Condition 21(5) access headroom review

On 15 March 2007, TNT Post UK Limited ("TNT Post") submitted a formal request to Postcomm to review the current level and scope of margin squeeze protection.

This is the information referred to in that request in which we seek "to demonstrate that the current level of headroom / margin squeeze protection offers insufficient scope to enable long term investment by access operators and is inadequate for the purposes of promoting effective competition in the longer term".

This also sets out the rationale for extending the current scope of the protection against margin squeeze to all relevant Royal Mail services.

Background

In May 2003, Postcomm issued a proposed determination which would have set an access price of 11.46 pence for IMC access (sorted to delivery office) and 11.88 pence (for Delivery Office Access). Postcomm stated that these prices would "allow Royal Mail to cover an appropriate part of its costs together with a reasonable return".

In August 2003, Postwatch published its own analysis and concluded that the access price for delivery office access should be 9.91 pence and should decrease, in real terms at RPI-3% per annum, so that the price would be 9.33 pence in 2005/06.

Downstream access prices and related terms were agreed in February 2004, between Royal Mail Group plc ("Royal Mail") and UK Mail Limited. For IMC access they were set at the considerably higher price of 13.375 pence (default sortation).

Royal Mail stated that its basis for reaching this price was to be retail prices minus avoided costs and published a legal opinion in support of this position.

TNT Post entered into a substantially identical agreement with Royal Mail on 6 April 2004.

New competition has come almost exclusively from upstream operators – with end-to-end competition in licensed letter mail having fallen back from 99.7% in 2004/05 to 99.8% in 2005/06.

Royal Mail is in a super-dominant position and, given this indomitable market strength, is under an especial duty not to take any actions which would damage competition.

In light of the VAT distortion and the provisions in the downstream access agreement which have the effect of blocking the use of delivery operators other than Royal Mail, the prospect of any significant end-to-end competition at any time in the next few years is remote.

Those offering a nationwide distribution service must use Royal Mail for final delivery.

TNT Post has – as have other operators - invested in employees, sorting equipment, IT and infrastructure on the basis of the retail and wholesale pricing differential. Our total investment to date is [REDACTED].

There was some margin squeeze between April 2004 and 30 March 2006 (the relevant date for the setting of the current margin squeeze protection). This was, in many cases, effected by changing the volume bands downwards to make retail discounts more readily available. The table set out in Annex A provides more details on the evolution of the prices.

There is considerable "incumbent-inertia" when customers make a switching decision. In order to attract customers away from using Royal Mail, it is essential to offer at least a 10% discount. 75-80% of customers said that they would not switch all of their mail if offered the same price and quality (Postcomm – Business Customer Survey, 2006). 60-65% of customers said they would not switch all of their mail, even if offered the same quality of services and a 10% price reduction. (Postcomm – Business Customer Survey, 2006). This demonstrates that the market reality requires there to be a significant discount in order to overcome this "incumbent-inertia". At this very, very early stage of market opening, it is essential to take these market conditions into account when assessing the need for margin squeeze protection.

Current margins

For pre-sorted mail, TNT Post charges an average upstream price of [REDACTED]

The total average price (including the Royal Mail charges) is [REDACTED].

Our average costs of upstream handling of pre-sorted mail are around [REDACTED]

While there is currently a theoretical margin of between 3.11 pence (700 CBC > 100k items) and 5.2 pence (1400 Letter), the reality is that, before we can apply a margin or covering our cost of investment and start up losses:

- a significant discount from Royal Mail retail prices must be offered; (typically a minimum of 10-12%)
- a further discount to win the business from other upstream operators must be offered;
- any mailing-house discounts or loyalty payments will need to be addressed;
- we need to cover the cost of cash-flow and bad debt.

For unsorted mail, TNT Post charges an average upstream price of [REDACTED]

The total average price (including the Royal Mail charges) is [REDACTED].

Our average costs of upstream handling unsorted mail are around [REDACTED]

Providing a competing access based service requires investment in both premises and in new jobs. Investors need to see a return on investment.

As can be seen from the above figures, our current return on sales from our upstream pre-sorted mail services is [REDACTED]. For upstream unsorted mail services, the return on sales is [REDACTED].

This sits well below the TNT Group internally expected return on sales of [REDACTED]. Unless there is a significant increase in this level of return on sales, the UK market will remain relatively unattractive for future significant investment. Any reduction in this return may well render the UK market much less attractive for future investment.

During the extensive consultation on the current price control, access operators, including TNT Post, identified the risk of further margin squeeze as a key area where *ex ante* protection was essential, given the total dependence of upstream operators on Royal Mail and recognising that an *ex post* review of margin squeeze which would inevitably take time to complete could well be too late.

The inclusion of a benchmark set of retail services in Royal Mail's licence in May 2006 was a useful starting point but it has become apparent that margin squeeze is taking place from other retail services and the absence of *ex ante* control exposes access operators to margin squeeze from them.

The maintenance of the current level and scope of margin squeeze protection is inadequate and needs to be increased and widened for the following reasons.

In summary: with pre-sorted margins of around [REDACTED] and unsorted margins of around [REDACTED] it is abundantly clear that the current level of headroom is insufficient in that it fails to recognise the investment and activities by upstream operators and the benefits derived by Royal Mail. If customers are to benefit from the promotion of competition, headroom must be significantly increased – not reduced. Put simply, to allow Royal Mail to reduce headroom by the 2 – 2.5 pence levels they suggest would destroy any competition.

A. <u>Increasing the level of margin squeeze protection</u>

a) <u>Delivery Costs of 8 pence</u>

We current pay around 13 pence for downstream processing and final delivery. Royal Mail Operations Director, Alan Barrie, in the January 2007 edition of *Courier* said that it costs 8 pence to deliver a letter. In light of this statement from a senior employee who can reasonably be expected to understand the costs of the operation, it would appear that a 5 pence uplift on this cost of delivery is excessive. A lower price was anticipated by both Postcomm and Postwatch. It is also notable that certain Royal Mail retail services, which purport to be provided at cost, charge for delivery at around 8 pence (e.g. the Mailsort Light mailings which precede or follow the main mailing).

b) <u>Original margin and price increases</u>

The original price for downstream services was said to include a margin of at least 6%.

The table in Annex A sets out the evolution of retail prices, access prices and headroom.

It is wholly unclear how the costs of providing the downstream service can have increased by more than the level of these access price increases to the extent that, not only has the 6% margin disappeared but, also, the services are now loss-making.

c) Efficiency and increased productivity (downstream)

The price control assumes a year on year efficiency gain. This has not been reflected in the downstream access prices. If such efficiency gains have not been made, then it appears that there in insufficient incentive within Royal Mail to achieve this. The answer would appear to be to maintain or reduce downstream access prices to create an incentive to reduce operating costs and improve Royal Mail's margin, rather than merely pushing up prices the wholesale prices, keeping retail prices static and and squeezing the margins of Royal Mail's competitors. If there are operating cost increases, these must, at the very least, be reflected equally in the retail and wholesale prices - which must include a nominal downstream access price under condition 10.5 of Royal Mail's licence (see below for further comment on condition 10.5).

d) Efficiency and increased productivity (upstream)

The exacting conditions of the downstream access agreement. It is believed that the savings to Royal Mail from the activities carried out by wholesale customers are not adequately reflected in the pricing. Aside from collecting, sorting, labelling, bagging and handing over to Royal Mail, wholesale customers are required to carry out a number of activities such as:-

- Providing seven day and 24 hour forecasting – so Royal Mail can accurately predict staffing levels;
- Accurate electronic data uploads;
- Processing through the mail centres rather than the RDC network;
- Arrival at restricted time slots at quiet times of day;
- Investment in yorks which, according to the terms of the agreement are to be provided by Royal Mail;
- The use of trays rather than bags;
- Through the provision of guarantees, a significant reduction of bad debt risk;
- Improved cash flow;
- Improved mail preparation;
- Improved revenue protection through exact bag fill requirements and manifest reporting;
- Reduction of account management costs;
- Reduction of invoicing, collection and administration costs;
- Increased efficiencies from larger volumes supplied from a single wholesale customer rather than a number of small retail customers;
- Removal of the RPI-1% price cap on access price increases, as originally agreed.

When compared with retail services, we do not believe that these additional benefits are fully factored in as discounts from the corresponding retail price. The original prices were based on a retail minus rather than a cost plus basis which was first envisaged by Postcomm.

e) Historical margin squeeze from February 2004 to April 2007

Some significant margin squeeze, in nominal terms, took place in April 2005 (see Annex A). In real terms, taking into account the effect of inflation, the squeeze was even more pronounced.

As can be seen, the headroom from the 50-100k item prices was squeezed for the 120 and 700 services.

Further margin squeeze took place in August 2006, at the introduction of Pricing in Proportion (see Annex A).

As can be seen, the headroom on all services decreased (these are marked in green) and in some cases the headroom reduced to below the April 2004 level (these are marked in red).

Margin squeeze has also taken place from services other than Mailsort 2, such as Packetpost and Cleanmail. Operators have invested in expensive, state-of-the-art sorting machinery in order to make discounts available to customers with unsorted mail. Cleanmail retail prices are one of the key competing retail services. As can be seen below, there has been tremendous margin squeeze from these services in the last three years where headroom has been reduced by 23.22% in nominal terms.

	April 2004	April 2005	August 2006	April 2007
DSA 120 CBC	13.05	12.90	13.01	13.28
Cleanmail*	20.2	20.0	18.5	19.4
Headroom (p)	7.15	7.10	5.49	6.12

*Lowest Cleanmail price

f) Hidden margin erosion

In the period since February 2004, a number of factors have operated to reduce the available margins.

Inflation on upstream services costs
In February 2004, the RPI figure was 183.8. In April 2006 it was 196.5 and, in February 2007, it was 203.1 (an increase of 10.5% over the three year period).

While the cap on Royal Mail retail prices was included in the price control in order to drive greater efficiency within Royal Mail's business, the same incentive is not required for upstream operators. We, and the other operators, have been in a build-up phase involving start up investment costs and start-up losses with no historic inefficiencies. At the very least, we face cost increases at RPI. This means that inflation has increased our costs of operation and has eroded the available margin in real terms.

By way of example, from February 2004 to February 2007, headroom for 120 OCR (<50k items) increased in nominal terms from 4.25 pence to 4.53 pence. However, applying RPI increases over the same period would have given a headroom of 4.70 pence. This means that, in real terms, the headroom has decreased by 3.75%.

Absorbed VAT
Upstream operators have to charge VAT on their element of the service. When selling to VAT exempt customers, at an upstream charge of 2 pence, this represents a margin erosion of 0.35 pence. VAT exempt customers typically expect upstream operators to absorb all or a very substantial proportion of this VAT in the charges they levy. As our costs (and related charges) have increased, so too has the amount of VAT we need to absorb.

Fuel price increases
In the period from February 2004 to August 2006, when PiP prices were introduced fuel prices increased by 27.94% and this increase has, largely, had to be absorbed by upstream operators from available headroom. Assuming that fuel represents around [REDACTED] of our costs, this represented a [REDACTED] increase in costs. It is presumed that, while Royal Mail also had to cover increases in fuel costs, the proportion of its costs represented by fuel is significantly lower than for our business.

Discounts
As customers expect a discount, typically expressed as a percentage of the retail price - and usually no less than 10% - this has meant that the amount of expected discount has increased over time but without a corresponding increase in headroom.

Indirect discounts to mailing houses
The QMP scheme for mailing houses, offering up to 1.5% discounts for mailing houses which use Royal Mail's services, offers discounts for mailing houses processing mail for Royal Mail retail services which undergo considerably less pre-work than access mail. We currently have to overcome these barriers to switching within mailing houses. The situation is expected to worsen as the QMP scheme will shortly be replaced by the Mailing Agency Scheme, which will offer indirect discounts of up to 3% of the Royal Mail retail price to customers, by paying these amounts to mailing houses for using Royal Mail services. This will operate as a further margin squeeze, as upstream operators will be required to fund discounts or other financial incentives from the currently available margin if they are to be able to overcome the understandable resistance by mailing house resistance against switching from Royal Mail. The effect of loyalty schemes of this nature is to create inertia at the mailing house level, thus stalling or even blocking completely, customer switching decisions. This is a market condition which we are required to contend with – and the result is another erosion of headroom and, thus, margin. We request Postcomm to look closely at these proposed changes as an illegal way of indirectly introducing discounts through channel pricing that are aimed at influencing the market, locking customer in to using the super-dominant supplier and indirectly reducing the headroom between retail and wholesale prices.

Loyalty offerings
Proposals to award customers discounts for increased volumes and/or committing to agreeing to an increased minimum contract duration have the effect of further reducing available margin. Customers will seek to secure equivalent discounts. Wholesale customers are not offered similar volume or temporal commitment incentives. Even where such offers are withdrawn, the effect is to stall the switching decision thus not merely squeezing margin but depriving competitors of any margin at all.

Surcharges
The headroom level supposes that the price paid is the stated access price. However, in reality, the price paid is higher because of the application of surcharges e.g. for additional under- filled bags and missorts which are all charged at first class single tariff letter rate.

g) Wholesale overhead

The direct overhead attributable to wholesale activities is minimal and it is not appropriate to allocate shared costs which have no relation to such activities if they are not justified by the underlying activity. For example, Wholesale has no need for sales and marketing or branding costs or for much of the shared services applicable to other Royal Mail activities. To the extent that there are shared overheads allocated to the operations, these must, as required by condition 10.5 of the licence, be borne proportionately by all customers i.e. both retail and wholesale customers. In other words, these costs belong not in wholesale (which is merely a small administrative office) but in operations so there is no question of any additional cost or overhead allocation to wholesale prices. Any change to the proposed access rates must not be based on a pure reallocation of overheads and redefinition of the allocation of operating costs which can be cleverly manipulated to demonstrate the outcome desired.

h) Condition 10.5

As Royal Mail must charge itself the same amount as it does third parties, under condition 10.5 of its licence, any increase in wholesale prices must be reflected in the retail prices.

Royal Mail must demonstrate the component parts of all its retail services to show:-

- the internal “condition 10.5” transfer charges for all operational activities
- direct costs of selling, marketing, invoicing, collecting payment
- direct costs of account management
- allocation of shared costs where direct attribution is not possible; and
- margin.

If this is not done, there is a risk of predation which Royal Mail is under a duty to avoid.

We do not understand how such a cost breakdown could allow Royal Mail to charge the current prices it does for services such as 2nd Class stamped / franked / PPI mail;

Presstream; Door to Door; PacketPost; Cleanmail Advance; Mailsort Lite or Mailsort 3 services. This is not an exhaustive list.

It is not clear how volume related discounts reflect a reduction in costs. If there is such a reduction in costs, why are these not reflected in the wholesale prices where there are no volume related discounts.

It might be expected that, with upstream volumes being lost to competition, Royal Mail's upstream unit costs will have increased, rather than decreased. This would require an increase in retail prices.

The build-up of prices which underlie zonal access (and zonal retail) prices is far from clear and is essential to enable condition 10.5 compliance. Arbitrage between national and zonal access prices and between zonal access and retail services is taking place. This also needs to be assessed.

Proposal

The level of margin squeeze protection has been substantially reduced since access prices were set in April 2004.

It is our proposal that the price for access should be reduced to take into account:
the additional work carried out by wholesale customers;

- the benefits which Royal Mail derives from this additional work;
- the apparent, 8 pence costs of delivery plus any directly attributable costs;
- the level of margin squeeze, both direct and indirect, which has taken place since April 2004.

As can be seen, the current level of margin squeeze protection is insufficient to create a commercial return or sales, to allow operators to recover the cost of their investment or to enable them to make a commercial margin.

The level of margin squeeze protection must be increased if Postcomm is to promote effective competition, recognising that, for the foreseeable future, there will be no material increase in end-to-end competition.

B. Widening the scope of margin squeeze protection

Postcomm confirmed in its final proposals for the price control that the set of benchmark services in the licence would establish a principle which would apply to other services.

Given that this formulation is vague and involves a substantial degree of uncertainty and exposes upstream operators to the risk of margin squeeze, Postcomm should (a) require a full cost breakdown for every retail service – including a condition 10.5 internal charge - and (b) fix a margin squeeze percentage to every one of Royal Mail's retail services (both existing and future) to ensure that margin squeeze cannot be achieved round the flanks, where necessary, be requiring the retail price to be increased.

We see no reason for excluding any of the Royal Mail services from this requirement.

Future review

As Royal Mail controls the supply of 99.8% of downstream services, the need for *ex ante* margin squeeze protection remains critical. If and when delivery competition emerges, it will be appropriate to see if the margin squeeze protection can be removed, but condition 10.5 transparency will still be vitally important to ensure that prices cover costs and that there is no unfair discrimination.

At the moment, given the almost total absence of existing delivery competition and of any realistic prospect of any material delivery competition in the next few years, access will remain the predominant form of competition and Postcomm must move to increase the current level of headroom protection and implement stronger *ex ante* measures to protect that competition from margin squeeze in the future.

TNT Post UK Limited
30 March 2007

Submitted version – version for publication

ANNEX A

Evolution of retail and access prices and headroom

DSA Product	Apr-04	Apr-05	Apr-06	Aug-06 PIP	Apr-07	
120 OCR DSA (p)	13.150	13.000	13.250	13.110		13.580
DSA % Change		-1.15%	1.89%	-1.07%		3.46%
RM Retail Price MS2 (p)						
0-50K	17.40	17.40	18.20	17.64	Letter (0-19999)	18.23
50-100k	17.10	16.62	17.40	16.86	Letter20 (20000-39999)	17.90
>100k	16.60	16.56	17.30	16.70	Letter40 (40000-79999)	17.47
					Letter80 (80000-119999)	17.25
					Letter120 (120000+)	17.08
Headroom (p)						
0-50K	4.25	4.40	4.95	4.53	Letter (0-19999)	4.650
50-100k	3.95	3.62	4.15	3.75	Letter20 (20000-39999)	4.320
>100k	3.45	3.56	4.05	3.59	Letter40 (40000-79999)	3.890
					Letter80 (80000-119999)	3.670
					Letter120 (120000+)	3.500
Headroom %						
0-50K	24.43%	25.29%	27.20%	25.68%	Letter (0-19999)	25.51%
50-100k	23.10%	21.78%	23.85%	22.24%	Letter20 (20000-39999)	24.13%
>100k	20.78%	21.50%	23.41%	21.50%	Letter40 (40000-79999)	22.27%
					Letter80 (80000-119999)	21.28%
					Letter120 (120000+)	20.49%
120 CBC DSA (p)	13.05	12.90	13.15	13.01		13.28
DSA % Change		-1.16%	1.90%	-1.08%		2.03%
RM Retail Price MS2 (p)						
0-50K	17.20	17.19	18.00	17.43	Letter (0-19999)	18.01
50-100k	16.90	16.41	17.20	16.65	Letter20 (20000-39999)	17.69
>100k	16.40	16.35	17.00	16.49	Letter40 (40000-79999)	17.25
					Letter80 (80000-119999)	17.03
					Letter120 (120000+)	16.86
Headroom (p)						
0-50K	4.15	4.29	4.85	4.42	Letter (0-19999)	4.730
50-100k	3.85	3.51	4.05	3.64	Letter20 (20000-39999)	4.410
>100k	3.35	3.45	3.85	3.48	Letter40 (40000-79999)	3.970
					Letter80 (80000-119999)	3.750
					Letter120 (120000+)	3.580
Headroom %						
0-50K	24.13%	24.96%	26.94%	25.36%	Letter (0-19999)	26.26%
50-100k	22.78%	21.39%	23.55%	21.86%	Letter20 (20000-39999)	24.93%
>100k	20.43%	21.10%	22.65%	21.10%	Letter40 (40000-79999)	23.01%
					Letter80 (80000-119999)	22.02%
					Letter120 (120000+)	21.23%

Submitted version – version for publication

700 CBC DSA (p)	13.00	12.85	13.09	12.96		13.23
% change		-1.17%	1.83%	-1.00%		2.04%
RM Retail Price MS2 (p)						
0-50K	16.80	16.77	17.60	17.01	Letter (0-19999)	17.58
50-100k	16.50	15.99	16.80	16.23	Letter20 (20000-39999)	17.25
>100k	16.00	15.93	16.60	16.07	Letter40 (40000-79999)	16.82
					Letter80 (80000-119999)	16.60
					Letter120 (120000+)	16.43
Headroom (p)						
0-50K	3.80	3.92	4.51	4.05	Letter (0-19999)	4.350
50-100k	3.50	3.14	3.71	3.27	Letter20 (20000-39999)	4.020
>100k	3.00	3.08	3.51	3.11	Letter40 (40000-79999)	3.590
					Letter80 (80000-119999)	3.370
					Letter120 (120000+)	3.200
Headroom %						
0-50K	22.62%	23.38%	25.63%	23.81%	Letter (0-19999)	24.74%
50-100k	21.21%	19.64%	22.08%	20.15%	Letter20 (20000-39999)	23.30%
>100k	18.75%	19.33%	21.14%	19.35%	Letter40 (40000-79999)	21.34%
					Letter80 (80000-119999)	20.30%
					Letter120 (120000+)	19.48%
1400 Letter DSA (p)	13.00	13.150	13.400	13.300		13.580
% Change		1.14%	1.87%	-0.75%		2.06%
RM Retail Price MS2 (p)						
Directs	18.10	18.30	19.01	18.50	Letter (0-19999)	19.53
					Letter20 (20000-39999)	19.31
					Letter40 (40000-79999)	19.20
					Letter80 (80000-119999)	18.99
					Letter120 (120000+)	18.88
Headroom (p)						
Directs	5.096	5.150	5.610	5.200	Letter (0-19999)	5.950
					Letter20 (20000-39999)	5.730
					Letter40 (40000-79999)	5.620
					Letter80 (80000-119999)	5.410
					Letter120 (120000+)	5.300
Headroom %						
Directs	28.16%	28.14%	29.51%	28.11%	Letter (0-19999)	30.47%
					Letter20 (20000-39999)	29.67%
					Letter40 (40000-79999)	29.27%
					Letter80 (80000-119999)	28.49%
					Letter120 (120000+)	28.07%