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2006 ROYAL MAIL PRICE AND SERVICE QUALITY REVIEW

Initial proposals

DMA's RESPONSE

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DMA

The Direct Marketing Association (DMA) UK Ltd is the largest trade association in the communications sector, representing both users and suppliers of direct marketing. We represent the majority of the major users of postal services and our client membership base represents the largest Royal Mail customer group. We represent all aspects of the supply side of postal services from mailing houses to consolidators and from agencies to data bureaux. We were actively involved in the consultation and deliberations on the price control principles consultation, late last year and welcome the opportunity to contribute to Postcomm's initial proposals.

POSTCOMM'S APPROACH

It is essential Postcomm return to the fundamental reason for operating a price control, namely to act as a surrogate for competition. It is correct to treat Royal Mail as a commercial entity but they must ensure they do not end up micro managing Royal Mail. In addition the price control must not be treated as guaranteed price increases for Royal Mail, which many perceive it to be. The four stands of Postcomm's objectives: ensuring USO, promoting effective competition, incentive regulation and transparency are the correct objectives but the mechanics behind these objectives need to work effectively.

COVERAGE

Approach to determining the coverage of the next price control

A competition test remains the most effective way of determining whether a product is in the price control or not. Postcomm needs to carefully consider the situation where Royal Mail replace products but position them as new products. Such an approach could lead to most of Royal Mail products sitting outside price control. For example Royal Mail are currently reviewing their product range with the intention of introducing new products from April 2006. These new products would effectively replace existing portfolio, although Royal Mail would leave the existing products in place. Under current competition test proposals these new

products could sit outside price control. The impact and lack of protection for users is immense.

Which of Royal Mail's retail products should be price controlled?

Postcomm's believes there is limited evidence of competition within the UK market, although many products are facing competition and have done for some time. In addition the wholesale access market will probably reach 2 billion items by the end of 2005, which equates to @ 9% of Royal Mail's volumes. Inclusion into the price control should always be based on a competition test. The competition test should be applied after setting and implementation of the price control, to allow for the rapid development of competition in a certain area. Any product, which has effective competition, should be excluded from the price control. Any new products should be excluded, except where by their very nature they are substitutional. Where a products service is below competition then again they should be excluded. This applies to standard parcel. Airmail and surface mail exist in a defacto competitive market and price control must be seen as a retrograde step. Based on the above comments, the following should not be included in the price control

- Standard parcel (effective competition)
- Airmail (competitive environment)
- Surface mail (competitive environment)
- Mailsort 120 3 (new products)
- Mail media (new products)
- Special delivery (effective competition)
- Special delivery 9am (new product/ effective competition)

The exclusion of Presstream, from price control, is an interesting move by Postcomm, which it has not replicated elsewhere on other products in similar positions. By applying price control to effectively the same products, bar two, as the existing 2003 control, Postcomm is effectively micro managing Royal Mail.

Regulation of New Products

New products should be excluded from the price control providing they are genuine new products. If Royal Mail introduces products to substitute existing products within the existing price control, then these new products should

be examined to see whether they should be within the price control. The new products introduced by Royal Mail since the last control should be excluded from the new control, as they are genuine new products. The notable exception to this would be response plus, which many would argue is a substitutional product. Therefore it should be examined to see whether it should be included in the control.

The process for removing products after the control has been set

Formulating the process for considering the removal of products from the price control is eminently sensible and welcomed. Postcomm must ensure they balance regulatory certainty for product users against giving Royal Mail the ability to react to competition. The 5-part process or criteria, plus the competition test give plenty of warning and due consideration but potentially limited flexibility for Royal Mail. Postcomm must examine this to ensure a fair and equitable process, meeting the requirement of users and Royal Mail.

ACCESS PRODUCTS

Bringing access products within the price control.

The DMA has argued that bringing access products within the price control would be regulatory interference in a competitive environment. Postcomm should concentrate on the implementation and compliance to, the access code developed prior to the Royal Mail/UK Mail deal and the removal of barriers such as VAT. Postcomm should resort to a legal framework by invoking one of Royal Mail's licence conditions, rather than waiting for Royal Mail to develop, voluntary an access code.

The inclusion of access products within the price control is understandable in the context of preventing anti-competitive activity by Royal Mail, such as zonal access pricing deals. But surely Postcomm should attack the root cause rather than use price control as an anticompetitive control measure.

Approach to price controlling access products.

At the heart of price controlling access products is Royal Mail's behaviour from a margin erosion perspective and potential anti-competitive activity, both of which are example of Royal Mail effectively pre-empting competition.

Such behaviour by Royal Mail must be addressed and acted on. Unfortunately the regulatory process to address this is long and tortuous.

To counter this long process, Postcomm should adopt the price control option, which regulates the margin between access and retail products. In order to ensure Royal Mail are not penalised through cost changes or use it as an excuse to change the control, Postcomm should have an annual review on Royal Mail's costs, primarily focusing on access provision. In establishing the margin, Postcomm must ensure they are examining an efficient Royal Mail operation or make assumptions of an efficient operation with margins geared to cost.

Zonal access

Royal Mail's move to zonal access pricing could be construed as a clear attempt to preserve/protect their relationship with the end client, which they lose under normal access relationship or offering true customer choice to major customers. The difficulty, here is one of balance and long-term implication. Any restriction could be argued, against, on the basis of 'customer choice'. Although, if the provision of maximum customer choice in the short term creates an environment in which a real national alternative cannot be properly supported/developed, then in the longer term, extensive and true, real choice will not become available. This will not be good for the customer, in the longer term, as it then creates a situation in which there is a lack of comprehensive, alternative provision and the opportunity for an incumbent to distort/control the market by changing product specifications, at a later date. This could be something much less attractive than current likely offerings. So the 'balance' is the short-term advantage versus the long-term benefit.

Quality of service for regulated access products

The existing quality of service targets and compensation scheme for access should remain in place for the benchmarked (price controlled) access products. Royal Mail should supply quality of service statistics to access operators as a matter of commercial norm. If they do not Postcomm should regulate to ensure they do.

Non-price terms and conditions

There is a great deal of concern of the use by Royal Mail of non-price terms and conditions, as a means of leveraging

price. The DMA have raised many instances of this, such as volume related discounts and PPIs. Royal Mail will look to use these conditions to leverage price or impact on their competitors. It is essential that Postcomm tighten its regulatory control in this area, to ensure Royal Mail consults and seeks approval from Postcomm. Where appropriate Postcomm should consult with industry. Royal Mail should report and publish its intended price changes for price controlled access products.

FORM AND DURATION

Form of control

RPI-X price control is the only form that creates an environment of incentivising Royal Mail to reduce costs; all others tend to recast the control dependant on cost movements. The downside of RPI-X is where Royal Mail benefits from higher than expected volumes, generating windfall revenue but do not generate any cost efficiencies.

Choice of price index

CPI was developed to eliminate the disproportionate effect of mortgage interest payments, which gave a bias to the RPI. So as an indicator of real consumer spending in the economy, CPI is a fairer measure. Therefore it would seem appropriate to adopt CPI, unless Royal Mail costs are disproportionately impacted by mortgage payments. Although for consistency we understand Postcomm's proposal to retain RPI.

Re-opening the price control.

The existing price control re-opening mechanism is fit for purpose, allows for key eventualities and should be retained.

Duration of control

A 4-year price control appears inconsistent if the market is fully opened by Jan 2006. This will give Royal Mail 4 years of controlled prices in a completely open market. The risk that the control was set wrongly is too high a risk to take, especially as it could act as a brake on competition and/or give Royal Mail no flexibility. On the issue of data quality, it is Postcomm's responsibility to ensure Royal Mail cost data is fit for purpose. Revising this as an

issue 4 years after the creation of Postcomm and 3 years after Royal Mail's licence is totally unacceptable. It needs resolving as a matter of priority. If Postcomm are not happy with the data and the assumptions underlying any analysis then the price control period should be reduced.

STRUCTURE

Single or multiple controls?

If price control is a proxy for competition, surely it makes sense to create individual price caps. As has been discussed earlier there are some products, which DMA believe should not be in the price control, including new products.

An aggregated approach at the captive/ non-captive level may create confusion, as the groups seem to bear no relevance to the actual situation. We are not convinced of the relevance of a captive and non-captive group. The competitive threat posed to non-captive Royal Mail products, from new entrants will not be homogenous threat, so why group Royal Mail products into groups with homogenous price controls.

Approach to cost attribution

We concur with Postcomm's approach with the exception related to pension deficit costs. Users should not meet pension deficit costs. Royal Mail have used pension costs as an excuse for price increases, on three separate occasions, prior to the price control regime. The lack of contributions over 13 years flowed through into profits and dividends to the benefit of the shareholder. This is where responsibility lies for the deficit. We also notice that Postcomm's approach, though difficult to justify according to economic theory, is the best practical way to allocate joint costs in these circumstances.

Rebalancing threshold

If Postcomm pursue the captive and non-captive groups with separate tariff baskets, flexibility must be given with each basket. Competition is not homogenous and therefore Royal Mail's products will face different threats in the non-captive group. The degree of flexibility depends on the degree of competition and its speed and intensity. A flexible approach triggered by external conditions should be examined. A 4% rebalancing threshold above the allowable

average price change does give RM a great deal of scope and could present users with particular high price hikes. Any rebalancing should be strictly limited.

Changes to pricing structures

Postcomm must continue to use condition 19 to evaluate price changes. The time taken by Postcomm to come to a decision must shorten, dependant on Postcomm receiving adequate data supporting the pricing proposal. Although Postcomm must ensure they receive quality data from RM. The implementation date or time allowed to prepare for increases and changes is vital. Clients cannot test overnight they need time to evaluate. Postcomm should include zonal pricing within the coverage of condition 19, to ensure there are no abuses by Royal Mail.

Non-price terms

DMA have raised a series of complaints with Postcomm on the use by Royal Mail of non-price terms to increase prices. In fact bulk mailers have experienced nothing but price increases over the last 4 years. The list includes mailsort re-engineering, where Royal Mail changed the method by which mail was presented and its volume, so adding costs to the mailing house sector. On the issue of PPIs, Royal Mail reduced the variants available only permitting their designs and rejecting all others. This added considerable cost to the industry. On the issue of BREs, Royal Mail changed the basis that they operated on, so clients could no longer use multiple BREs. On all of the above cases, Postcomm ruled against the DMA.

Postcomm must ensure they see all non-price terms, with a short period by which they must get back to Royal Mail on their likely action.

We have concerns about the National Geographic Posting profile (NGPP). Royal Mail have invented a measure of their own without any reference or consultation which can be used on a mailing to mailing basis to measure the acceptability of traffic into their network. This has the effect of influencing business decisions about the usage of end to end competitors to Royal Mail services, because to grow end to end service providers, of necessity they start by servicing only a proportion of the entire mainland. This in turn may lead to potential cost penalties if the remaining mail a customer hands over does not meet Royal Mail's pre-determined criteria. This is a very delicate balance between growing end-to-end competition and "cream skimming".

There exists a ridiculous situation for many major mailers in which mail posted on a Friday costs more than mail posted on a Monday, unless it is held. The "feast and famine" nature of mail production and release is now effecting the processing of mail through the Royal Mail network as DMA predicted (this was raised with Postcomm in official complaints on volume related discounts). Royal Mail operations are as much against the compliance requirement to post over 100k per day for maximum discount as the customers are. If this proposal is about Price control both within and without the Royal Mail business the 100k posting per day requirement should be removed, it would reduce Royal Mail's costs and reduce their customers' costs quickly and effectively.

One other issue not perhaps for this response is the lack of a Royal Mail protocol when quoting and comparing general bulk mail prices. Consideration needs to be given for the creation of a standard protocol for price quotation on bulk mail products. Here the proportions of Directs and Residue could be fixed for general quotes. At the extreme if we do not have a price protocol; changes may appear to meet the price control requirements but in fact may not. Favourable cost comparisons could be engineered, to appear to be within the controls, by the manipulation of the direct and residue splits.

APPROACH TO FINANCING

"Cash" or "Regulatory value" approach

We were not persuaded by the initial reasons put forward in the first consultation for the regulatory approach. Postcomm's initial analysis demonstrated the benefit of a cash approach. We are concerned that the LECG efficiency report has not been published nor is it available. This report is fundamental to this issue. It is essential that Postcomm make this report available, with no further delay. We are very concerned that the implication is that Royal Mail will under invest to the order of £40m, which is totally unacceptable.

Setting the opening regulatory value.

We do not dispute Postcomm's approach, analysis or calculation of the opening regulated asset base.

Implementing the "regulatory value" approach.

We have a series of concerns on the implementation of the regulatory value approach:

- Customers have effectively paid for Royal Mail's capital expenditure. It's inclusion in the RAB could lead to customers paying twice for the capital expenditure
- Effective incentives for Royal Mail to realise existing assets, which could lead to lower prices for customers.
- The apportionment of costs between captive and non-captive product baskets does not reflect how those products use the assets. For example the usage of property could be markedly different dependant on the mail process involved.
- Future resetting of RAB must reflect the development of competition

LEVEL

Postcomm's overall approach

Postcomm must consider the following in its overall approach:

- Royal Mail can provide the universal service but do not assume that competition will erode the cost of the universal service. In addition Postcomm must consider the competitive advantage of providing the universal service
- Mail media competing with other media within the communications mix
- Customers' expectations from competition for lower prices. Something users have not received from Royal Mail over the last price control
- Royal Mail as an efficient operator, which it currently it is not
- Incentivise Royal Mail to improve efficiency and grow its business
- Pension costs not to be met by users. Royal Mail have used pension costs as an excuse for price increases, on three separate occasions, prior to the price control regime. The lack of contributions over 13 years flowed through into profits and dividends to the benefit of the shareholder. This is where responsibility lies for the deficit. This matter is

not at all relevant to the price control. Postcomm are proposing an allowance of £300m per annum for four years, which will effectively, be met by the users. With the continuing rise of the equity markets, this deficit of £4.5bn could disappear in a couple of years. We would assume then that Royal Mail would reduce prices.

- Excess profits generated by volume growth rather than Royal Mail efficiencies, should be clawed back by Postcomm. The redistribution of the excess profits should be to the user, through reduced prices or discounts
- The impact of PIP (assuming it is agreed) should be reflected in mid year review of the price control and a delayed introduction of the price control (to facilitate 12 month notice period)

Setting revised price caps.

We do not disagree with the setting of $x=3\%$ for captive and $x=2\%$, which could lead to some real downward pressure in prices, for the first time in the era of regulated prices.

QUALITY OF SERVICE

Postcomm's approach to combine products into groups, for the purpose of quality of service measurement makes no sense. It disadvantages users, as the performance of a product and its measurement could be influenced by another product they do not use. Such an approach will distort the compensation scheme.

The proposal to include international mail is welcomed but combining the destinations to one amalgamated average, makes no sense, as Royal Mail are not responsible for the final delivery within each country.

The compensation scheme should remain but the recent farcical proceedings on the payment of compensation should be resolved to ensure users receive compensation for poor service on the basis that they received poor service not on the basis of their payment record.

The measurement of the quality of service should be on an independent basis and should not be commissioned by Royal Mail. The research should be commissioned, monitored and reported on by Postwatch. Postcomm should also insist that the Postwatch audit report be published on a wide scale basis.