

**Postcomm's review of Royal Mail's
Pricing flexibility and the level
of access headroom
(the 'Interim Review' of the price control):
The Postwatch Response**

9th October 2007

1. OVERVIEW

- 1.1 Postwatch welcomes the opportunity to respond to this consultation on certain aspects of the current price control. We are particularly encouraged by Postcomm's emphasis on the need for Royal Mail to transform its business and to put greater emphasis on customers, although it is unclear how Postcomm envisage that Royal Mail should achieve this. We also believe that this is a complex and vital area, with implications beyond this review. Any changes to pricing flexibility should be considered in a wider context when Postcomm looks at further requests by Royal Mail, such as zonal pricing, and any future price control revisit in 2008.
- 1.2 We note, and agree, that no case was made for any change to the access headroom. Royal Mail failed to demonstrate a robust understanding of its costs in this area. We believe first, that this confirms the need for more transparency concerning access costs; and second, that a full modernisation and investment plan should be required from Royal Mail in conjunction with any request from them for further pricing flexibility.
- 1.3 Postwatch strongly believes that consumers should not be required to pay, through higher prices, for management failure. Postcomm's proposals recognise that Royal Mail has experienced changes in volume and product mix. But the proposals also recognise that:
 - costs are higher than forecast owing to Royal Mail's failure to achieve the efficiency savings required of it,
 - Royal Mail is taking two years to take out costs which it was supposed to take out in one year, and
 - Royal Mail has included some cost items which Postcomm deliberately disallowed at the time of the last price control.
- 1.4 Collectively viewed these are powerful arguments *against* allowing any price increases. Additionally, Postwatch is not persuaded by the arguments presented in favour of increasing the rebalancing threshold to 8.5%. We are in favour of cost reflective pricing, and we recognise that significant rebalancing will be required in due course, as a natural consequence of liberalisation. But we cannot support any proposal to reopen the price control in the absence of transparent data which would demonstrate that the changes made would constitute proper realignment of genuine costs. Furthermore, it is unclear how Royal Mail would use any additional rebalancing freedom - which means that we do not know which customers would be adversely affected.
- 1.5 Postwatch is not opposed in principle to allowing Royal Mail greater flexibility to align some of its retail prices with costs, provided that this happens only where a robust case has been made for change. But we are disappointed that social customers continually have to bear the brunt of price increases. According to the recent Roland Berger research, residential and SME customers believe postal services to be currently affordable. We would ask Postcomm whether they have undertaken any research to assess whether an additional 3p

increase on second class, leading up to 2010, would substantially alter this view or would cause some smaller businesses to switch to electronic media. Postwatch is also concerned that price rises for social customers will continue should Royal Mail choose to revisit the price control in 2008.

- 1.6 Without the publication of information beyond the regulatory accounts it is not possible for those outside Postcomm to ascertain how serious is the financial situation Royal Mail faces. Clearly Royal Mail did not provide sufficient evidence to underpin its requests. We urge Postcomm to undertake a programme of work in order to understand the costs surrounding access, as this will become significant during the next price control, in any further price control review in 2008 and, more broadly, in understanding the threats to the universal service obligation.
- 1.7 Postwatch is concerned that re-opening the price control appears to be a no-lose option for Royal Mail. At best, from its perspective, they achieve a weaker control and raise revenues. At worst the existing control stays in place. This asymmetry may incentivise Royal Mail to seek changes just in case they benefit. It would help in future if there could be some clearly defined down-side if the arguments for re-opening the control were rejected. Post is not a risk free business and it is wrong when all the risk rests with customers, including postal operators using the access agreements.

2. THE POSTWATCH VIEW

- 2.1 Postwatch challenges Postcomm's proposal to increase Royal Mail's pricing flexibility, and in turn the price of 2nd class stamps, in the lead up to 2010, as we do not believe that a robust case has been made by Royal Mail. The evidence base is not readily apparent and it is clearly not in the best interests of customers, primarily social and SMEs. Royal Mail state that its finances are in disarray and they need regulatory assistance, however, it is our view that Royal Mail has not made this case robustly enough to be allowed further pricing flexibility at this time.
- 2.2 It is accepted that Royal Mail may be struggling financially but the suggested actions to remedy this are inappropriate. It is not just the concept of a further price increase for social users, but associated with the recent perception of a deterioration of service by consumers e.g. loss of second delivery, performance falling owing to strikes, later deliveries and fewer and earlier collections, price increases without huge efficiency improvements will not be welcomed by customers, including SMEs.
- 2.3 It is felt that an excessive rise in the price of second class stamps would affect SMEs and potentially drive communication to e-mail and the internet and that such a move would have a negative impact on Royal Mail's mail volumes, and potentially revenues. It is important that initiatives that are introduced, whether pricing or innovation orientated, encourage customers to use mail rather than abandon it. However, we would ask Postcomm whether it has undertaken any

work in this area to assess the potential impact of such a price rise and the elasticity of postal prices.

- 2.4 A major part of our previous response to Postcomm was that consumers should not pay for management failure. Royal Mail could be excused (and therefore possibly permitted to increase prices) for unforeseen circumstances beyond its reasonable control, but where Royal Mail is suffering financially owing to management failure to address issues which are foreseeable and within its control, consumers should not be penalised through higher prices. This would follow the same guiding principle as that related to the suspension of the C factor and would form an integral part of any future assessment of price increases while incentivising Royal Mail management to make every endeavour to achieve efficiency targets. Postcomm clearly states that “Royal Mail should not be seen as a passive victim of lower market volumes”, in addition to this there is much to suggest that management failure applies to poor efficiency improvements, taking 2 years to take costs out of the business when volumes change.
- 2.5 We previously called on Postcomm to undertake a rigorous, independent analysis of Royal Mail’s business case to see whether the call for price rises was justified and we remain unconvinced that the case has been made for price changes to be allowed at this time. Royal Mail has freedom under the current control to increase prices which should be sufficient prior to any review of the control in 2008. Further pricing flexibility is not of obvious benefit to customers, and should not be allowed unless the case has been presented and an overwhelming need has been established. That need has yet to be demonstrated. Postcomm should be more forthright and proactive at this time requesting information from Royal Mail in advance of the indication that there will be a more thorough review of access in 2008.
- 2.6 Postwatch believes that before Royal Mail is given any relaxation in pricing policy there should be more openness about the investment programme facilitated by the major injection of funds by the Government. How and where is the money being spent, the timings and anticipated benefits for customers. It may be viewed that Postcomm is simply proposing to give Royal Mail more flexibility, as progress with efficiency improvements are slower than anticipated and not to the fault of customers, without having received a detailed economic case from Royal Mail for the current pricing policy to be changed.
- 2.7 It is important that Postcomm assesses the potential adverse impact any further pricing flexibility may have on certain customer groups or industry sectors. It is apparent that any move to Zonal Pricing, based on the current application, will heavily impact upon the publishing industry. It has also become apparent that the proposals within this interim review could, potentially, have a considerable impact on the postal bills of Presstream users within the publishing industry.
- 2.8 Postcomm proposes to permit the 8.5% rebalancing and 2nd class price rises, but does not fully explain why (given the management failures clearly identified

in its own report) it believes such rises are justified. We are also unaware in what areas Royal Mail would use this flexibility and how customers, in total, would be affected. There is no discussion e.g. that if Postcomm were not to allow the price rise, Royal Mail finances would be put at risk and the universal service would be under threat (as it does in relation to refusing the access headroom request). Postwatch therefore sees no genuine and reasoned justification for the proposed price increase.

- 2.9 Additionally, it cannot help long-term planning and investment by competitors if financial controls are to change at such frequent intervals.

3. CONCLUSION

- 3.1 Postwatch has continually called for a complete investigation into Royal Mail's costs in order to fully assess the threats to Royal Mail as a mail provider and as a result to the provision of the universal service. Only then can fully transparent decisions be taken on price increases and truly cost reflective pricing. This request remains valid as it is unclear why Royal Mail is being allowed certain price changes and that access costs are not understood.
- 3.2 We agree that Royal Mail must become more efficient and innovative in the market. However, this must be balanced through incentivising it to become more efficient and allowing it further flexibility to increase prices based on costing evidence and not attributable to management failure. To reiterate the detailed financial case for a relaxation in the price increase does not appear to have been made – whether a price increase is warranted or not.
- 3.3 We welcome the fact that Postcomm states that Royal Mail must transform its business and put greater emphasis on customers. We await Royal Mail's response to this and would encourage Royal Mail to put the customer at the forefront of all its future pricing and product initiatives. Postwatch looks forward to working with both Postcomm and Royal Mail in achieving this objective which can only benefit the market as a whole.