

15th October 2007

Tony Spencer
Deputy Director
Postal Services Commission
Hercules House
6 Hercules Road
LONDON
SE1 7DB

Dear Tony,

“Interim review” of Royal Mail Price control.

Following my conversation with Kate Walters and our meeting last week, I’m writing to provide UK Mail’s response to Postcomm’s proposals on the “Interim review” of Royal Mail’s Price Control.

As you know, UK Mail (UKM) is a member of the Mail Competition Forum (MCF) and supports the response being submitted by the MCF. Hence I have essentially limited my comments here to Postcomm’s proposals in relation to the access price headroom and, specifically, the request made by UKM. This response may be made public and attributed to UK Mail.

UKM is reassured that Postcomm correctly proposes to reject the request made by Royal Mail (RM) for an unwarranted and material increase in access charges which would have a profoundly damaging impact on competition in the postal market and the choice and benefits now enjoyed by an increasing number of customers.

But we strongly believe that Postcomm is wrong to propose rejecting the request made by UKM (for an increase in headroom and extension of the margin squeeze protection) and that Postcomm has not set out a sufficient basis for this proposal.

1) Reliability of data

In 5.40 Postcomm says it has “little confidence that the underlying access cost data currently provided to it by the three applicants can be used to provide the degree of assurance that is needed”.

While UKM understands this may be the case with the RM data (given the several comments made by Postcomm expressing grave concerns with the data supplied), at no time did Postcomm suggest to UKM that it had concerns with the quality of data provided by UKM.

Hence we fail to understand the statement made in 5.40 and why the UKM request has not been considered on its own merits. Instead it seems the UKM request has wrongly been blighted by the failures in the RM request.

In the data provided to Postcomm, we believe we clearly demonstrated that, while being a highly efficient 'upstream' operator (more efficient than RM), UKM suffers from RM access charges that are higher than can be justified and which hence apply undue margin squeeze.

We believe UKM provided ample evidence to justify our request for reduced access charges, we are greatly concerned that Postcomm propose not to agree to the request and we ask that Postcomm reverse this proposal in making the final decision to recognise the validity of the UKM request.

2) Application of RM cost data and RM inefficiency

We are a little confused by the way in which Postcomm use 05/06 cost data from RM to assess the true cost of providing access services (and arrive at a 0.5p per item loss) yet then apply this 'loss per item' to 06/07 volumes to state a £12m loss on access in 06/07. Indeed (in para 17) Postcomm use this 0.5p per item figure from 05/06 as a 07/08 loss.

Even if the 0.5p per item loss in 05/06 is correct (the first full year of access with volume of 1.15bn items), we struggle to understand how this same loss can be used for 07/08, when access volumes are forecast to be nearly four times higher at 4bn items.

Either Postcomm are wrong to use the same figure for three years or the implication is that RM has not and will not achieve any volume efficiency (or any other efficiency) between 05/06 and 07/08.

This was an important aspect of the UKM request – that RM has not achieved the downstream efficiencies that it should have made under the price control and to which UKM, as a customer is reasonably entitled.

RM has focused in making efficiencies in its upstream operation (where it is facing some, limited degree of competition) at the expense of no downstream efficiency (where it remains absolutely dominant with >99% of the market).

UKM's request for lower access charges sought to recognise that there should be some efficiency improvement by RM over time and as access volumes grew – or at least to ensure that RM did achieve future efficiencies through Postcomm reducing the access charges.

3) Access headroom protection

UKM is very disappointed that Postcomm is not proposing to recognise the need to extend the principle of access headroom protection to other access services. In our request we provided clear information on how the access headroom set in the first agreement between UKM and RM has not been maintained in respect of other access specifications.

In 5.27 Postcomm confirm that the access products with the higher headroom are the two that were set in the first agreement – when there was a clear background of

regulatory scrutiny and a potential determination. Subsequent headrooms are significantly lower – in the absence of such regulatory scrutiny.

Postcomm have recognised (in 5.43) that it intended the access headroom in the Price Control to be a “signal to the market”. But this has not happened and, UKM argues, will only happen if the access headroom protections are extended as UKM requested.

UKM can now refer to the Access Premium agreement it recently reached with RM as a clear example of where the pressures of commercial negotiation with a super-dominant supplier have resulted in an access charge higher than would have been the case if the access headroom protection had applied. (At the time of its request UKM could not cite this example due to the status of its negotiations with RM).

This is evidence that unless access headroom protection is extended as a formal element in the Price Control, the “signal to the market” will not hold.

4) Access market volume

In 5.9, Postcomm comment that “Most commentators expect access volumes to plateau at around 5-6bn items as the size of the addressable market is limited”.

Although the footnote says this relates to “*second class bulk mail*”, we consider this remains misleading. While it may be true that the size of the addressable market into which UKM initially entered (second class bulk, presorted mail) may eventually plateau at that level, UKM has made very significant invested in capability and reached new access agreements with RM in order to extend its service offering to other markets (e.g. second class unsorted mail and first class mail).

It would be wrong to imply that there is a 5-6bn item limit to the overall, potential market for UK Mail.

5) UKM Margin

In 5.28 Postcomm quote the 7.1% margin reported by UKM in the Annual Report & accounts of its parent, Business Post Group plc, for 2006/07. A footnote mentions that this is influenced by substantial CDA mail. However, we do not feel this footnote gives adequate or prominent enough explanation of this overall margin.

The presence of CDA mail in the overall volumes handled by UKM is significant as for this mail the RM access charge is not included in the UKM accounts. For ‘standard’ access mail the c13p access charge makes up the great majority of UKM costs and is recovered (without mark-up) in UKM revenues and profit margin is on that basis. For CDA, the same profit might be made but on a very much lower revenue as the c13p is not included and the profit margin reported is hence much greater.

As CDA mail makes up a large element of UKM overall volumes, this effect can be marked in the total profit margin reported.

UKM is also very puzzled by the statement in 3.3 that “For each item of access mail, Royal Mail retains about 13p of a total price of about 17.5p”. The 13p is clearly correct,

but we do not recognise the 17.5p total price as our information would put this figure significantly (in the context of headroom) lower.

Unlike RM, which has not achieved downstream efficiencies and has sought instead to increase access charges, UKM has achieved efficiencies in its operation to rise to the reasonable challenge from customers seeking continuing postage cost savings - while broadly maintaining its margin.

6) RM ability to mitigate access 'loss'

UKM notes that Postcomm has identified a number of actions that RM could take within the existing Price Control provisions (e.g. in Table 11) that would address the issues which cause RM to seek an increase in access prices (in para 17 Postcomm say these would address the majority of the 0.5p per item loss).

Postcomm has noted (para 15) that the forecasting requirements set by RM for access mail impose a burden on access customers but with no cost saving to RM. Postcomm propose that RM justify these forecasting requirements or discontinue them.

And Postcomm notes that RM costs for revenue protection are vastly greater for access mail (0.37p per item) than for retail mail (0.02p). UKM suggests this is because of undue focus on access mail which should be corrected.

Given these points noted by Postcomm, UKM believes that Postcomm should not consider any future request by RM for an increase in access charges unless and until RM has:

- a) taken the actions it already can under the existing Price Control provisions
- b) ceased the forecasting requirements
- c) brought revenue protection on access mail into line with that on retail mail

7) RM commercial attitude

UKM also notes and agrees with the several comments made by Postcomm in the Foreword and elsewhere that RM's recent poor financial performance has very little to do with competition and far more to do with factors that lie within RM's control and for which RM is responsible.

UKM supports Postcomm's comments in para 20 that RM seems reluctant to embrace access and could look to the example of the USA where a positive attitude to access has meant increasing mail volumes.

In summary:

UKM believes that Postcomm's proposals in relation to access headroom are only partly correct.

Postcomm is right to propose rejecting the RM request for higher access charges and has given a clear justification for that proposal.

But Postcomm is wrong to also propose rejecting the UKM request for lower access charges when that request has been supported by clear and robust information.

Postcomm is also wrong to propose rejecting the request for extension to the access headroom protection provisions when it is clear that the lack of such protection has failed to achieve what Postcomm is on record as intending.

Postcomm must change its stance on the UKM requests.

Regards,

Ian Paterson
Strategy & Regulatory Affairs Director
UK Mail Ltd.