

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

31 January 2002

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Note: ✕ denotes figures removed at Postcomm's request due to commercial sensitivity

1 Background and summary

Introduction

- 1.1 This report has been prepared on behalf of the Postal Services Commission ('Postcomm'). It is a summary of a substantially longer report that sets out in detail our approach, assumptions and the full set of results of our work.
- 1.2 These results are subject to some important limitations which are set out below and in more detail in our full report.
- 1.3 In this chapter, we first set out the objectives and scope of our work, our approach and our main findings. In Chapter 2, we describe in more detail the approach we have adopted and the key assumptions we have used. In Chapter 3, we present the modelling results relating to the main findings in more detail.

Objectives of this report

- 1.4 Postcomm is required to have regard to the financial viability of Consignia and some of its business segments. This follows from the Postal Services Act 2000 ('the Act') under which Postcomm is required:
- first, as stipulated by Section 3(1) of the Act, to act in a way that it considers is best calculated to ensure the provision of the Universal Postal Service (UPS); and
 - second, as stipulated by Section 5(4) of the Act, to have regard to the ability of licensed postal service operators to finance activities authorised or required by their licenses.
- 1.5 Consignia both holds a postal service licence under the Act and, as part of its licence conditions, is required to provide the UPS.
- 1.6 Accordingly, Postcomm has asked Andersen to examine the potential impact on Consignia's financial performance of a range of scenarios, specified by Postcomm, for market liberalisation and the associated level of competition. Our main findings are described in this report.

Scope of our work

- 1.7 The scope of our work covers a number of specific market liberalisation scenarios that we have been directed by Postcomm to analyse. This work was conducted in two stages. Within the first stage we considered the potential impact of the following scenarios:
- **No Liberalisation Scenario** (maintaining the status quo of a 350g Reserved Area¹);
 - **EC Proposal Scenario** (reducing the Reserved Area to 100g by 1 January 2003 and to 50g by 2006, including full cross-border liberalisation); and
 - **Full Liberalisation Scenario** (with liberalisation effective from 1 April 2002).

¹ Throughout the report we refer to a Reserved Area ('RA') which is the segment of the Licensed Area which Postcomm may Reserve exclusively to Consignia.

- 1.8 Postcomm then advised us to consider the potential impact of, and sensitivities around, the following scenario:
- **Postcomm Proposals Scenario** (reflecting the combination of the weight price threshold reduction and bulk mail liberalisation, followed by full liberalisation by 1 April 2006, as proposed by Postcomm in its proposals dated 31 January 2002).
- 1.9 Our work is restricted to the potential financial impact of these scenarios on Consignia. The primary impact of these scenarios in terms of market share loss has, as directed by Postcomm, been modelled through sensitivity analysis (as explained further below) rather than through a predictive behavioural market model. We understand Postcomm asked us to adopt this approach due to uncertainties about the ability of a market model to 'predict' the impact of competition, and because appropriately structured sensitivity analysis can capture a wide range of possible competition outcomes.
- 1.10 We have not been asked to assess the scale of any funding requirement for the UPS which might exist after competition becomes fully established, or to consider how this requirement might be met in practice².

Approach

Model construction

- 1.11 There are two broad existing approaches for considering the financial viability of the provider of the UPS. These are the Net Avoided Cost ('NAC') and the Entry Pricing ('EP') approaches. The NAC approach compares the financial impact on the postal operator with and without an obligation to provide the UPS (generally under no liberalisation). The EP approach examines the financial impact of introducing competition, while providing the UPS.
- 1.12 The approach we have adopted combines aspects of the NAC and EP models. We have examined the potential financial impact on Consignia of liberalisation by constructing an integrated financial model. It is based on a static assessment of the financial performance of Consignia and various segments of its business in the Base Year. The dynamic effects of liberalisation are tested through scenarios and sensitivity analysis. This approach allows us to incorporate a requirement for overall cost recovery within a framework which enables flexible analysis of the potential effects of liberalisation on volumes served and costs incurred.
- 1.13 Our model has FY00-01 as the Base Year and projects forward to FY10-11 under a set of assumptions. These assumptions are the product of four sets of drivers.
- 1.14 We describe our approach and model construction in more detail in paragraphs 2.4 to 2.31.

² This issue has been noted separately by Postcomm in its June 2001 discussion document, *An assessment of the costs and benefits of Consignia's current Universal Service Provision*, and its January 2002 proposals.

Drivers

- 1.15 Within our model, the financial performance of Consignia is determined by four sets of drivers:
- **Competition** – we have modelled the potential impact of competition through sensitivities on the level and pattern of market share loss across products. We have also modelled sensitivities covering limited price responsiveness by Consignia to new entrants;
 - **Postcomm policy** - policy sensitivities other than liberalisation cover some of Postcomm's possible approaches to the price control, to defining the UPS and to defining the scope of Consignia's business over which the financial assessment is performed;
 - **Efficiency/ parcels profits** – the level of cost savings achieved in the business and the success or otherwise of achieving profitability in the parcels business constitute a key set of sensitivities; and
 - **Other market and company factors** – our remaining group of sensitivities cover factors largely outside Consignia's control (e.g. market growth and cost of capital) and some sensitivities on Consignia's cost structure which may be within Consignia's control.
- 1.16 We have adopted a set of Base Case assumptions in respect of each of these key sets of drivers. We have compared each market liberalisation scenario on this consistent Base Case, and hence estimated the impact of liberalisation.
- 1.17 We have also estimated the significance of the various sets of drivers through our sensitivity analysis. In particular, we have assessed the impact of alternative levels of competition, and the relative significance of the level of competition compared to Postcomm's policies, efficiencies/ parcels profitability and other market and company factors. This has required us to specify a sensitivity range for each of the key drivers, in addition to a Base Case value.
- 1.18 We summarise below our approach to deriving the Base Case, and sensitivity ranges, for each of the four sets of drivers above.
- Competition*
- 1.19 Postcomm has asked us to model a Base Case in which Consignia loses 20% of the market segment opened to competition. We have been asked to assume in the Base Case that this loss is staggered equally over three years from the date of liberalisation, with Consignia's prices unchanged, and with some specified level of 'critical mass effects' (i.e. some loss of market share in the already liberalised segment)³. We have also been asked to assume there is no cream-skimming of Consignia's most profitable 'routes' by entrants in the Base Case⁴.
- 1.20 Postcomm has also asked us to consider a range of market share losses between 0% and 30%, and to use Consignia's own predictive market modelling approach, the Entry Pricing (EP) model, within our own model to generate further sensitivities in order to assess aspects of the impact of competition as viewed by Consignia.
- 1.21 Our competition assumptions are described in more detail in paragraphs 2.32 to 2.53.

³ Modelling 'critical mass' effect implies that the current degree of market liberalisation is so limited that competition above the weight/price threshold or in Presstream (a newspaper and magazine distribution service which is not Reserved) is not effective since these are not 'large enough' market segments to encourage significant entry.

⁴ Cream-skimming occurs where a new entrant is able to target successfully routes that are priced significantly above the incremental cost of those routes. Cream-skimming is particularly significant because of the requirement on Consignia to provide UPS products at a uniform nation-wide tariff.

- Postcomm policy*
- 1.22 Postcomm has asked us to assume that the Interim Price Control applies for the duration of the modelled period. This price control was established in Consignia's licence dated 23 March 2001 and imposes a nominal price freeze on the majority of Consignia's products. We have also been asked to adopt Postcomm's working definition of the scope of the UPS set out in their proposals dated 31 January 2002⁵. We have been asked to model the entire business of Consignia.
- 1.23 Our model implicitly assumes that Consignia's current service specifications are maintained⁶.
- 1.24 Postcomm has also asked us to consider, as a sensitivity, the impact of switching to a real price control, under which all currently controlled prices would be allowed to increase at the rate of inflation. We have been asked to consider a scenario under which the scope of the UPS is 'Narrow' (including only Second Class, Standard Parcels and Special Delivery). We have also been asked to consider the implications of conducting the financial assessment excluding Consignia's non-postal and overseas operations.
- 1.25 Our Postcomm policy assumptions are described in more detail in paragraphs 2.54 to 2.60.
- Efficiencies/ parcels profits*
- 1.26 We have not been asked by Postcomm to conduct an efficiency review of Consignia. We have instead been asked to construct a Base Case efficiency assumption in the context of Consignia's recently announced intention to make gross cost savings of £1.2bn by the end of FY02-03 (following a substantial deterioration in Consignia's financial performance from FY99-00 to FY00-01, during which period total costs increased by 13.7%), advice provided to Postcomm by its efficiency consultants and to ensure consistency with the Interim Price Control.
- 1.27 Postcomm has commissioned Frontier Economics to conduct a study of productivity gains across UK utilities and overseas postal operators, and to determine a reasonable productivity profile for Consignia. Postcomm has commissioned WS Atkins (in association with MMD and Canada Post International) to conduct a detailed efficiency review of Consignia as part of the price control review. Postcomm has made WS Atkins' interim findings available to us. We have also been asked to consider a downside under which Consignia fails to achieve efficiency improvements. Finally, we have been asked to model a sensitivity under which Consignia fails to achieve profitability in the parcels business but instead achieves breakeven.
- 1.28 Our efficiency and parcels assumptions are described in more detail in paragraphs 2.61 to 2.80.
- Other market and company factors*
- 1.29 Consignia's projected performance is affected by a range of other factors. These include market factors, such as demand growth, and factors internal to Consignia, such as cost avoidability. We have determined a Base Case for these factors based on information provided to us by Consignia.
- 1.30 We have also determined appropriate sensitivities for the key drivers. We have based these on further evidence provided to us by Consignia, or by Postcomm and or its other consultants (e.g. Postcomm has asked Frontier Economics to conduct a review of Consignia's market growth projections), or based on our own judgement of a relevant sensitivity range.
- 1.31 Our assumptions in relation to these other market and company factors are described in more detail in paragraphs 2.81 to 2.85.

⁵ See Table 3 below.

⁶ We have however modelled an efficiency related to Consignia's stated intention to achieve a gross saving of £1.2bn by FY2002-2003. Any changed service standards associated with this identified saving are assumed to be consistent with the continued provision of the UPS at acceptable service standards.

Financial focus and financial measures

- 1.32 We have modelled the net present value (NPV) at 1 April 2002 of Consignia's free cash flows associated with each liberalisation scenario under the Base Case (common to all scenarios). NPV is a standard measure of the value of a business.
- 1.33 We have compared the NPV of the business under the alternative scenarios as a measure of the impact of liberalisation, and also under the alternative sensitivities outlined above as a measure of the relative significance of the various drivers identified.
- 1.34 We have compared the NPV obtained with a minimum 'threshold' NPV which reflects a market-based value of Consignia's assets that are required for the ongoing commercial operation of the business. This comprises principally the value of property and other tangible assets. No value is attributed in this minimum 'threshold' NPV to the Consignia brand or other intangibles. If the NPV is below the 'threshold' value even after identifying all available strategies and options to enhance it, then this implies that the ongoing operations are eroding even a minimum value and the owners of the business, if operating on a purely commercial basis, would choose to re-deploy their assets in other activities in order to earn higher risk-adjusted returns.
- 1.35 Our selection of 'threshold value' is for indicative purposes and does not imply that Postcomm should choose to treat this as the regulatory value (i.e. the value upon which the regulator intended to provide a return). Furthermore, we note that where we have calculated an NPV in excess of the 'threshold value', this does not preclude the possibility that Postcomm would act to reduce the NPV through the exercise of its policy levers (e.g. through a price cut).
- 1.36 Thus, the NPVs and threshold value are not valuations placed on Consignia's business by Postcomm. Rather, they are measures for testing various sensitivities. The overall levels of the NPVs should be treated with some caution since they are very sensitive to some of the underlying assumptions. We have therefore sought to highlight the relative change in the NPVs caused by certain factors such as market share loss and efficiency.
- 1.37 As discussed above, we have modelled the entire business of Consignia. We have also modelled, at a lower level of detail, the exclusion of the overseas and non-postal activities, and the UPS business segment only. The rationale for examining these alternative segments is set out in paragraphs 2.13 to 2.19.

Summary of Base Case and key sensitivities

- 1.38 Our key results in this report relate to the Base Case analysis of the four market liberalisation scenarios. In summary, this Base Case is characterised by:
- Competition: a total 20% market share loss staggered equally over three years, 'critical mass' effects outside the liberalised area, no cream-skimming;
 - Postcomm policies: Interim Price Control maintained, UPS working definition adopted, financial assessment conducted for entire business⁷;
 - Efficiencies/ parcels profits: 15% gross efficiency in FY02-03 and 2.5% annual net efficiency thereafter, parcels profits as calculated under Consignia's assumptions⁸; and

⁷ Although Postcomm's working definition of the UPS is specified in the Base Case, the definition only affects the financial results under the competition sensitivity which assumes cream-skimming, as cream-skimming is applied only where Consignia is constrained by the requirement to provide a given product at a uniform price.

⁸ We have described the basis for the efficiency assumptions in more detail in paragraphs 2.61 to 2.80.

- Other market / company factors: long-run marginal cost factor around 0.6, market growth using Consignia's most recent projections available to us, including inland letter growth at 2.7% pa, international letter growth at -0.2% pa and parcels growth at -0.4% pa⁹.

1.39 In addition to this Base Case, we have considered a range of sensitivity analysis around all of the key drivers. The full set of results is contained in our main report. However, in this summary report we have focused on a number of sensitivities as follows:

- **'Increased Competition Sensitivity'** –Consignia loses 31% market share with differential loss across products and weight steps as derived from Consignia's EP model¹⁰. Consignia is also assumed to lower its prices on certain price controlled products¹¹. We have modelled a variation of this sensitivity where Consignia loses 20% market share for each product in the liberalised segment, but loses the most profitable 'routes'. We have adopted this alternative when examining the impact of changing the scope of the UPS, since the extent of cream-skimming depends on which products are subject to a uniform tariff. We have indicated the specific results which are based on this alternative;
- **'Efficiencies Downside'** –Consignia is assumed to achieve only a 5% gross efficiency in FY02-03 and no ongoing efficiencies;
- **'Combined Efficiencies and Parcels Downside'** - this combines the efficiencies downside with an assumption that the parcels business achieves break-even rather than the profits obtained in the Base Case; and
- **'Market Growth Downside'** – instead of an average 2.7% pa growth in inland letters, the growth rate is an average 0.7% pa.

1.40 We have also been asked by Postcomm to examine, in conjunction with these sensitivities, the impact of Postcomm exercising certain 'policy levers', in particular:

- **'Exercise of Policy Levers':**
 - real price control – instead of the Interim Price Control, all currently controlled prices would be allowed to increase at the rate of inflation;
 - 'Narrow' UPS definition – instead of Postcomm's working definition of the UPS, Postcomm adopts a 'Narrow' definition, comprising Second Class, Standard Parcels and Special Delivery¹²; and
 - exclusion of non-postal and overseas operations from the financial assessment.

1.41 The next section summarises the limitations of our work before we turn to the summary of results.

⁹ The growth rates are the compound annual average growth rates to FY10-11.

¹⁰ This reflects the inter-product cream-skimming in the EP model but not the route-wise cream-skimming by product.

¹¹ The nature of this price pressure is discussed in the more detailed assumptions on competition in paragraph 2.50.

¹² See footnote 7.

Limitations of our work

- 1.42 Our modelling results are intended to identify the relative impact of different factors on the financial performance of Consignia and some of its business segments under alternative liberalisation scenarios and policy options. Our work is not intended to provide a forecast of Consignia's financial performance but rather to inform Postcomm's evaluation of the risks and benefits of various policies associated with possible market liberalisation through a series of scenarios and sensitivities.
- 1.43 Our analysis is subject to a number of important limitations. The main limitations are summarised immediately below and are covered in more detail in our main report.

Availability of Strategic Plan for 2002-2007

- 1.44 We recognise that it may be necessary to update our work to reflect aspects of Consignia's revised Strategic Plan for 2002-2007.
- 1.45 We describe in detail in Chapter 2 our model development procedure in the context of the data which have been available to us.

Projections in the context of Consignia's current financial performance

- 1.46 Consignia does not currently appear to be in a stable financial condition. In FY00-01 Consignia's operating profits (before exceptionals) declined from £381m in FY99-00 to a loss of £3m. The interim results of FY01-02 issued on 26 November 2001 report a loss for the first six months of £100m (before exceptional items).
- 1.47 To respond to this deteriorating performance, Consignia is facing the prospect of significant internal change. This includes making a rapid gross cost reduction amounting to around £1.2bn by FY02-03 and even the possible exit from the currently loss-making parcels business. We have not conducted an efficiency review of Consignia or assessed any of its strategic initiatives. As stated above, we have used certain efficiency profiles based on Consignia's high level identification of cost savings and advice provided to Postcomm by WS Atkins and Frontier Economics.
- 1.48 Consignia has identified significant funding challenges in the short term. We have presented the financial results under various scenarios, but not sought to determine Consignia's ability to finance its operations.

Projections in the context of exogenous uncertainties

- 1.49 Consignia faces a range of uncertainties over which it has limited control and which are difficult to project. These include:
- the nature of competition: this may be significantly different from that reflected in our modelling sensitivities;
 - REIMS: the re-negotiation of the REIMS agreement which expired on 31 December 2001 may materially affect Consignia's net revenues from terminal dues¹³;
 - e-substitution: the substitution of mail traffic by internet traffic, over and above that already taken into account within the current volume projections, may have a significant effect on Consignia's demand in the medium to long-term; and

¹³ We understand from Consignia that the REIMS renegotiation is still ongoing and that the previous agreement remains in place in the interim.

- Special privileges: we have not modelled the effect of a change in any of Consignia's special privileges, including its VAT status. We understand these privileges are subject to review by Postcomm but that there are no firm proposals at this stage.

Countervailing factors

- 1.50 We understand that various factors have determined Postcomm's selection of sensitivity range for market share loss.
- 1.51 First, at higher levels of market share loss, new market entrants might be increasingly expected to contribute to the provision of the UPS through contribution to a fund or be available as candidate UPS providers themselves.
- 1.52 Second, Postcomm's proposals have indicated its intention to grant Consignia a measure of downwards pricing flexibility when competition is sufficiently strong. Therefore, under such a policy, it may be considered unlikely that Consignia would be subject to the combination of high levels of market share loss and extensive cream-skimming. Postcomm expects that Consignia will respond strategically to the prospect of entry in other ways before pricing flexibility is granted (e.g. through targeted service standard improvements).
- 1.53 Third, Postcomm considers that Consignia has strong incumbency advantages, which will help it continue to retain market share.
- 1.54 In view of these factors, among others, the interpretation of our model results must necessarily be short- to medium-term since our sensitivity analysis (presented in Chapter 2) cannot capture the full effect of all such uncertainties or the combination of their impacts, or the possible policy responses identified above.

Data issues

- 1.55 We have not performed any audit, checks or verification of the data provided to us by Consignia or Postcomm. However, we have reviewed the internal consistency of the data.
- 1.56 There are a number of data issues that it has not been within the scope of our work to address. These include:
- Pensions: Consignia has stated that additional contributions to its pension funds may be required as a consequence of achieving the £1.2bn gross savings identified above. These contributions could be in the range £0-800m depending mainly on the age profile of redundancies and early retirements under the efficiency plans. However, we have not been able to estimate this impact with any greater degree of accuracy. In the absence of further information, we have assumed additional contributions of £600m in FY02-03 in our Base Case analysis¹⁴.

¹⁴ In the various sensitivities we have flexed the pension costs relating to redundancies linearly from nil at 7.5% efficiency savings to £800m at 17.5% efficiency savings.

- Cost allocation: Consignia allocates costs to products using its Cost and Contribution Model. It does so following the rules set out in the EU Postal Directive. However, we note that Ernst & Young, Consignia's auditors, have expressed a number of concerns about this model but we are not aware of the extent to which these concerns have been addressed by Consignia. We have identified a material amount of costs allocated by end state apportionment (i.e. in proportion to all directly or indirectly allocated costs), comprising £665m of central overheads and £364m of unapportioned non-pipeline service delivery costs in FY00-01 (derived from Consignia's Activity Based Costing System). Other methodologies may be appropriate. The issue of cost allocation is especially important in terms of assessing the financial performance of business segments, determining cost avoidability in the presence of competitors and benchmarking prices against cost.
- Volume measurement: Consignia estimates its volumes of postal packages delivered on two bases - operational measurement and 'revenue equated'. The first measure (accepted by its auditors) is based on a physical assessment of volumes handled and results in a higher number than the second measure which is derived from recorded revenues received. In FY99-00 and prior years, this discrepancy had a significant impact on cost allocation (which is largely driven by volumes across products) and hence on the relative profitability of different business segments. Consignia has stated that in FY00-01 the discrepancy is no longer material in the context of our analysis, and we have verified this through a sensitivity in our modelling.
- Limits on scope of our analysis: although we have modelled Consignia's entire business, our focus has been primarily on inland letters and domestic parcels. We have not received detailed information on a number of business segments including post office counters, the international businesses and non-postal businesses.

1.57 Our report has been completed before the final findings have become available from the efficiency study being conducted on behalf of Postcomm by independent consultants WS Atkins (in association with MMD and Canada Post International) as part of the price control project. We have, however, been provided with initial findings from WS Atkins' bottom-up review of efficiencies, and a report on a reasonable productivity profile by Frontier Economics.

Interaction with Consignia

1.58 Our interaction with Consignia has comprised a number of data requests and a series of meetings with Consignia staff concerned with financial planning, regulation and business strategy.

1.59 We have not had direct access to Consignia's records or budgeting systems nor have we verified any of the data used as inputs for the model.

1.60 Our interaction with Consignia in relation to our modelled Base Case is discussed in the next section.

Interpretation of results given limitations

1.61 Given the data we have used and the limitations noted above, our Base Case will not necessarily bear a close correspondence to Consignia's own Strategic Plan (even under the same liberalisation assumptions). But in any case it has not been the intention of this work to be able to replicate - under Consignia's assumptions - their own Strategic Plan. Accordingly, there are likely to be differences between the projections in our scenarios and those of Consignia. Our objective, as stated above, is not to provide forecasts but rather to illustrate the potential impact of a range of liberalisation scenarios and sensitivities.

- 1.62 We have, however, sought to determine Consignia's view of the reasonableness of our No Liberalisation Scenario Base Case assumptions and results. The resulting projections have been discussed with Consignia in order to understand the reasons, at a high level, for any deviations from their internal forecasts. We have not asked Consignia to reconcile our projections with those obtained from their own planning systems. These have been provided under illustrative efficiency scenarios on which Consignia has not been asked to comment in detail.
- 1.63 Based on these review meetings, Consignia indicated that they considered our financial modelling approach to be sound and the assumptions to be broadly reasonable in the No Liberalisation Scenario (i.e. before applying liberalisation impacts).
- 1.64 Consignia has, however, indicated that the inland letter growth rate data with which we have been provided are likely to be high relative to the new Strategic Plan. Revised and final estimates for inland letter growth have not been made available to us within the time frame required to reflect them in our modelled results.
- 1.65 Consignia indicated that the latter years of the ten year model would be particularly subject to e-substitution risk implying both that a lower rate of volume growth would be appropriate for the second half of the ten year model and that a wider margin of uncertainty applied to volume forecasts further into the future.
- 1.66 We have included a pessimistic inland growth rate sensitivity of 0.7% pa growth from FY01-02 onwards.
- 1.67 Consignia also indicated that their views were subject to change upon the finalisation of the new Strategic Plan for 2002-2007.
- 1.68 We have also provided our Base Case EC Proposal and Full Liberalisation Scenarios to Consignia. We have received comments from Consignia and have reflected these in our modelling where we considered it appropriate to do so.
- 1.69 Postcomm has not asked us to review the Postcomm Proposal Scenario with Consignia. There is therefore a range of issues around this liberalisation scenario which Consignia may be able to identify (that are not wholly captured in their consideration of the EC Proposal and Full Liberalisation Scenarios) that are not reflected in this report.
- 1.70 Given the limitations and uncertainties about Consignia's present financial position (paragraphs 1.46 to 1.48 above), the challenges it faces in the short term implementation of its cost reduction programme (which is assumed to be successful) and the exogenous uncertainties described in paragraph 1.49 above and given that the projections relate to an extended future period in which events and circumstances are likely to differ from those projected, we cannot predict how closely the results ultimately achieved by Consignia will correspond with those we have projected.

- 1.71 It is for this reason that our results are presented primarily as the differences in financial terms between the No Liberalisation Scenario Base Case and our other scenarios. This provides an indication of the relative scale of the impact of regulatory actions and competition without needing to deal with all the uncertainties in the outcome of each projected scenario.

Main findings

- 1.72 We have provided the change in NPV in our scenarios relative to the Base Case No Liberalisation which we use as a reference point. This is intended to highlight the relative financial impact of the different scenarios and sensitivities. This is shown in Table 1 below.
- 1.73 We have also shown the change in NPV that results under the more stringent conditions of the Increased Competition Sensitivity (by applying the non-uniform volume loss results by product and weight step of Consignia's Entry Pricing model and price pressure on selected products to the Postcomm Proposals Scenario) and the Efficiencies Downside¹⁵.

Table 1 – Change in NPV in FY02-03 relative to Base Case No Liberalisation under liberalisation scenarios and range of sensitivities: £bn¹⁶

NPV in No Lib Base Case = £bn Threshold value = £bn	No Liberalisation	EC Proposal	Postcomm Proposals	Full Liberal – isation	Postcomm Proposals plus Increased Competition Sensitivity
Panel A					
Base Case	-	(3)	(3)	(3)	(3)
<i>Independent sensitivities</i>					
One-off efficiencies 5%	(3)	(3)	(3)	(3)	(3)
Annual efficiencies 0%	(3)	(3)	(3)	(3)	(3)
Combined downside					
Efficiencies Downside	(3)	(3)	(3)	(3)	(3)
PANEL B					
Combined Efficiencies Downside plus Exercise of Policy Levers	(3)	(3)	(3)	(3)	(3)

¹⁵ However, as we explain in paragraphs 2.47 to 2.49 and accompanying footnotes, our estimated impacts of liberalisation are not the same as those from the EP model.

¹⁶ As explained in paragraphs 2.34 and 2.35, the results presented do not include the effect on the NPV of upstream liberalisation, existing licences and any subsequent licences to be issued for 'defined activities' under Postcomm's proposals.

1.74 The results in Table 1 illustrate our main findings:

- Finding 1: *'The nature of competitive entry has a material effect on Base Case liberalisation results'*: the NPV under the Postcomm Proposals Scenario Base Case, assuming 20% market share loss, is around £<bn lower than in the No Liberalisation Scenario. The NPV under Postcomm's Proposals is lower by around a further £<bn under the Increased Competition Sensitivity. Thus, the impact of increased competition can be significant.
- Finding 2: *'Consignia has larger challenges than the prospect of liberalisation'*: while liberalisation impacts relative to the No Liberalisation Scenario do not exceed around £<bn ('moving across' Panel A in Table 1), the impact of not achieving efficiencies in combination can be up to around double this or £<bn ('moving down' Panel A in Table 1). Achieving efficiencies is only part of the internal challenge at Consignia, and the impact of 'moving down' Panel A is indicative of selected challenges.
- Finding 3: *'Efficiency gains and market growth are critical'*: within our assessment of 'downside' risks, the failure to achieve any annual efficiency gains reduces the NPV by around £<bn. Alternatively, should Consignia achieve only a 5% one-off gross efficiency benefit in FY02-03 (compared to the gross 15% in our Base Case, NPV is reduced by up to around £<bn. The failure to achieve one-off and annual efficiencies combined is worth around £<bn. We present results for market growth in Chapter 3.
- Finding 4: *'Postcomm has potentially effective policy levers'*: even under the Efficiencies Downside identified above, Postcomm could in principle exercise certain policy levers to mitigate the scale of the NPV reduction. In particular, relaxing the Interim Price Control to a real price control and excluding the overseas and non-postal operations, would generate an NPV of £<bn under the Postcomm Proposals Scenario, which is around the threshold value^{17,18}.

1.75 In summary, the impact on Consignia in our modelled scenarios of failing to realise efficiency gains ('moving down' Panel A in Table 1) is greater than the impact of liberalisation ('moving across' Panel A in Table 1).

1.76 Should Postcomm consider that liberalisation tended to *encourage* efficiencies, it would be relatively less likely that outcomes would be in the bottom right of Panel A in Table 1. It would therefore be incorrect to interpret Table 1 as *necessarily* presenting an erosion of Consignia's value resulting from liberalisation¹⁹.

¹⁷ The threshold value varies slightly under departures from the No Liberalisation Scenario Base Case due to the disposal of assets.

¹⁸ In this case, redefining the UPS as 'Narrow' would not make a difference as no cream-skimming is assumed.

¹⁹ We note in any case that where Consignia realised efficiency savings that generated a return in excess of its required rate of return, Postcomm would be likely to seek to impose price controls which recovered some of these benefits for consumers.

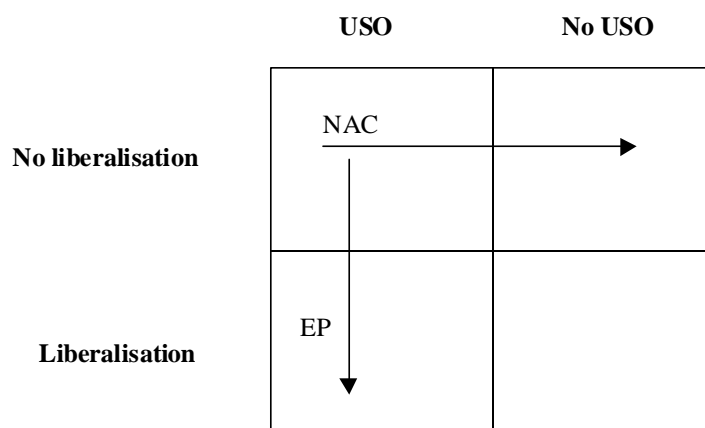
2 Our approach

- 2.1 Our approach has been to construct a high level financial model of Consignia based on the latest year of statutory data, FY00-01 (our 'Base Year'). We have used this model to project forward the prospective financial performance of Consignia to FY10-11 under the different liberalisation scenarios identified by Postcomm.
- 2.2 We have then undertaken extensive sensitivity analysis in order to derive an assessment of the exposure of Consignia's financial performance to a range of different policy, data and market assumptions.
- 2.3 We next explain why we have adopted this approach. We then explain the nature of the financial analysis we have conducted and our overall approach to model development. Finally, we review our approach to determining the Base Case and sensitivities for each of the four sets of drivers – competition, Postcomm policy, efficiencies/ parcels profitability, and other market and company factors – and summarise the sensitivities employed.

Measuring financial performance under liberalisation scenarios

- 2.4 Postcomm's concern with the financial viability of Consignia principally arises because Consignia as the provider of the UPS may be incurring costs associated with some elements of the UPS that are not recovered directly by the tariffs on UPS products. To date, such 'excess costs' have been recovered by inter- or intra-product cross-subsidies. Inter-product cross-subsidies arise where some products have been priced on aggregate above cost and others below cost. Intra-product cross-subsidies arise where some elements of a product have been priced above costs (e.g. city centre to city centre 1st Class mail), while others have been priced below cost (e.g. city centre to remote rural 1st Class mail).
- 2.5 However, such cross-subsidies may become unsustainable to the extent that market liberalisation promotes effective and extensive competition. Competitors to Consignia will be attracted to services and products that are at present priced above cost. In other words, effective competition will expose any excess costs associated with the provision of the UPS.
- 2.6 There are two broad existing approaches for considering the financial viability of the provider of the UPS. These are the Net Avoided Cost ('NAC') and the Entry Pricing ('EP') approaches. As shown in Figure 1, the NAC approach comprises a comparison of the financial impact with and without an obligation to provide the universal service ('USO') (generally under no liberalisation) and the EP approach consists of a comparison of financial impact with the introduction of competition, while providing the UPS.

Figure 1 – Comparison of NAC and EP approaches to financial viability assessment



- 2.7 One approach to assessing the financial impact of the 'excess costs' of the UPS is straightforwardly to estimate the costs that would be avoided in the event that the UPS provider ceased to be obliged to provide the UPS. This is the NAC methodology. Postcomm has already estimated the NAC implicit in Consignia's current provision of the UPS in its discussion paper, *An assessment of the costs and benefits of Consignia's current Universal Service Provision*, June 2001.
- 2.8 The main limitation of the NAC approach is that, as a static analysis, it calculates the financial impact of dropping the non-profitable elements of the UPS on the basis of the assumption that the costs and revenues in other business segments remain unaffected. Most importantly, it does not take account of the joint fixed costs which require to be funded even after the loss of profitable units. The unavailability of these joint fixed costs may cause the allocated cost and hence prices of other products to rise (following the loss of unit volumes). This in turn may cause the loss of further market share to competitors and so exacerbate any financial performance problem.
- 2.9 Consignia estimates its total fixed unavoidable costs to be around 40% of total costs, and joint fixed costs may form a substantial portion of these.
- 2.10 An alternative approach, used by Consignia in its EP model, is to model directly the erosion in the operating profits used to support the cross-subsidy that occurs as a result of market liberalisation. The form of competition is assumed to be cream-skimming at a 'route-wise' level, which, as noted in the NAC discussion paper, may be considered an unlikely extreme. A further problem with this modelling approach is that while it is more dynamic than the NAC approach and capable of more sensitivity analysis around key parameters, like the NAC approach it does not take into account the ability of the business to bear the loss in contribution over time, in the context of changing prices, costs and market demand. Moreover, the operating profit impact is estimated after assuming that the UPS provider incurs costs to meet the demand that it then loses to competitors without any anticipation of the market share loss.
- 2.11 The approach we have adopted combines aspects of the NAC and EP models, and sets these in a dynamic financial model of Consignia's business. It is based on a static assessment of the financial performance of Consignia and various segments of its business in the Base Year. The dynamic effects of liberalisation are tested through scenarios and sensitivity analysis. This approach allows us to incorporate a requirement for overall cost recovery within a framework which enables flexible analysis of the potential effects of liberalisation on volumes served and costs incurred.

- 2.12 The appropriate focus of our financial model in terms of the business segments which should be analysed and the appropriate measure of financial performance is a function of the wider policy context within which the results of our work need to be assessed. We now turn to this.

Financial modelling focus and financial performance measures

- 2.13 The financial modelling could in principle be focused on the 'Entire Business' of Consignia (including non-UPS postal and non-postal businesses) or on particular business segments (such as the UPS business or the UPS business plus Reserved Area products), i.e. excluding the non-UPS or non-Licensed business segment.
- 2.14 The appropriate focus to some extent depends on the approach taken by Postcomm to interpreting its statutory duties. Options for safeguarding the UPS have been discussed in Postcomm's consultation document *Promoting effective competition in UK postal services*, June 2001, and include maintaining a Reserved Area, restrictive licensing policies and external funding support through direct subsidy or an industry fund.
- 2.15 A Reserved Area approach might lead to focusing the analysis commensurate with the Reserved Area plus UPS products, since the Reserved Area can be viewed as the 'provider' of cross-subsidy and the UPS products can be seen as the 'recipient' of cross-subsidy, and jointly these products should be financially viable.
- 2.16 The external funding approach might lead to a focus on the UPS business (and its associated funding requirement) only.
- 2.17 However, we also note that where the focus is less than the Entire Business there are problems associated with cost allocation and the incentives on Consignia to improve the profitability of its non-UPS business segment. For example, Consignia may be disincentivised from making efficiency gains that would serve to reduce financial support for its UPS products where the focus of analysis is constrained to the UPS business.
- 2.18 The Section 5(4) duty under the Act may require the focus to be on the Entire Business of the licence holder, which is consistent with our use of Entire Business measures.
- 2.19 Accordingly, in our modelling we have derived results for both the Entire Business of Consignia and the business segment providing the UPS under the alternative definitions of the scope of the UPS.
- 2.20 In terms of financial performance measures, we have calculated profit margins, rates of return and liquidity and solvency ratios. In addition, we have calculated the net present value ('NPV') of free cash-flows. We have benchmarked this NPV against a 'threshold value' for the Entire Business.
- 2.21 This threshold value has been taken as the market value of the operational fixed assets required by Consignia for the on-going commercial operation of its business. Recovering this value (whether from tariffs or other sources) in NPV terms is necessary for Consignia to recover the minimum opportunity cost of the assets deployed in providing postal services.

- 2.22 The operational fixed assets of Consignia (unlike those of many other regulated entities which operate monopoly network businesses) may be relatively easily valued at open market prices since they are principally property and vehicles. We have adopted an open market valuation for land and buildings, as provided by Consignia²⁰.
- 2.23 The total net assets include, in addition to the operational assets, goodwill (£421m in FY00-01) and cash and short-term investments (£2.2 bn in FY00-01). This total asset value increases substantially in excess of the fixed asset value in many of our scenarios in the period to FY10-11 because surplus cash is retained within the business. However, NPV values that are less than the threshold value represent an inability to recover the minimum commercial cost of sustaining the postal operations of Consignia²¹.
- 2.24 The measures we have used are relevant to financial performance analysis and are similar to those employed by other regulators such as Ofgem.

Model development

- 2.25 Our financial model of Consignia is based on the latest year of statutory data (FY00-01). The projections to FY05-06 use the high level assumptions contained in Consignia's Strategic Plan 2001-2006, which are Consignia's most recent integrated projections available to us, subject to certain adjustments. We made these adjustments where there was more recent and sufficient evidence to warrant them.
- 2.26 In particular, we modelled alternative efficiencies, since our base year is FY00-01 and reflects a significant increase in costs compared to the base year of the Strategic Plan (FY99-00). We also modelled prices determined by the Interim Price Control, rather than Consignia's previous assumptions. Finally, we modelled liberalisation scenarios, rather than the particular liberalisation scenario assumed in the Strategic Plan for 2001-2006.
- 2.27 Consignia's accounting for pension costs is subject to change under the new accounting standard FRS17. Consignia indicated to us that they would be required to start making contributions to the POSSS pension scheme, following a contribution holiday. We had a meeting with Consignia to determine the likely impact of these changes and have modelled them accordingly.
- 2.28 The projection from FY05-06 to FY10-11 uses additional assumptions and includes the calculation of a terminal growth rate to allow us to calculate the NPV of the free cash-flows of the business.
- 2.29 Consignia is in the process of finalising a Strategic Plan for the period 2002-2007. This will in effect have FY01-02 as its base year from which re-projections will be applied. We have identified within our report sensitivities which we believe are likely to capture some of the main elements of this new plan. However, at this stage we cannot estimate with certainty the direction or quantum of any changes which might be necessary to our modelling arise and whether the current sensitivity range encompasses the new Plan.

²⁰ This valuation basis differs from that adopted in the statutory accounts, and required an £81m downwards adjustment of the balance sheet value of land and buildings.

²¹ The 'threshold' value varies slightly under some of the scenarios and sensitivities we have examined due to the disposal of assets. We have reported the relevant threshold value, after taking this into account, in the results.

- 2.30 We have, however, been provided by Consignia with updates to some of the projections contained in the Strategic Plan 2001-2006, which we understand are consistent with the new Plan. In particular, we have received revised international letter and parcels volume projections.
- 2.31 We have used the data submitted further to our information requests to Consignia to provide a greater level of underlying detail than the published statutory accounts, particularly as relates to product profitability in individual weight steps.

Drivers

Competition

Interpretation of liberalisation scenarios

- 2.32 We have modelled four liberalisation scenarios, as directed by Postcomm. The four scenarios are shown in Table 2.

Table 2 - Summary of liberalisation scenarios

Liberalisation options	Details of option
No Liberalisation	Maintain status quo of a 350g Reserved Area
EC Proposal	Reduction of the Reserved Area to 100g by 1 January 2003 and to 50g by 2006
Full Liberalisation	Full liberalisation from 1 April 2002 (excluding upstream access)
Postcomm Proposals	Reduction of the Reserved Area to 100g by 1 January 2003. Liberalisation of bulk mail above 4,000 items on 1 April 2002 and above 500 items on 1 April 2004. Full liberalisation on 1 April 2006

- 2.33 In modelling Postcomm's liberalisation scenarios we have made a number of simplifying assumptions on account of the level of detail of Postcomm's approach and the data available. These are described below.
- 2.34 First, we have not been able robustly to model the impact of upstream liberalisation (i.e. access for third parties to Consignia's network) due at this stage to insufficient data. In principle, we note that Consignia's current 'retail-minus' access charges might leave it relatively neutral, in operating profit terms, to varying levels of workshare²². In practice, however, the impact of access will depend, inter alia, on the application of Licence Condition 9 and in particular the form of access pricing that is adopted, the allocation of avoidable costs and the selection of retail prices. We have not reviewed Consignia's current access charges in detail and we have also not considered any possible interaction between third party access and end to end liberalisation.
- 2.35 Second, we have not modelled the impact of existing licences or any subsequent licences to be issued for 'defined activities' under Postcomm's proposals. All existing licences have a duration of one year and they therefore have limited significance for projected financial performance other than in the immediate short-term. Since Postcomm has not at this stage defined its criteria for issuing 'defined activity' licences, it is not possible to estimate their impact. In this context, Postcomm has stated that it intends to have regard to the financial impact on Consignia of issuing such licences on a case by case basis.

²² Under 'retail-minus', access charges are based on final retail prices less the incremental cost of the activity (i.e. the cost of the work avoided by Consignia).

- 2.36 Third, we have assumed that the liberalisation of bulk mail above 4,000 items will expose to competition those products which are currently Reserved and which have a minimum of 4,000 items as their service standard²³. We note that this excludes any bulk mailings of this volume through products with lower thresholds.
- 2.37 Fourth, we have assumed that Postcomm's liberalisation step on 1 April 2004 to achieve liberalisation of 70% of inland letter product volumes in the final phase of the transition path will require an exposure to competition of all products with thresholds above 1 but below 4,000 items per mailing, plus a pro rata exposure of all remaining products up to the point that Postcomm's target is achieved²⁴. Thus, we have not sought to model any threshold directly, but rather to simulate Postcomm implementing a transition path that had the effect of exposing to competition the target level of business measured in volumes.
- 2.38 Fifth, we have modelled the impact of the EC Proposal liberalisation steps from 1 April (i.e. the first day of Consignia's financial year) following their 1 January implementation date.

Base Case

- 2.39 As a Base Case, Postcomm has asked us to model the impact of Consignia losing 20% of its volumes exposed to competition, on the assumption that average contribution units would be lost (i.e. no cream-skimming).
- 2.40 In the Base Case, we have also included critical mass effects, i.e. we have assumed that liberalisation will affect already liberalised weight steps (above 350g) and Presstream (which is already liberalised, but which Postcomm subjected to price control in 2001 on the grounds that it was not subject to effective competition). We have applied the same scale of critical mass effects relative to primary liberalisation effects as obtained in the EP model under full liberalisation.
- 2.41 Where competition results in the volumes of certain products falling, we have assumed that Consignia could avoid costs for those products at the rate of the LRMC factors provided to us. Furthermore, we assume that Consignia would dispose of assets in a fixed proportion to its reduction in operating expenditure. In making these assumptions, we recognise that while Consignia may anticipate some volume losses and be able to plan accordingly, there will be a proportion of volume losses which Consignia might not reasonably be expected to anticipate.
- 2.42 We have considered it reasonable to assume costs are avoided in the same year as volume losses. This is because we consider it unlikely that market share loss would be truly linear from the date of liberalisation over three years. Rather, there is likely to be a lag before market share is actually lost. Thus, Consignia is likely to have some time to adjust in the expectation of competition²⁵.

²³ These products comprise Mailsort 700, Mailsort 120, Mailsort 1400, Walksort and Flatsort 3.

²⁴ Thus, for example, we have assumed that Cleanmail, which has a threshold of 2,000 items, is fully liberalised in the final phase of the transition path.

²⁵ Consignia has indicated that it considers a one year lag for the avoidance of the non-labour elements of costs would be appropriate in this case.

2.43 We have not assumed any strategic 'reaction' by Consignia to the loss of market share. This is consistent with the EP model which in previous analysis does not assume a price response²⁶. However, we understand from Consignia that in applying the EP results within their own strategic planning process, they do assume some 'reaction' which has the effect of diminishing the actual projected impact on the business compared to the results obtained directly from the EP model.

Sensitivities

2.44 Postcomm has asked us to model a number of sensitivities around the Base Case assumptions.

2.45 In particular, we have been asked to examine a range of market share loss between 0% and 30%.

2.46 Postcomm has also asked us to develop some competition sensitivities based on Consignia's Entry Pricing (EP) model. We have developed two such sensitivities.

2.47 First, we have obtained the pattern of market share loss by product and by weight step from the EP model under full liberalisation. We have applied this pattern of market share loss to our model. The overall level of market share loss is 31% and varies considerably between products. We recognise that this sensitivity does not fully capture all aspects of the EP model, but we consider it captures a major element of the impact predicted by that model²⁷.

2.48 Second, we have combined our assumption of uniform market share loss across products and weight steps (e.g. at 20%) with a form of extreme cream-skimming, where we assume that within each product the most profitable routes are lost first²⁸. This is not intended to replicate the EP model, but to capture the impact of extreme cream-skimming given market share loss.

2.49 We have also modelled the combination of higher levels of uniform market share loss with extreme cream-skimming²⁹.

²⁶ We have, however, modelled a policy sensitivity where the UPS is defined 'narrowly'. We assume under this sensitivity that only the residual UPS products will suffer cream-skimming when this form of combination is applied as an additional sensitivity. This may be interpreted as Consignia adjusting prices on the non-UPS products to avoid cream-skimming. However, following our general approach, we have not modelled a price response to competition and capture the competition effect wholly through the loss of volumes and the consequent avoidance of costs.

²⁷ The procedure will not capture all the EP model effects for a number of reasons. In particular: (i) the EP model is based on FY99-00 data rolled forward under certain assumptions to FY03-04 and we have applied the results to a Base Year FY00-01 which has a different distribution of volume, revenues and costs; (ii) the EP model assumes 'cream-skimming' of most profitable routes within products and weight-bands, which our procedure does not capture; and (iii) the EP model is based on tariffs (i.e. list prices) rather than average revenues as with our accounting data.

We have not considered it appropriate at any stage of our modelling to use tariffs, since we consider it is unreasonable to assume that new entrants would have an advantage in the short- to medium-term compared to Consignia in excluding underpaid and other contributory items. We note that Postcomm is proposing liberalisation mainly through bulk mail before 2006, and this mail is less susceptible to revenue loss than other products. Finally, we note that our model excludes any benefit to Consignia over the projection period of improving its revenue collection.

Our procedure results in a total loss of contribution under Full Liberalisation of around £3<m at 31% market share loss in FY05-06 (i.e. after the full liberalisation impact is experienced), equivalent to around 83% of the £3<m impact under the EP model in the year FY03-04.

²⁸ This procedure results in a total loss of contribution under Full Liberalisation of around £3<m at 20% market share loss in FY05-06, equivalent to around 84% of the impact under the EP model in the year FY03-04.

²⁹ For example, 30% market share loss combined with extreme route-wise cream-skimming results in a contribution loss of around £3<m in FY05-06, around 19% in excess of the amount predicted by the EP model for FY03-04.

2.50 Postcomm has also asked us to model, as a sensitivity, the impact of Consignia pricing certain products at lower than the price control. These products are ones for which Consignia projected prices in the Strategic Plan 2001-2006 at a lower level than the price control subsequently imposed by Postcomm. These products comprise Presstream, Airmail Public Tariff, Surface Public Tariff, Special Delivery and Standard Parcels.

2.51 Finally, we have modelled 'leakage' as a further sensitivity³⁰. In particular, we have assumed that upon a given weight-based liberalisation step (e.g. to 50g), the weight step immediately below is also de facto exposed to competition (e.g. to 40g).

2.52 In this summary report, we have reported the Base Case results and the:

- **'Increased Competition Sensitivity'** – instead of 20% market share and no cream-skimming, Consignia loses 31% market share with differential loss across products and weight steps as obtained from Consignia's EP model. Consignia is also assumed to lower its prices on certain price controlled products.

2.53 We understand that Postcomm considers the above sensitivity to provide a reasonable 'outer limit' given the intention to grant pricing flexibility once competition is well established (i.e. we understand Postcomm would not expect to encounter a situation of high market share loss combined with cream-skimming given its proposed policy response). We also understand that Postcomm considers the modelled range of market share loss provides a reasonable 'outer limit' given that at higher levels of market share loss it would consider the need for a fund and view other postal operators as candidate providers of the UPS.

Postcomm policy

2.54 The potential scale of the financial obligation associated with the UPS depends not just on the impact of competition on the UPS provider's revenues and costs but also on:

- the scope of the UPS products; and
- the price of UPS products relative to their costs, recognising on the one hand, that costs are a function of the service standard associated with the UPS and the approach taken to allocating costs across UPS and non-UPS products, and on the other hand that UPS product prices may be constrained by definitions of 'affordability' and 'uniformity'³¹.

2.55 In our financial model, when we assume a cream-skimming pattern of entry as a sensitivity, the impact will be larger the more broadly the UPS is defined, and will be a function of the relative prices and costs of UPS units. This is because a 'broad' UPS under Postcomm's working definition imposes pricing uniformity across more products and so increases the scope for cream-skimming behaviour.

³⁰ 'Leakage' refers to the incumbent losing volumes, due to competition, from *within* the residual de jure monopoly area. This could occur because of monitoring problems or the substitution of demand across weight steps to take advantage of lower prices.

³¹ The Act requires the provision of universal postal services '...all at affordable prices that are uniform throughout the UK'.

- 2.56 The UPS is defined at a high level in the Act. In its proposals, Postcomm has adopted a working definition of the Act but has also stated its expectation that the UPS would 'narrow' over time. Postcomm has also indicated that it intends to consult on the definition of the UPS later in 2002. We have considered two particular options for the scope of the UPS, as set out in Table 3, while recognising that there may be other significantly different approaches to 'defining' the UPS³².

Table 3 - UPS policy options

UPS policy option	Products included
'Broad' UPS (in line with Postcomm's working definition) (Base Case)	UPS products as currently defined by Consignia ³³
'Narrow' UPS	Second Class, Standard Parcels and Special Delivery

- 2.57 Under the UPS obligation, as noted above, the UPS products must be provided at 'affordable' prices. Postcomm has not determined its basis for interpreting this requirement and so we have also considered two policy options for the price control, which regulates UPS prices. These policy options are summarised in Table 4 below.

Table 4 - Price control policy options

Price control policy option	Price levels set
Interim Price Control (Base Case)	Nominal price freeze or real price freeze as determined in the Interim Price Control ³⁴
Real price freeze	Real price freeze for all products and weight steps including UPS products

- 2.58 We have not modelled any benefits or costs which might arise from Postcomm interpreting UPS service standards to be different from those currently provided by Consignia.
- 2.59 We have assumed that the Post Office counters network (POL) will be funded in such a way that POL's losses will not increase (this may in principle involve some combination of the gilts on Consignia's balance sheet, other sources of funding and/or variations in social policy).

³² The 'Narrow' definition we have adopted is based on the minimum set of products, as suggested by Postwatch, that would satisfy the definition of the UPS set out in the Act (see Chapter 5 of Postcomm's proposals document). For modelling purposes, we have included all weight steps of Second Class and Standard Parcels and Special Delivery, although Postwatch has submitted that the UPS could be satisfied by Second Class up to 750g and Standard Parcels from 750g to 20kg, together with Special Delivery.

³³ The UPS as defined by Consignia includes inland letter products excluding Presstream and Door to Door, certain international products (Airmail Public Tariff, Fees/ Forces/Misc, Import, Surface Public Tariff) and certain parcels products (Special Delivery, Standard, Export Standard).

³⁴ The Interim Price Control was established in the licence granted to Consignia on 23 March 2001.

2.60 In this summary report, we have reported the Base Case results and the:

- **'Exercise of Policy Levers'**³⁵:
 - real price control – instead of the Interim Price Control, all currently controlled prices would be allowed to increase at the rate of inflation;
 - 'Narrow' UPS definition – instead of Postcomm's working definition of the UPS, Postcomm adopts a 'Narrow' definition; and
 - exclusion of non-postal and overseas operations from the financial assessment.

Efficiency/ parcels profitability assumptions

Background

2.61 Consignia's last Strategic Plan was based on FY99-00 as the Base Year. Between FY99-00 and FY00-01, our Base Year, Consignia experienced a large increase in costs. It is therefore appropriate for our modelling to reflect efficiency assumptions which address this cost increase and determine the ongoing level of efficiency.

2.62 There is considerable uncertainty around the future profitability and organisation of Consignia's parcels business. For this reason, we have also been asked to devise a sensitivity for the parcels business.

2.63 Our Base Case assumptions for efficiencies are based on discussions with Consignia, ongoing consistency with the Interim Price Control, and advice to Postcomm from Frontier Economics and WS Atkins. We have also considered a sensitivity based solely on the Frontier Economics and WS Atkins findings. We review the information available on efficiencies below.

Discussions with Consignia

2.64 Consignia has announced its intention to make a gross £1.2bn reduction to its cost base by the end of FY02-03. Based on our discussions with Consignia, we understand that it expects to realise lower net savings which are after, inter alia, redundancy costs and the sharing of efficiency improvements through the existing productivity bonus scheme (PBS)³⁶. We have assumed that all of the cost savings identified by Consignia would be consistent with the service standards to be maintained under the UPS.

2.65 Consignia has also indicated which elements of the cost increase between FY99-00 and FY00-01 might be 'non-recurring' in the sense of being a transitory part of the cost base. Based on these indications, we have estimated that the range of non-recurring costs is between £237m and £470m. (We have not conducted our own review of the Base Year or Prior Year costs to identify non-recurring items.) This range includes 'uncontrollables' (such as the costs associated with the Hatfield rail disaster) and increases to additional costs (such as increased expenditure on technology infrastructure).

2.66 We understand from Consignia that a significant proportion of these non-recurring costs are potentially available as additional savings over and above the announced gross saving of £1.2bn.

³⁵ Tariff re-balancing on a possibly more cost reflective basis - in contrast to the current weight-based tariffs - would also assist Consignia while also arguably resulting in more economically efficient tariffs.

In addition, as noted in paragraph 2.58, we have not assumed any changes in service standards of UPS products. Changing these could be used as an additional safeguard by Postcomm.

³⁶ Under this scheme, Consignia shares the benefits of labour productivity improvements with the workforce.

2.67 Consignia's previous Strategic Plan for 2001-2006 set out an ongoing rate of efficiency improvement of 3% pa in pipeline costs (equivalent to around 1.8% of total inland letter, international and parcels costs, assuming no efficiencies outside the pipeline)³⁷. Consignia's recent announcement has not been related by Consignia to the long run rate of productivity improvement it plans to achieve.

2.68 This evidence suggests it would be reasonable to assume a substantial short-term 'catch-up' in efficiency and ongoing efficiencies of at least 1.8% pa.

Frontier Economics and WS Atkins advice

2.69 Postcomm has also commissioned an independent assessment of the potential scope for efficiency improvements within Consignia's business. It has asked Frontier Economics to identify a reasonable range based on benchmarks from other postal operators and UK regulated utilities. Postcomm has also asked WS Atkins (in conjunction with MMD and Canada Post International) for preliminary estimates from their detailed efficiency review of Consignia's operating and capital expenditure. This review is being conducted as part of Postcomm's review of Consignia's price control.

2.70 Frontier Economics has indicated that price controls for a range of de-regulated UK utilities have in the past embodied efficiency assumptions of 1.5% to 6.6% pa, but they have suggested that the lower end of the range may be a poor benchmark for post since it relates to the water sector and reflects substantial investments in environmental and quality improvement. Frontier Economics has also reported achieved reductions in Real Unit Operating Cost ('RUOC') for electricity distribution, National Grid Company and British Gas of between 4.4% and 7.1% pa. The higher rates of productivity growth were achieved by British Gas that benefited from some economies of scale in their measurement.

2.71 Consequently, Frontier Economics has concluded that Consignia could achieve a net efficiency improvement of 10% in FY02-03 and 7% in FY03-04. Subsequently, efficiency improvements could range between 2% and 4%, with an expectation that they would be in the upper part of this range in the short- to medium-term.

2.72 WS Atkins has provided an efficiency profile which indicates that maximum efficiencies may not be achieved until FY04-05. They have provided a profile rising from 4% in FY02-03, to 10% in FY04-05 and declining to 4% by FY05-06.

Interim Price Control

2.73 Given the importance of the NPV calculations, it is clearly important that our price control cost assumptions are internally consistent. Postcomm's current nominal price control freeze with an inflation factor of 2.5% pa is equivalent to an RPI-2.5% price control. This is equivalent to an assumption of 2.5% ongoing efficiency gains to FY10-11³⁸. The terminal growth rate is 0%, so we do *not* assume an ever widening price-cost margin.

³⁷ Pipeline costs are the direct costs of the mail operations (e.g. sorting machines and labour and delivery vehicles and labour). They exclude local and central overheads.

³⁸ Economies of scale result in changes to real unit operating cost without efficiencies (since incremental units are cheaper than average units). Thus, with growing volumes and economies of scale, Consignia could achieve the 2.5% 'X' factor with efficiencies of less than 2.5%. We have checked that our approach is consistent with the potential significance of economies of scale effects through performing a cross-check on the annual change in RUOC compared to the range identified by Frontier Economics. This is reported in paragraph 2.76.

Summary of Base Case and sensitivities

- 2.74 Taking the above factors into account, in the Base Case we have modelled a 15% gross reduction in the cost base in FY02-03^{39,40}. We have modelled direct redundancy costs assuming 18 months salary costs per head. We have also modelled the impact of the £600m pension related redundancy cost⁴¹. In the Base Case, we have assumed that after the initial efficiency, Consignia would make net efficiencies at the rate of 2.5% per annum to match the conditions of the Interim Price Control.
- 2.75 The resulting net efficiency in FY02-03 is £428m before the pension related redundancy cost and (£172m) after taking it into account in the Postcomm Proposals Scenario.
- 2.76 These assumptions result in an annual change in actual RUOC of -5.0% pa under the Postcomm Proposals Scenario (i.e. after economies of scale benefits), or around -3.8% pa before economies of scale over the ten years from FY00-01 to FY10-11. The actual RUOC is -6.2% pa after economies of scale, or around -5.3% before economies of scale over the five years from FY02-03 to FY06-07.
- 2.77 These productivity improvements are consistent with the range of X factors and RUOC's identified by Frontier Economics. They compare to the 5.8% efficiency and 6.6% annual efficiencies over the five years from FY02-03 to FY06-07 advised by Frontier Economics and WS Atkins respectively. The subsequent rate of efficiency is consistent with the Interim Price Control.
- 2.78 We have considered an efficiencies downside in which Consignia achieves only a gross 5% efficiency in FY02-03 and no ongoing efficiencies.
- 2.79 In addition to the efficiencies sensitivity, we have also considered a sensitivity in which Consignia's parcels business achieves break-even rather than the profits generated under the projection assumptions provided by Consignia. We have not modelled any other scenarios for the parcels business.
- 2.80 In this summary report, we have reported the Base Case results and the:
- **'Efficiencies Downside'** – instead of a 15% gross efficiency in FY02-03 followed by 2.5% annual efficiencies, Consignia is assumed to achieve only a 5% efficiency in FY02-03 and no ongoing efficiencies; and
 - **'Combined Efficiencies and Parcels Downside'** - this combines the previous downside with an assumption that the parcels business achieves break-even rather than the profits obtained in the Base Case.

Other company and market factors

Background

- 2.81 Consignia's projected performance is affected by a range of other factors including factors largely outside Consignia's control (e.g. market growth) and also within Consignia's control (e.g. cost avoidability).

³⁹ We have not modelled the incremental PBS costs directly. The 15% is therefore net of PBS costs.

⁴⁰ The cost base to which the saving is applied is limited to inland letters, international letters and parcels.

⁴¹ Consignia has estimated this cost could be in the range £0-800m in the context of its recently stated efficiency target of £1.2bn. We have modelled an additional cost of £600m in the Base Case in the year of the step change in efficiency (FY02-03). Since we have modelled a figure at the upper end of the range, we have not modelled a sensitivity for this factor.

Base Case

2.82 We have determined a Base Case for these factors based on information provided to us by Consignia. The Base Case assumptions are summarised in Table 5.

Sensitivities

2.83 We have also determined appropriate sensitivities for the key drivers. We have based these on further evidence provided to us by Consignia (e.g. their own upside/downside estimates), or by Postcomm and or its other consultants (e.g. Postcomm has asked Frontier Economics to conduct a review of Consignia's market growth projections), or based on our own judgement of a reasonable sensitivity range.

2.84 We briefly mention here the relevance of each sensitivity:

- Market demand for inland letters: there is uncertainty over market demand due to the current economic environment and, in particular, the possible effects of e-substitution. We have modelled a range of estimates from 3.2% per annum inland letters growth (estimated by Frontier Economics in a separate report to Postcomm) to 0.7% per annum.
- Market demand for international letters and parcels: We have not had a basis for modelling sensitivities to the market demand for international letters and parcels. We note however that we have been provided with updated projections for inward international letters and all parcels, which we understand are consistent with the new Strategic Plan, and which are significantly lower than the projections in the Strategic Plan 2001-2006.
- LPMC: the long-run marginal cost ('LPMC') factor determines the cost exposure of Consignia to changes in demand. Thus with a factor of 0.6 a 1% increase/decrease in demand causes a 0.6% increase/decrease in costs. In the Base Case, we have modelled product-specific LPMCs in line with those provided to us by Consignia (around an average of 0.6 for inland letters). We have modelled a range under which the LPMC for PPI/STL 1st Class Mail ranges from 0.5-0.9 (around an average of 0.6) and other inland letter LPMCs change proportionately⁴².
- Operational vs revenue equated: this relates to the selection of a data set generated by Consignia's alternative methods for measuring volumes. We explain this issue in more detail in paragraph 1.56 above.
- Terminal value: our detailed projections cease in FY10-11. Thereafter we have assumed a terminal value growth rate between -2% and 2% in free cash flows, in line with Consignia's range⁴³.
- Cost of capital: we have assumed a weighted average cost of capital ('WACC') of 8.7% nominal post-tax. We have modelled a range around this value.

⁴² A critique of Consignia's estimated LPMCs is presented in Postcomm's discussion document, *An assessment of the costs and benefits of Consignia's current Universal Service Provision*, June 2001.

⁴³ The higher the terminal value growth rate, the higher is the present value of the free cash flows Consignia is assumed to generate after the end of the explicitly modelled period. A 0% terminal value growth rate in our model implies that Consignia's free cash flows remain constant in nominal terms from FY10-11.

2.85 In this summary report, we have reported the Base Case results and the:

- **'Market Growth Downside'** – instead of an average 2.7% pa growth in inland letters based on the Strategic Plan for 2001-2006, the growth rate is an average 0.7% pa.

Summary of sensitivities

2.86 We have described above the basis our approach to model development, and to determining the Base Case and sensitivity ranges for each of the sets of drivers. We consider that the ranges we have adopted for these sensitivities are reasonable in the context of the objectives of the work performed (i.e. to analyse the sensitivity of the financial performance of Consignia to various factors) and given the limitations of our work noted above (in particular noting that the ranges do not specify an absolute upside or downside and that the estimates within the ranges do not constitute a forecast of Consignia's business).

2.87 The Base Case values and sensitivities are summarised in Table 5.

Table 5 - Summary of sensitivities

Sensitivity	Options modelled (Base Case shaded)	Details of option
Competition		
Level of entry	20% market share loss	Arbitrary exogenously set level of market share loss assumed to occur over three years
	0%-30% market share loss	Range of levels of market share loss modelled around 20%
	EP model result	Level of market share loss predicted by Consignia's EP model
Pattern of entry	No cream skimming	Units of average contribution lost within the liberalised part of the market
	Andersen modelled cream-skimming	Highest contribution units on 'route-wise' cases lost per product
	EP model result	Units lost as per the EP model
Leakage	No leakage	Market share loss confined to liberalised weight bands
	Leakage	Market share loss extends to weight band below the liberalised weight band
Price pressure	No price pressure	All Consignia's prices unchanged after competition (as with EP model)
	Price pressure	Selected Consignia price controlled products have lower prices than price control level
Postcomm policy		
Prices	Interim Price Control	Assume that the Interim Price Control (combining nominal and real price freezes on specific products) sets prices
	Real price freeze	Assume that products with a nominal price freeze under the Interim Price Control are subject instead to a real price control
UPS	'Broad' UPS	Postcomm's working definition
	'Narrow' UPS	Second Class, Standard Parcels and Special Delivery
Efficiencies		
Exclusion of parcels profits	Inclusion	Consignia's projected turnaround of parcels business included
	Exclusion	Parcels assumed to break even
Annual efficiencies (steady rate for modelled period)	1.8% pa with 0% downside	Consignia assumption in Strategic Plan 2001-2006
	2.5% pa	Efficiencies to match nominal price freeze
	3.0% pa	Intermediate sensitivity
	4.0% pa	Top end of Frontier Economics range of efficiencies
One-off gross efficiencies 2003	15%	Based on discussions with Consignia, and ensuring consistency in the long-run with efficiency rates of Frontier Economics and WS Atkins
	5%-17.5%	Range of alternatives
Other market and company factors		
Market growth inland letters	3.2% pa letters (weighted average compound rate)	Frontier Economics reforecast of Consignia's demand equation October 2001
	2.7% pa letters (weighted average compound rate)	Consignia Strategic Plan 2001-2006 extrapolated to FY10-11
	1.5% pa letters (weighted average compound rate)	Sensitivity
	0.7% pa letters (weighted average compound rate)	Sensitivity

Market growth international letters	-0.2%% pa letters (weighted average compound rate)	Including re-estimates of international inward by Consignia January 2002 extrapolated to FY10-11
Market growth parcels	-0.4% pa parcels (weighted average compound rate)	Re-estimates by Consignia January 2002 extrapolated to FY10-11
Long run marginal cost (LRMC) factor	Product specific LRMC's with an average of 0.6 for inland letters	Consignia's central LRMC estimate
	A range in the average from 0.5-0.9	Range modelled around Consignia's estimate
Operational vs revenue equated data	Operational data	As used by Consignia in the audited Regulatory Accounts
	Revenue equated data	As used by Consignia in their EP model
Terminal value ('TV') growth rate	0%	Low end of Consignia's TV assumptions
	-2% - +2%	Range modelled around Consignia's estimate
Weighted average cost of capital ('WACC')	8.7%	Andersen adjusted estimate of Consignia's WACC
	7.0% - 11.0%	Range modelled around Consignia's estimate

3 Modelling results

Consignia's historic performance

- 3.1 Before providing the results of our projections, we set out the recent historical performance of Consignia and the relative performance of its main postal products. This provides an important context that emphasises the uncertainties associated with the financial projections.
- 3.2 We show in Table 6 the rise in Consignia's turnover over the last seven years of some 38% to over £8bn. However, over the same period operating profit margins have peaked at nearly 8% in FY97-98 and subsequently fallen back to around zero. Indeed, in FY00-01 the net profit margin is only positive due to the contribution of interest payments from the gilts on Consignia's balance sheet.

Table 6 - Historic financial performance measures for the Entire Business

Financial performance measure	Entire Business						
	Historic period					Prior Year	Base Year
	FY94-95	FY95-96	FY96-97	FY97-98	FY98-99	FY99-00	FY00-01
Turnover (£m)	5,878	6,210	6,370	6,759	7,010	7,522	8,119
Operating profit (before exceptionals) (£m)	434	387	477	528	394	381	(3)
Profit after tax (£m)	314	270	361	447	496	(267)	64
Profitability ratios							
Operating profit margin	7.4%	6.2%	7.5%	7.8%	5.6%	5.1%	(0.0%)
Net profit margin	5.3%	4.3%	5.7%	6.6%	7.1%	(3.5%)	0.8%
Asset turnover	220%	208%	190%	176%	157%	169%	161%
Return on net assets	12.1%	9.3%	11.0%	11.8%	11.5%	(6.5%)	1.5%
Return on capital employed	11.8%	9.1%	10.7%	11.6%	11.1%	(6.0%)	1.3%
Liquidity ratios							
Current ratio	1.2	1.2	1.5	1.7	1.6	1.8	1.8
Solvency ratios							
Borrowing	0.1%	0.0%	0.0%	0.0%	2.1%	6.5%	13.8%
Dividend cover	n/a	n/a	n/a	n/a	n/a	(1.8)	0.7

Source: Consignia, Andersen

Notes: (1) Borrowing relates to international businesses. (2) Consignia did not pay a dividend before FY99-00.

- 3.3 The decline in profit may partly be explained by a relatively flat or declining trend in 1st Class mail volumes, while the beneficial effect of an increase in 2nd Class volumes has partly been offset by a reduction in the 2nd Class letter price.
- 3.4 However, the FY00-01 results have also been adversely affected by an increase in costs over FY99-00 of nearly £1.0bn. Initial analysis suggests that some £237-470m of this cost increase may be non-recurring.

- 3.5 More detailed analysis reveals that Consignia's performance has varied significantly across its business segments as shown in Table 7. The Reserved Area (under the operational volume allocation of costs) has losses of over £300m, while the UPS products as a whole provide a profit of over £200m. Non-postal service business are in aggregate loss-making.

Table 7 – Financial performance of key business segments in the Base Year (FY00-01) and prior year (FY99-00)⁴⁴

Financial performance measure	Entire Business		UPS		Licensed Area ('operational' data)		Non-Licensed area		Non-postal services	
	FY99-00	FY00-01	FY99-00	FY00-01	FY99-00	FY00-01	FY99-00	FY00-01	FY99-00	FY00-01
Turnover (£m)	7,522	8,119	5,184	5,454	4,041	4,223	2,236	2,165	1,358	1,769
Operating profit (£m)	381	(3)	309	202	(158)	(317)	492	292	(547)	(41)
Operating profit margin (%)	5.1%	(0.0%)	6.0%	3.7%	(3.9%)	(7.5%)	22.0%	13.5%	(40.3%)	(2.3%)

Source: Consignia Regulatory Accounts 2000-01

- 3.6 This result is to some extent unexpected because the Reserved Area is in part intended to provide Consignia with the necessary protection from competition to generate the cross-subsidies to support the UPS products.
- 3.7 The relative performance of the Reserved Area and UPS products is accounted for by Consignia's practice of linking prices to weight, while recognising that costs are a function of other factors (such as dimensions and type of recipient).
- 3.8 This feature of the relationship between Consignia's fully allocated costs and product prices is especially important because it serves to highlight that the incremental effects of liberalisation of these products are likely to be 'muted' given that the lower weight step products are in aggregate already loss-making.

⁴⁴ The business segments are defined in the Regulatory Accounts. The UPS segment includes all products within Consignia's current universal service provision (these products are also listed in Postcomm's January 2002 proposals). The Licensed Area is that currently defined by the 350g and £1 thresholds. The non-Licensed Area includes UPS products above the monopoly weight and price thresholds.

3.9 We show this in detail in Table 8 below.

Table 8 – Individual contribution by weight step (FY00-01), 'operational' volumes

Weightband	FY00-01			
	Revenue (£m)	FAC (£m)	Profit (£m)	Profit % on FAC
UPS Products				
0-20g	1,588	(1,856)	(268)	(17%)
20-40g	763	(908)	(145)	(19%)
40-50g	166	(226)	(60)	(36%)
50-60g	138	(186)	(48)	(35%)
61-100g	422	(438)	(16)	(4%)
101-150g	290	(257)	33	11%
151-200g	169	(139)	31	18%
201-250g	188	(118)	70	37%
251-300g	106	(69)	36	34%
301-350g	81	(52)	30	37%
351-400g	61	(35)	26	42%
401-450g	62	(33)	29	47%
451-500g	51	(25)	26	52%
501-600g	100	(47)	53	53%
601-700g	63	(26)	36	58%
701-750g	34	(13)	22	63%
751-800g	24	(9)	16	65%
801-900g	53	(17)	36	68%
901-1,000g	51	(16)	36	69%
1,001g+	160	(38)	123	77%
Non UPS Products				
Door to Door	80	(76)	4	5%
Presstream	205	(176)	29	14%
Total	4,856	(4,758)	98	2%

Source: Consignia

3.10 International letter services were profitable overall in FY99-00 but unprofitable overall in FY00-01. Imports are currently unprofitable though this may change with the renegotiation of REIMS. Finally, we note that parcels are in aggregate unprofitable. Losses in FY00-01 were (£100m) though the UPS parcel products generated a profit of £78m.

Summary of modelling results

Base Case Liberalisation

3.11 We begin by presenting the results of our Base Case which we use as a reference point. The Base Case assumes 20% market share loss in the areas of the market liberalised.

3.12 Our Base Case analysis of the impact of market liberalisation under the four scenarios is reported here on the assumption that the parcels business is restored to profitability and the overseas and non-postal businesses are included (though they remain loss-making in aggregate).

- 3.13 Given our Base Case assumptions, the NPV of free cash-flows in each liberalisation scenario remains in excess of the threshold NPV. We show this in Figure 2 below which projects the NPV and compares this to the threshold NPV.

Figure 2 - Base Case projected NPV and threshold NPV in liberalisation scenarios

[chart ✕]

Source: Andersen

- 3.14 This result is reflected in the profile of operating profits as shown in Figure 3. Operating profits recover markedly in FY02-03 with the assumed one-off efficiency savings and then fall slightly only under the Postcomm Proposals and Full Liberalisation Scenarios.

Figure 3 - Base case projected operating profit for the Entire Business under liberalisation scenarios

[chart ✕]

Source: Andersen

- 3.15 Figure 4 shows the EBIT for the Entire Business under the various liberalisation scenarios. This is calculated after exceptional items, which include redundancy costs and our assumed £600m pensions related cost of redundancies in FY02-03.

Figure 4 - Base case projected EBIT (after exceptional items) for the Entire Business under liberalisation scenarios

[chart ✕]

Source: Andersen

- 3.16 We have calculated financial key performance ratios for the Entire Business over the projected period.
- 3.17 We present these ratios below for the Entire Business under the scenarios for No Liberalisation and Postcomm Proposals Scenario. We also show the results under the Postcomm Proposals Scenario in the situation where Consignia fails to make its projected efficiency gains and cuts costs in FY02-03 by only 5% and thereafter achieves 0% efficiency gains.

Table 9 - Base Case financial performance for the Entire Business under No Liberalisation Scenario

	FY00-01 (actual)	FY01-02	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07	FY07-08	FY08-09	FY09-010	FY10-11
Profitability ratios											
Operating profit margin	(0.0%)	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
EBIT margin	(0.7%)	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Net profit margin	0.8%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Asset turnover	1.6	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Return on net assets	1.3%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Return on capital employed	1.3%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Liquidity ratios											
Current ratio	1.8	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Solvency ratios											
Borrowing	14.1%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕

Source: Andersen

Table 10 - Base Case financial performance for the Entire Business under Postcomm Proposals Scenario

	FY00-01 (actual)	FY01-02	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07	FY07-08	FY08-09	FY09-010	FY10-11
Profitability ratios											
Operating profit margin	(0.0%)	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
EBIT margin	(0.7%)	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Net profit margin	0.8%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Asset turnover	1.6	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Return on net assets	1.3%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Return on capital employed	1.3%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Liquidity ratios											
Current ratio	1.8	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕
Solvency ratios											
Borrowing	14.1%	✕	✕	✕	✕	✕	✕	✕	✕	✕	✕

Source: Andersen

- 3.18 Under the Postcomm Proposal Scenario, and under the Base Case assumptions, the Entire Business' financial performance does not deteriorate substantially in terms of its key liquidity and solvency ratios as shown in Table 10. While return on capital employed falls relative to No Liberalisation from around 3-3% (between FY05-06 and FY10-11) to 2-2%, the current ratio falls from its FY00-01 level to 2 but recovers its starting level by FY05-06.
- 3.19 Under the Postcomm Proposal Scenario, Consignia has a funding requirement (before FY03-04 when the business turns cash positive) of £2m.
- 3.20 Under the Postcomm Proposals Scenario without efficiency gains, however, the financial ratios deteriorate significantly compared to the Base Case and over time.

Table 11 - Financial performance for the Entire Business under Postcomm Proposal Scenario assuming 5% one-off efficiency gains and 0% ongoing efficiencies

	FY00-01 (actual)	FY01-02	FY02-03	FY03-04	FY04-05	FY05-06	FY06-07	FY07-08	FY08-09	FY09-010	FY10-11
Profitability ratios											
Operating profit margin	(0.0%)	2	2	2	2	2	2	2	2	2	2
EBIT margin	(0.7%)	2	2	2	2	2	2	2	2	2	2
Net profit margin	0.8%	2	2	2	2	2	2	2	2	2	2
Asset turnover	1.6	2	2	2	2	2	2	2	2	2	2
Return on net assets	1.3%	2	2	2	2	2	2	2	2	2	2
Return on capital employed	1.3%	2	2	2	2	2	2	2	2	2	2
Liquidity ratios											
Current ratio	1.8	2	2	2	2	2	2	2	2	2	2
Solvency ratios											
Borrowing	14.1%	2	2	2	2	2	2	2	2	2	2

Source: Andersen

- 3.21 The return on capital employed falls relative to No Liberalisation from around 3-3% (between FY05-06 and FY10-11) to negative returns in the range 2%-2% and the current ratio falls from 1.8 in FY00-01 to 2 by the end of the projection period.
- 3.22 Under this downside, Consignia has an ongoing and increasing funding requirement as cash flows are negative in all years to and including FY10-11.

Finding 1: 'The nature of competitive entry has a material effect on Base Case liberalisation results'

- 3.23 We have modelled the impact of 20% market share loss in the Base Case. However we have also performed sensitivities incorporating both higher market share losses and the effect of non-uniform market share loss across products and weight steps and of cream-skimming across 'routes'. We show here the impact of results based on the level of market share loss and the non-uniform pattern across products and weight steps obtained from Consignia's EP model methodology together with pricing pressure on certain Consignia products.

Table 12 - NPV impact of liberalisation sensitivities: £bn

FY02-03	Threshold NPV	Base Case NPV	Base Case plus Increased Competition Sensitivity NPV	Change in NPVs	Surplus/ (deficit) over Threshold NPV
No Lib	∞	∞	n/a	n/a	∞
EC Proposal	∞	∞	∞	∞	∞
Full Lib	∞	∞	∞	∞	∞
Postcomm Proposal	∞	∞	∞	∞	∞

- 3.24 This shows that there is a progressively larger impact in NPV terms as the market is opened up under more extreme competition. Fiercer competition costs between £∞bn and £∞bn in NPV terms relative to the liberalisation modelled in the Base Case depending on the scenario. However, the NPV is above the threshold value in all cases.

Finding 2: 'Consignia has larger problems than the prospect of liberalisation'

- 3.25 We have considered the impact on the Postcomm Proposals Scenario Base Case NPV of some of the downside sensitivities we have identified. The results are shown in Table 13 below.

Table 13 – NPV impact of various downside sensitivities⁴⁵

FY02-03	Threshold NPV	NPV	Change in NPVs relative to Base Case	Surplus/ (deficit) over Threshold NPV
Base Case	∞	∞	n/a	∞
Increased Competition Sensitivity	∞	∞	∞	∞
Efficiencies Downside	∞	∞	∞	∞
Combined Efficiencies and Parcels Downside	∞	∞	∞	∞
Market Growth Downside	∞	∞	∞	∞

⁴⁵ In this table we have modelled an alternative Increased Competition Downside in which Consignia loses 20% market share across all products in the liberalised segment, and loses the most 20% profitable 'routes' within each product. By modelling 'cream-skimming' explicitly, we are able to examine the significance of changing the scope of the UPS in later analysis.

- 3.26 The results show that relative to the Postcomm Proposals Scenario Base Case, the Efficiencies Downside is the most significant factor, resulting in a fall in NPV of around £<bn. This is more than three times the £<bn impact from competition of changing from No Liberalisation to the Postcomm Proposals Scenario Base Case shown in Table 12. Moreover, the incremental impact on NPVs under the Postcomm Proposals Scenario of a Market Growth Downside impacts NPV by around £<bn, while the impact of the Increased Competition Downside is around £<bn. Only in the Efficiencies Downside and the Combined Efficiencies and Parcels Downside is the NPV below the threshold value.

Finding 3: 'Efficiency gains and market growth are critical'

- 3.27 The effects of efficiency gains and market growth assumptions within the upside and downside sensitivities have the most material effect.
- 3.28 Failing to achieve the 15% gross efficiencies in FY02-03 and instead achieving only 5% efficiency gain is itself worth some £<bn to £<bn on the scenario NPV results for FY02-03 as shown in Table 14 below.

Table 14 - NPV impact of efficiency sensitivities: £bn

FY02-03	Threshold NPV	Base case NPV	Base Case plus 5% efficiency NPV	Change in NPVs	Surplus/ (deficit) over Threshold NPV
No Lib	<	<	<	<	<
EC Proposals	<	<	<	<	<
Full Lib	<	<	<	<	<
Postcomm Proposals	<	<	<	<	<

- 3.29 This shows that the failure to achieve the one-off efficiencies (even assuming the annual efficiencies) could result in an NPV around the threshold value even in the EC Proposals Scenario.
- 3.30 Similarly, the impact of the 'pessimistic' market growth assumptions is in the range of £<bn to £<bn as shown in Table 15 below. Although this is a material impact, the NPV is above the threshold value in all cases.

Table 15 - NPV impact of growth sensitivities: £bn

Scenario	Threshold NPV	Base case NPV	Base Case plus Consignia pessimistic growth NPV	Change in NPVs	Surplus/ (deficit) over Threshold NPV
No Lib	<	<	<	<	<
EC Proposal	<	<	<	<	<
Full Lib	<	<	<	<	<
Postcomm Proposal	<	<	<	<	<

Finding 4: 'Postcomm has potentially effective policy levers'

- 3.31 Postcomm has some significant policy levers that it may be able to activate to counter-act to a significant extent the adverse effects in the event of a 'downside' occurring.
- 3.32 We have represented the downsides shown above, and also shown an additional combined downside of the Market Growth Downside and Increased Competition Sensitivity combined.
- 3.33 The results are shown in Table 16 below.

Table 16 - NPV impact FY02-03 of policy levers on Postcomm Proposals Scenario: £bn⁴⁶

FY02-03	Downside sensitivity NPV	Threshold NPV	Excluding overseas operations and non-postal services	Narrow UPS	Real price control	Combined effect of policy levers
Increased Competition Sensitivity	⌘	⌘	⌘	⌘	⌘	⌘
Efficiencies Downside	⌘	⌘	⌘	n/a (no cream-skimming)	⌘	⌘
Combined Efficiencies and Parcels Downside	⌘	⌘	⌘	n/a (no cream-skimming)	⌘	⌘
Market Growth Downside	⌘	⌘	⌘	n/a (no cream-skimming)	⌘	⌘
Increased Competition Sensitivity and Market Growth Downside combined	⌘	⌘	⌘	⌘	⌘	⌘

Note: The efficacy of the levers applied individually does not sum to their efficacy when applied together.

- 3.34 This shows that by exercising the levers collectively Postcomm can have a significant effect on Consignia's NPV. In the Increased Competition Sensitivity and Market Growth Downside combined, the levers can restore the NPV above the threshold value. However, notably, in the Efficiencies Downside (combining a failure to achieve efficiencies and profits in the parcels business), the stated levers would only return the NPV to around the threshold value.
- 3.35 This analysis demonstrates the *potential* efficacy of the various policy levers – it does not propose that they would be optimally used in the conditions identified. Rather, it is the regulatory framework which will be established by Postcomm which will in effect allocate the risk of not achieving efficiencies, or other contingencies, between Consignia and consumers.

⁴⁶ We have adopted the revised definition of the Increased Competition Downside as in Table 13 to examine the impact of changing the scope of the UPS.

Summary of key findings

3.36 Our modelling results may be taken to support four key findings:

- Finding 1: *'The nature of competitive entry may have a material effect on Base Case liberalisation results'*: the impact of liberalisation has a material impact on the NPV of future cash-flows of Consignia. The impact may be worse than that derived from the 20% market share loss assumed in the Base Case, in particular where there is differential market share loss across products and weight-steps or cream-skimming entry across 'routes'.
- Finding 2: *'Consignia has larger problems than the prospect of liberalisation'*: the impact of market liberalisation in our analysis is dominated by the impact of management initiatives on efficiency and exogenous market factors.
- Finding 3: *'Efficiency gains and market growth are more significant than liberalisation'*: the level of efficiency gains and market growth are together significantly more important than the Base Case effects of market liberalisation.
- Finding 4: *'Postcomm has potentially effective policy levers'*: the possibility of cream-skimming together with other adverse assumptions can be offset to a significant extent by policy levers potentially available to Postcomm of which control over product prices is the most important. However, efficiencies downsides are likely to be difficult to fully mitigate.