



Tony Spencer
Deputy Director
Competition and Regulation Directorate
Postcomm
Hercules House
6 Hercules Road
London
SE1 7DB

Mail Users' Association
70 Main Road
Hermitage
Near Emsworth
West Sussex
PO10 8AX

Mobile: 07836 665530
Tel/Fax: 01285 750511

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Dear Tony,

INTERIM REVIEW OF THE PRICE CONTROL – POSTCOMM'S PROPOSALS.

1. General

- 1.1** Mail Users' Association (MUA) thanks Postcomm for the opportunity to respond to its proposals to: grant Royal Mail greater pricing flexibility; deny Royal Mail and its competitors the ability to adjust access headroom at this point in time (either up or down); and decline the request to extend the scope of headroom protection to other products.
- 1.2** From the outset of this response, MUA would state it strongly contends that the price control is in place to offer customers and new market entrants a degree of stability and predictability in a developing marketplace, and provide protection against potentially anti-competitive behaviour from a dominant market player.
- 1.3** Members therefore consider Postcomm's proposal to offer greater pricing flexibility by allowing changes to the sub-cap rebalancing thresholds, upends a fundamental principle of the price control by introducing business uncertainty, with very little justifiable reasoning for doing so from the Regulator.
- 1.4** MUA believes the general re-opening provision contained within the price control should only be initiated in circumstances where factors 'beyond management's control' pose a serious threat to the universal service obligation, and/or the general health and welfare of the UK postal industry.
- 1.5** In respect of the present request, however, MUA does not believe Royal Mail has demonstrated a robust enough case to justify enacting the general re-opening provision of the price control, on which the UK postal industry has based its forecasts, figures and business contingencies up until 2010.

- 1.6** Members also consider the price control already contains mechanisms to safeguard Royal Mail's interests in relation to its pension deficit and volume risk, and as Postcomm states in its 2006-2010 Price Control licence modifications document¹ 'If Royal Mail volumes decline significantly or its pension deficit deteriorates substantially, risk sharing mechanisms are in place to enable Royal Mail to recover an appropriate amount of additional revenue'.
- 1.7** In this respect, MUA is aware Royal Mail has also asked Postcomm to change the structure of the price control to make it easier for it to recover revenue from these adjustment mechanisms, and members also agree with the Regulator's view that this request should be considered as part of the next periodic price control review (or at the very least under a separate price control reopening, should Royal Mail decide to trigger one).
- 1.8** Postcomm stated in its licence modifications document at the end of the last Price Control Review 'Customers can expect that with the revenue from the prices they pay providing funds for the capital expenditure programme and recovery of the pension deficit, Royal Mail will be able to save costs by becoming much more efficient. Postcomm expects Royal Mail to achieve these cost savings through innovation and genuine efficiency, rather than through a degradation of customer service such as later delivery times or earlier collections. Postcomm will be monitoring these areas to ensure that there is no degradation'².
- 1.9** However, since the last price control was set, customers have in fact faced later and fewer deliveries (i.e. the revised delivery specification and loss of the second delivery), fewer and earlier collections, the collapse of quality of service due to strike action, and the suspension of the mechanism whereby business customers are entitled to gain compensation for the damage industrial action has caused their own businesses.
- 1.10** Over the same period of time, Royal Mail has failed to achieve the efficiency targets set in the price control, and is predicting further under-achievement into the future. The costs the organisation has so far managed to strip out of the business have been achieved over two years rather than one, leaving the organisation with far higher costs than had been predicted in the setting of the last price control. As referred to in Postcomm's document, the organisation has also failed to capitalise on the opportunities in growing segments of the mail market such as fulfilment of on-line packet orders and unaddressed mail, and has chosen not to take a number of actions which management could have been taken, to decrease its losses from access products.
- 1.11** Royal Mail management has now put together a case for change in the price control that by Postcomm's own admission, is based on questionable cost allocation data, and is proposing to address the high levels of volume migration from 1st to 2nd Class services, by increasing the cost of 2nd class stamps (and industry is presuming) by most likely reducing 1st class PPI and Metered Mail tariff in order to rebalance the basket). Members are concerned that irrespective of the argued benefits this increased cost reflectivity MAY bring to the market eventually, this action will act as a further disincentive to new mail users, and could adversely affect mail volumes further by creating additional pricing uncertainty in the market.

¹ Postcomm's Royal Mail's Price and Service Quality Review 2006-2010 – Licence Modifications – June 2006 Page 3, Paragraph S3

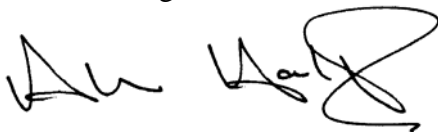
² Postcomm's Royal Mail's Price and Service Quality Review 2006-2010 – Licence Modifications – June 2006 Page 4, Paragraph S3

- 1.12** Nigel Stapleton identified in the forward of Postcomm's consultation document that the two major contributory factors to Royal Mail's deteriorating financial performance were 'its very high cost base and the customer reaction to being asked to pay higher prices'. Members therefore fail to see how offering Royal Mail the ability to raise 2nd Class prices by **8.5%** year-on-year rather than 3%, is going to incentivise the market to mail more and/or arrest further mail volume decline.
- 1.13** Particularly as Royal Mail are, at the same time, predicted to significantly under-achieve in stripping out its high cost base (with reference to the confidential financial projections seen by Postcomm that predict Royal Mail's efficiency improvements will be 80% lower than estimated in the price control). It is therefore arguable that Royal Mail's stated aim of intending to raise 2nd Class tariff may actually end up perpetuating further decline, as the organisation finds an increasing need to continually raise prices to chase an ever declining market.
- 1.14** MUA would also note that during the last price control review Royal Mail made a case for the need for additional revenue with which to modernise its network. This request was subsequently judged by Postcomm to be valid, and a provision for £1.2 billion was included in the new price control, representing a significant increase in capital expenditure. Members would argue Royal Mail's attempt to now re-open revenue negotiations at this point in time makes a mockery of the principles on which the price control is based, and represents the actions of an organisation (Royal Mail) that has nothing to lose by doing so.

2. Summary

- 2.1** In summation, MUA would state that it wholeheartedly agrees with Postcomm that no valid case has been put forward for any change to the access headroom by any of the parties, and that it demonstrates Royal Mail has yet to fully understand let alone manage its costs base. Members would also point out that without more transparent data it is extremely difficult for stakeholders to ascertain whether what is being proposed actually represents an accurate repositioning of Royal Mail's costs.
- 2.2** MUA also believes the case put forward by Royal Mail for greater pricing flexibility as laid out in Postcomm's document, is insufficient to justify the impact Postcomm's proposed action will have on the market, and members would urgently seek a meeting with Postcomm at the next available juncture to discuss these points in more detail.
- 2.3** I hope that this feedback is helpful in your deliberations, and I look forward to hearing from you with regards to arranging a meeting to discuss this matter further.

With best regards,



Alan MJ Halfacre
Chairman
Mail Users' Association