

# Royal Mail's comments on Frontier's final report on modelling mail volumes for Postcomm's final price control proposals

## FRONTIER'S RESPONSE

Royal Mail (RM) has responded to Frontier Economics' final January 2006 report on "Market share analysis for Postcomm's final price control proposals" through four papers, which we label Documents A to D in the rest of this note as follows:

- Document A: Royal Mail's response to Postcomm's final proposals and draft licence modifications (6th March 2006);
- Document B: Annex A5 to Document A;
- Document C: An assessment of l'Institut d'Economie Industrielle of Frontier's response to Royal Mail's comments (February 2006); and
- Document D: A review of the geographical dimension of Frontier's Economics Competitive Postal Market Model – Oxera (6th March 2006).

The RM's observations are related to the model structure of the Competitive Postal Market Model (CPMM), the data inputs and the output. Our response is set out under these three headings.

## MODEL STRUCTURE

### *Features of the CPMM*

In Document C, IDEI claims that Frontier "effectively concedes that their model is not founded on economic theory". This statement misrepresents what Frontier said in its response, which is clearly set out on page 48 of its January 2006 report – "*What Frontier does believe is correct, however, is that the construction of the model and its parameterisation is better rooted within a standard economic framework*".

IDEI claims Frontier has not addressed their claim that their "economically founded assumption of undifferentiated Bertrand duopoly, with a quality and brand dimension added is based on a peculiar configuration of preferences". Frontier did address this point on page 49 of our January report and concluded "*if we chose to extend our approach to endogenise price and product differentiation choices within the CPMM, then this would imply entrants taking a lower market share than would be under the approach we have adopted*".

IDEI remains of the view that the level at which consumers are assumed to choose between products is too high in the CPMM and that Frontier provides no evidence beyond the comment that "there is no evidence to support" another assumption. For avoidance of any doubt, Frontier and Postcomm surveyed a number of large mailers, who indicated that they would dual source by product or products/weight and leave entrant to dual source by zone. None of these large mailers supported the proposition that large customers would generally dual

source by zone (except for the local-to-local customers that are explicitly handled in the CPMM), or by the 32,000 routes that is the basis for competition in the RM's EPM at this stage of the development of the market.

IDEI states that we “appear to use the approach that our model ought to be considered as “correct until proven wrong”. We cannot understand why IDEI has placed this interpretation on our obligation to engage with RM and its advisors, which has been done in an entirely proper way. We do, of course, reject the proposition that such an engagement is scientifically not acceptable nor useful to the regulatory debate.

### ***Geographical effect***

In Document A (paragraph 5.9) and Document D (paragraph 3.1) RM and Oxera note that Frontier's new entrant costs show a significantly enhanced pattern of cost differential between zones, and “consequently, RM does not agree that it was “mistaken” when highlighting the degree of geographic dimension with the original CPMM, and remains concerned that the updated CPMM still reduced the effect”.

Frontier explained to RM that it believed RM was mistaken in its understanding of the model, when RM claimed that the CPMM does not allow zonal entry under the geographically uniform price constraint of the USO faced by RM. This point clearly related to the model's structure, which was raised by RM at the time (and continues to be raised, as evidenced by the penultimate paragraph of the previous section). RM never made this point in relation to the model's inputs, such as the estimates of the costs differential between zones. The point is relevant because Frontier believes the structure of the model was fundamentally misunderstood by RM, and has consequently not been changed in response to RM's comments. However, as indicated in our June 2005 report, work on the inputs to the model would continue up to finalisation of the price control, which is exactly what did happen.

## **INPUTS TO MODEL**

### **Entrant costs**

#### ***Original entrant cost levels***

In Document A (paragraph 5.9) and Document D (paragraphs 3.1 & 2) RM and Oxera note that our final entrant cost levels are “enhanced” as they show a more pronounced cost difference across delivery zones when compared to the (original) entrant costs we used for the Initial Proposals.

This is an accurate reflection of the work undertaken by Frontier and PLCWW on the estimation of entrant cost levels, which was substantially completed by the end of August 2005.

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### ***Entrant's scale of operation***

In Document B (paragraph 3.3) RM notes that our approach to entrant costs estimation has a circularity element for it relies on an assumption for the market shares expected to be won by the entrants.

This issue was analysed in full by Frontier. We chose fairly conservative (i.e. low) estimates of entrant costs yielding fairly large market share losses. The cost estimates used in the CPMM are based on upstream entrant targeting individually 5% market shares in the medium term. At this scale of operation, we found that the upstream scale effects flatten out, whilst downstream costs continue to exhibit a strong scale effect. For end-to-end entry, we assumed 5% targeted market share, a figure that was broadly consistent with the market share taken by new entrant E2E operators in those delivery zones where it did indeed attract new business.

In Document B (paragraph 3.4) RM notes that the market share an entrant takes depends on the number and type of the other entrants in the market and their prices not just those of itself and Royal Mail. RM argue that the CPMM assumes that an end-to-end entrant will win 10% of the market, with no evidence to support this assumption in terms of the possible number and size distribution of entrants to the market. Whilst this observation is valid, its relevance is less obvious for the current exercise. In adopting the costs of an individual entrant targeting 5% of the market in the medium term, we seek to derive conservative estimates of entry (i.e. high) for RM. With a lower market share level at firm level with a combined share of new entrants winning 5% of the market, the scale of entry would be lower than estimated in our central case.

### ***Entrant's products***

In Document B (paragraph 3.5) RM argues that there should be an adjustment to the quality parameter in the CPMM on the grounds that the entrant's second class service as described by Frontier is an "inferior" second class service as defined by Royal Mail (J+3). The same point is said to apply to first class.

In our separate report on entrant costs, we acknowledge in paragraph 3.4.2 that our second class service "averages out at J+3 (in the range of J+2 to J+4)". However, we do not believe that this makes the service of a lower quality as we believe that this service would attract 2<sup>nd</sup> class mail by offering a *defined* day of delivery.

Even if it was to translate into a lower quality, for the purpose of developing conservative estimates of market share losses for Royal Mail, it seems sensible to assume that the entrant offer a similar quality as Royal Mail. Had we followed RM's advice, the model would have forecast RM retaining higher market shares.

### **Volume levels**

In Document B (paragraph 2.7), RM says that it was right to submit its November projection to Postcomm.

RM presented this November submission as draft, after the end of the consultation period. At that time RM acknowledged in its correspondence with

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Postcomm that “at this late stage overall projections cannot be substituted”. Postcomm’s choice at the time related to whether it should use the September forecast rather than the earlier forecast used for the Initial Proposals. Based on outturns data for the first half of 2005/06 and the seasonality of mail in previous years, it was sensible to adopt the September projection.

## OUTPUT

### *Final volume forecast*

In Document B (paragraph 2.7) and Document A (paragraph 5.7) RM comments on the fact that Frontier’s final forecast is not consistent with the final price control proposals. As a result, it is not clear which volume forecast will be the basis for the comparisons between outturns and forecasts once in the control.

Frontier was instructed to run the model with the assumptions of the final price control, and the detail of this model run were provided to Postcomm and LECG who undertook a full financeability assessment as reported in section 5.4 of our report.

## RM’S ECONOMETRIC WORK

In Document C, IDEI replied by noting that whilst “Frontier has accepted the remarks of IDEI, they should not be used as arguments in favour of Frontier’s criticisms of RM’s predictions. IDEI maintains that RM’s use of the econometric model corrected by a break in the trend component in order to introduce information about phenomena too recent to be treated statistically satisfies all the requirements for the construction of the best possible predictions”.

We observe that IDEI chose not to respond to our comments on the way RM proceeded. We stand by our position that the reliance on a *single* piece of evidence to infer the magnitude of the overlay was poor practice on this occasion.

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