



SUMMARY OF PROPOSED APPLICATIONS FOR CHANGES TO ROYAL MAIL'S PRICE CONTROL TO FACILITATE MORE COST REFLECTIVE PRICES¹

¹ Cost reflective pricing is a key regulatory principle for Royal Mail and this has been facilitated by the introduction of 'Pricing in Proportion' and further enhanced through the retail zonal application.

RETAIL AND ACCESS HEADROOM

Royal Mail seeks to reduce the minimum difference between access prices and retail prices allowed under its Licence.

The situation today

Currently, the maximum prices for downstream access prices are regulated by reference to related retail prices less prescribed levels of headroom. The level of control was set based on the difference between the reference retail price and prices of the Wholesale services in the year running up to the current price control.

In general, the cost differences between Royal Mail Letters and Wholesale services have reduced in recent years. However the levels of headroom were set on March 2006 prices that did not reflect these changes sufficiently. This results in headroom levels that are now materially adrift from the respective costs of the Royal Mail Letters and Wholesale services. High headroom levels relative to costs accelerate downstream access artificially.

Notwithstanding separate regulated accounts for Royal Mail Letters and Wholesale business units of Royal Mail Group, and a Licence Condition which constrains the information flows between these two divisions, the mechanism seeks to provide additional ex-ante regulatory control against margin squeeze. However the consequences of the current mechanism affect both customers and competitors:

- Royal Mail is restricted from being able to pass on the savings which it has made in its upstream activities to its retail customers, without also passing those savings on to competitors through lower access prices.
- In facilitating market entry based on Royal Mail's pricing misalignments - which in the medium to long term will no longer exist - the mechanism is potentially creating unsustainable business models.

Royal Mail submits that the level of headroom created in the Licence should be based on the cost differences between Royal Mail Retail and Wholesale services.

Royal Mail's proposal for change

Royal Mail requests:

- A reduction in the level of headroom to reflect the actual additional costs to RM of providing a retail product over an access product.
- Consideration of other adjustments to the current operation of LC21(5b), including updating the level of headroom annually to reflect latest information on costs.

Such a change was already envisaged in Royal Mail's Licence (Condition 21(5b(i))) which confirms that Royal Mail, or another Licensee, may apply for a Direction from Postcomm to change the current levels of headroom.

PRICE REBALANCING

Royal Mail requests an increase to the extent and the speed with which it can move its prices closer to costs than is currently allowed in its licence.

The situation today

Royal Mail's current price control mechanism of two baskets with rebalancing sub-caps restricts the extent and speed with which the company can bring prices in line with underlying costs.

Ultimately Royal Mail intends to enhance its existing costing allocations to realign incremental costs. This move may result in changes in the cost attributed and allocated to its products and services, and as a result trigger changes in those costs within each basket, and to changes between products and services within the baskets. Such a change would be consistent with the telecommunications sector where BT was permitted to make significant changes to its prices to better align them to costs, and its costing methodology was updated to account for the development of the competitive market.

Royal Mail does not however expect to move to fully cost reflective prices under the revised costing methodology by the end of the current price control period. However, in the light of intensified competition beyond that envisaged when the price control was set, it does seek to make early progress in this direction, and, specifically, to achieve greater price rebalancing within the final two years of the current control.

Royal Mail's proposal for change

Royal Mail requests Postcomm address this in one of three ways:

- Make a direction under License Condition 21(16) to change the level of the sub-caps
- Change the value of X for each basket and potentially the sub-caps within each basket
- Modify Licence Condition 21 to form a single basket for the calculation of allowed revenues and alter the level of sub-caps

These options provide in turn progressively greater speed for Royal Mail to move its prices into line with costs.