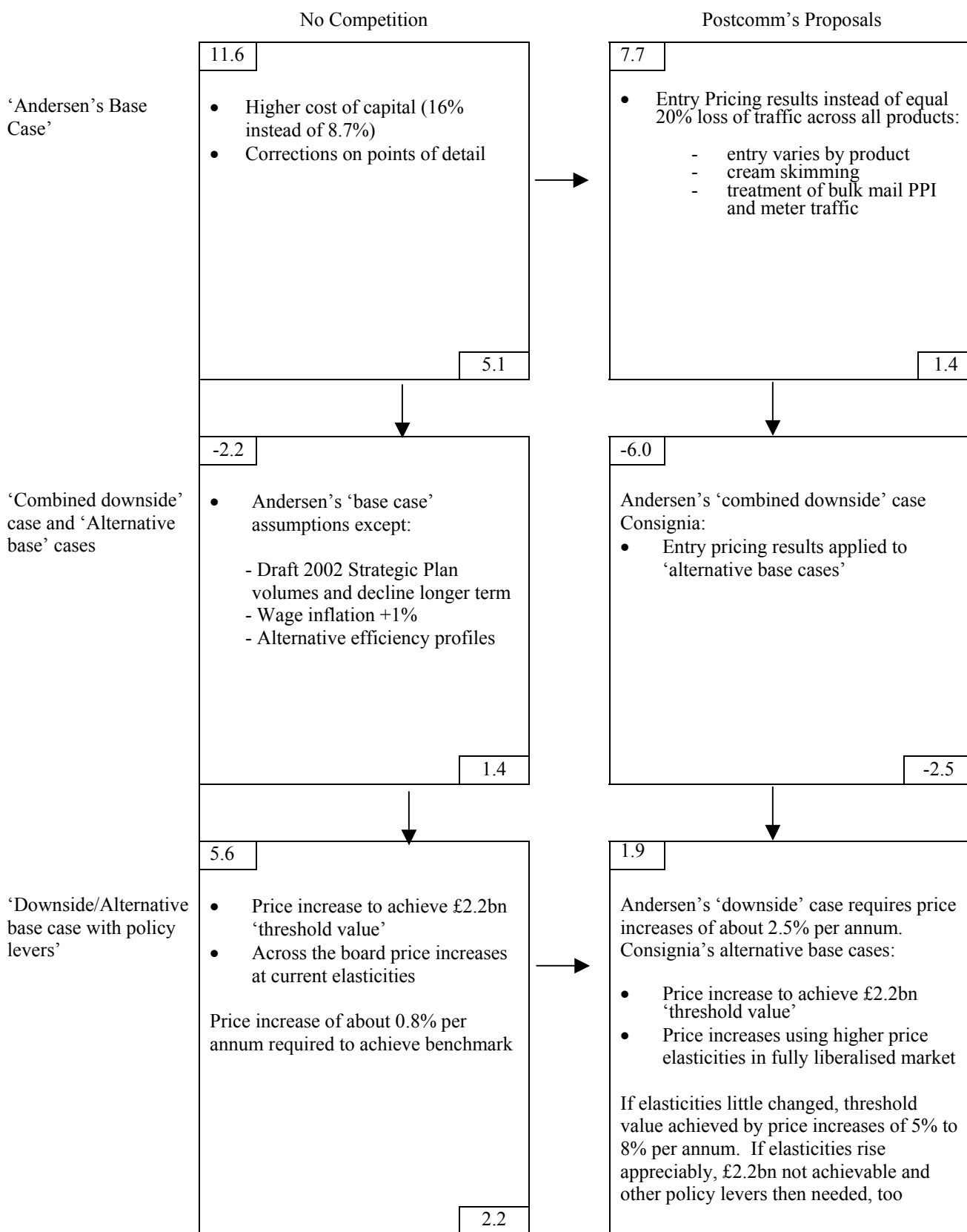
down the 'no competition' column reflect the risks to Consignia prior to liberalisation and comparison across the columns then highlights the additional risk from Postcomm's proposals on liberalisation. The 'alternative base with policy levers case' under Postcomm's proposals which is the box in bottom right hand corner of table A1.4, summarises the different conclusions reached by the two assessments of Andersen and Consignia. Both assessments have been undertaken in the same framework with most assumptions in common apart from those highlighted in the table.

## **A1.8 Wider Implications and Conclusion**

- A1.8.1 The results of Consignia's analysis and, in particular, in tables A1.3 and A1.4 raise a number of important issues and concerns. First, they challenge Postcomm's view that it has effective policy levers to ensure Consignia's financial viability in a fully liberalised market and hence its ability to ensure universal postal service. The price control is Postcomm's prime policy lever but, in fact, table A1.3 shows that under reasonable and appropriate changes to assumptions used by Andersen relating to letter traffic growth, efficiency, cost, entry and the responsiveness of demand to price under full competition, Postcomm may need to call on additional instruments to fund the impact of entry on Consignia's profitability. Price increases would be able to achieve only a part of the rise in NPV needed to reach the assumed threshold value for Consignia if the absolute value of price elasticity were to rise (in absolute terms) well above  $-1$  and/or the NPV were to be much below that in Consignia's alternative base cases and/or a higher threshold value were to be considered appropriate.
- A1.8.2 Secondly, the question then arises of the nature and availability of other policy levers to help offset the effect of entry on profitability. Raising prices across-the-board is not the approach that would be followed in a

commercial environment and makes price a blunter instrument than if

### Andersen and Consignia Assessment of Postcomm's Proposals Summary and Comparison of NPVs, £bn<sup>1</sup>



<sup>1</sup> Figure in top left hand corner of each box is Andersen's projected NPV and that in the bottom right hand corner is Consignia's projected NPV, also set in the framework of Andersen's financial model. The text sets out Consignia's alternative in each stage of the assessment.

prices were differentiated<sup>33</sup>. An additional policy lever that Postcomm might apply would be to allow prices in the more competitive parts of the market to reflect these pressures and rebalance prices towards higher cost customers subject to the clear statement in the Postal Services Act 2000 of the requirements for uniform, affordable tariffs and for regard to disadvantaged groups. The implication of such differentiation would be that price increases for public tariff customers would be higher than the averages recorded in table A1.3 and figure A1.5, perhaps by a significant margin.

A1.8.3 Another policy lever would be a reduction in the specification of the universal postal service which Postcomm in its discussion on price response includes albeit in a slightly different way as a 'narrower' set of universal service products. A compensation fund which would levy taxes on entrants would be a further policy lever although Consignia has expressed its view that this is not possible in practical terms. Postcomm itself mentions briefly within its document the position of Consignia's overseas and non-postal operations and including the interest from gilts held by Consignia. The approach being followed by the EU to pre-empt the need for such policy levers is to maintain a reserved area, an approach supported by Consignia and which further, as shown in section A1.7, would be expected to lead to annual price increases which would be a half or less those caused by Postcomm's proposals.

A1.8.4 Thirdly, given the diverse range of impacts and consequences of its proposals, it is perhaps surprising that Postcomm has not attempted an overall evaluation of the gains and losses in economic welfare from its proposals. Are the losses to customers from increases in letter prices and reductions in service specification that seem likely to result from its proposals greater or smaller than the gains from the falls in prices to some customers and the profits of entrants coming into the UK postal market? Are disadvantaged groups of

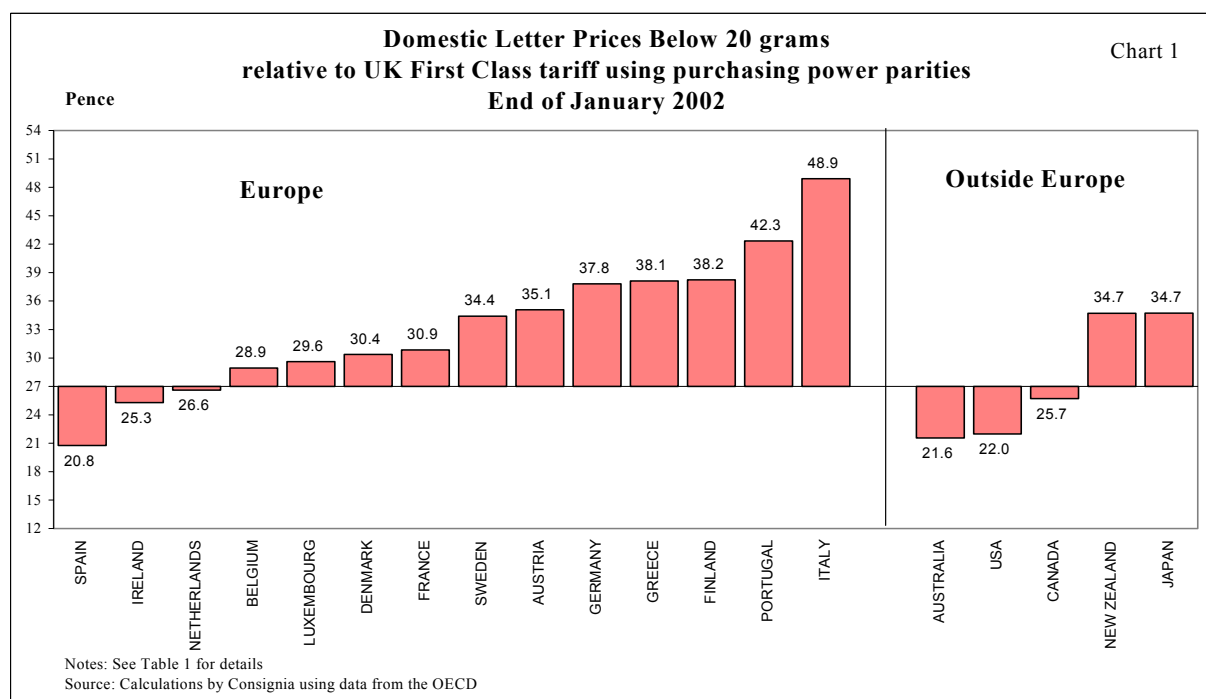
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<sup>33</sup> This point is acknowledged by Andersen in comments on the efficacy of price increases as a policy lever (Full report, page 117)

customers winners or losers from liberalisation? There is no evidence in the Andersen analysis (nor anywhere else in Postcomm's documentation) that Postcomm has attempted such assessments and balanced these gains and losses against the risks and costs highlighted by Consignia's analysis in the framework of Andersen's financial model.

A1.8.5 Many of these issues are linked inextricably to the current price control review for 2003 which is being taken forward by Postcomm. The proposals from that review will follow later in 2002 as indeed also will the determination on the access price to Consignia's network and the result of Postcomm's consultation on universal service. Postcomm's assumption appears to be that the price control framework will be able to ensure Consignia's financial viability to continue to meet the universal service obligation. However, this assumption is challenged by Consignia's analysis which is set in the framework of Andersen's financial model and has sought to maintain as many assumptions as possible consistent with Andersen's own analysis. The risks to financial viability are significantly larger than Postcomm claim and the consequences in term of higher letter prices to consumers are potentially more severe.

A1.8.6 Overall, prior to the completion of its price control review, Postcomm has put forward its proposals for the introduction of effective competition. Consignia has tested these within the framework of Andersen's model to check that Postcomm's statutory obligations could be satisfied after liberalisation. Consignia has undertaken these tests in the same framework as that used by Postcomm but having made reasonable and appropriate changes to the assumptions. Consignia has concluded that these tests are not satisfied and, consequently, that the proposals are contrary to Postcomm's statutory obligations.



**Table 1**

**INTERNATIONAL COMPARISONS OF DOMESTIC LETTER PRICES  
FOR UP TO 60 GRAMS (UK BASIC WEIGHT STEP)  
As of January 2002**

	<u>Rates in local currency</u>			<u>Rates converted to UK pence</u>					
	Weight Bands (grams):	< 20	20 - 50	50 - 60	< 20	20 - 50	50 - 60		
UK	P	←	27	→	←	27	→		
SPAIN	EUR	0.25	0.38	0.54	20.8	31.6	44.9		
IRELAND	EUR	0.38	0.44	0.57	25.3	29.3	37.9		
NETHERLANDS	EUR	0.39	0.78	1.17	26.6	53.2	79.8		
LUXEMBOURG	EUR	0.45	0.59	0.89	29.6	38.8	58.6		
BELGIUM	EUR	0.42	0.79	0.89	28.9	54.4	61.3		
FRANCE	EUR	0.46	0.69	1.02	30.9	46.3	68.4		
DENMARK	DK	4.00	5.50	6.50	30.4	41.8	49.3		
AUSTRIA	EUR	0.51	0.58	0.87	35.1	39.9	59.8		
SWEDEN	SKr	5.00	←	10.0	→	34.4	←	68.8	→
GERMANY	EUR	0.56	1.12	1.53	37.8	75.7	103.4		
FINLAND	EUR	←	0.60	→	0.90	38.2	57.3		
GREECE	EUR	0.41	0.59	0.79	38.1	54.8	73.4		
PORTUGAL	EUR	0.43	←	0.60	→	42.3	←	59.1	→
ITALY	EUR	0.62	←	1.24	→	48.9	←	97.8	→
AUSTRALIA	A\$	←	0.45	→	21.6	36.8	51.7		
USA	\$	0.34	0.57	0.80	22.0	36.8	51.7		
CANADA	C\$	0.48	0.77	0.96	25.7	41.2	51.4		
NEW ZEALAND	NZ\$	←	0.80	→	34.7	34.7	34.7		
JAPAN	YEN	80.0	90.0	140.0	34.7	39.1	60.8		

Source: Comparisons by Consignia based on source data from the Organisation for Economic Co-operation and Development.

**Notes:**

- i) Finland has a basic weight step that extends to 50 grams. For all other EU countries the first weight band is up to 20 grams (25 grams in Ireland).
- ii) The second weight band for the US is 28-56 grams, for Japan 25-50 grams and Canada 30-50 grams.
- iii) The third weight band prices apply to letters weighing between 50 and 100 grams for most of the countries.
- iv) The UK has only one weight step up to 60 grams. Most other countries have 2 or 3 weight steps.
- v) Tariffs are converted in a common currency (pence) by dividing the price in local currency by the Purchasing Power Parities.
- vi) Purchasing Power Parity (PPP): a common representative basket of goods is costed in each country, and the relative costs used to convert letter prices. PPPs change to reflect different rates of inflation in different countries. The PPPs used to convert letter prices into pence and Euros are PPPs for Gross Domestic Product. This means that the basket of goods priced to obtain the PPPs is a sample of all goods and services covered by the GDP.
- vii) The OECD publishes yearly PPPs. To obtain monthly PPPs, the yearly PPP is updated using the latest Consumer Price Index.
- viii) Letter prices for Japan and Greece are as of November 2001.
- ix) For Austria, Australia, Ireland, New Zealand and Japan, January's CPI was not available. The PPPs were updated for Austria, Ireland and Japan using December 2001's CPI rate from the OECD. For New Zealand and Australia 2001 Q4 PPPs were used.
- x) Prices for Sweden include VAT at 25%.
- xi) Some countries (e.g. Portugal, Italy) have a cheaper 'Standard' service and the first class equivalent service reported in the LPT is offered at much higher rates. Spain has, additionally, an 'Urgent' service, offered at much higher rates. The following table lists the services quoted in this report (basic letter services means there is a single basic letter service, instead of a First Class/Second Class option):

Country	Service	Country	Service
Austria	Basic letter service	Netherlands	Basic letter service
Belgium	Basic letter service	Portugal	Priority (Correio Azul)
Denmark	Prioritaire	Spain	Ordinaria
Finland	First Class	Sweden	Letters
France	Service rapide	UK	First Class
Germany	Basic letter service	Australia	Basic letter service
Greece	Priority	Canada	Basic letter service
Ireland	Basic letter service	Japan	Basic letter service
Italy	Posta Prioritaria	New Zealand	Fast Post
Luxembourg	Basic letter service	USA	First Class

