

**Issues to be addressed in the
2006 Royal Mail Price and Service Quality Review**

A Discussion Paper

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August 2004

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Executive Summary

Overall approach

Recommendation 1:

Postcomm's approach to setting new price caps must be underpinned by a robust framework for assessing the total amount of revenue that Royal Mail requires in each year of the next control period. A building block approach that calculates Royal Mail's revenue requirement as the sum of forecast operating expenditure, an allowance for depreciation of past capital investment and an allowance for profit, is both simple to use and, more importantly, founded on stronger economic logic than the methodology devised by Postcomm at the last review.

Calculating Royal Mail's revenue requirement

Recommendation 2:

When assessing future operating costs, Postcomm should seek to look at Royal Mail's current efficiency from a number of different angles using a number of different techniques. Benchmarking analysis, in particular, provides a reliable way to look at how far savings can be made by bringing best practice from elsewhere into the business and should receive more attention than 'bottom up' assessments of Royal Mail's business plan.

Recommendation 3:

Efficient pricing demands that customers should pay for the cost of Royal Mail's capital expenditure over a period of several years rather than on a pay-as-you-go basis. Since this approach may entail profiling costs and revenue over several control periods, Postcomm should establish a regulatory asset base for Royal Mail in order to provide a reliable and transparent basis for calculating how much customers will be expected to pay in years after the next control period ends.

Recommendation 4:

Unlike in other regulated industries, using the capital asset pricing model to determine the profit that Royal Mail requires each year may understate the business's exposure to risk and provide for too small a buffer against financial shocks. Postcomm will need to supplement conventional return on capital analysis with comparisons to the operating margins that similar businesses are able to earn and with financial modelling of Royal Mail's overall financial position under different scenarios for costs and revenues.

Volume risk

Recommendation 5:

All parties in the review must take seriously the uncertainty surrounding volume forecasts for the next control period. Unless price control arrangements are designed properly, there is a significant risk that unexpectedly high loss of market share will jeopardise Royal Mail's overall financial position and cause a deterioration in service to customers.

Pricing

Recommendation 6:

The freedom that Royal Mail has to set prices for individual products should be constrained to prevent the business from taking pre-emptive action to deter new entry. As such, there is a case for Postcomm to impose stronger restrictions than the basic test for predatory pricing used in competition law and move instead to place explicit price 'floors' on certain products.

Recommendation 7:

If individual price caps are also to be placed on certain products that have wider social importance, Postcomm must assure itself that Royal Mail retains sufficient pricing flexibility to recover all of the revenue that it is entitled to under the business' overall price control.

Quality of supply

Recommendation 8:

The case for a significant overhaul of existing incentives to improve quality of services rests on determining the underlying causes of recent deterioration in Royal Mail's performance. If the regulator is satisfied that recent poor service is a short-term consequence of the business's restructuring, it may be difficult to justify across-the-board increases in financial rewards and penalties.

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1. Introduction

This paper contains an independent and impartial examination of the issues that Postcomm will confront in its review of Royal Mail's prices and service quality.

It focuses on how the regulator can best achieve twin objectives of: (a) improving the performance and reliability of postal services in Great Britain; while (b) reducing the overall level of prices that consumers pay. To do this, the paper looks carefully at the policy decisions which will have the greatest impact on prices and service quality and aims to distinguish between actions which are likely to have a positive impact on the sector over the long term and those that place too much emphasis on short term gains, thus potentially jeopardising the interests of future customers.

From the outset, it is important to note that Postcomm's review takes place at a time when the postal sector is opening up rapidly to competition. The regulator has a difficult balance to strike in its review between obtaining the maximum possible reduction in Royal Mail's prices and creating an environment which facilitates efficient new entry so that competition can begin to replace regulation as a means of protecting customers. Its task is made even more complicated by the continued importance of Royal Mail's universal service obligations and by uncertainty surrounding the size of the market that Royal Mail will serve in future years. These are not difficulties that have confronted regulators of other network businesses and they require Postcomm to exercise genuinely innovative thinking during the course of its review.

Looking back at Royal Mail's recent record on service quality, market share and profitability, it is clear that there is significant room to improve on the existing price control arrangements:

- on service quality, Royal Mail's recent record has been disappointing with senior management admitting publicly that the business's performance is unacceptable;
- by contrast, group profits have at the same time increased to just over £200m a year in 2003/04 from a loss of £200m a year earlier, although the amount of money the firm is making is still well short of the level that would normally be expected; and
- revealingly, the main driver of improved profitability was an unexpected increase in volumes last year against expectations of declining volumes underpinning Royal Mail's price control calculations. This has enabled profits to rise despite Royal Mail falling behind the rate of efficiency improvement assumed by Postcomm.

Against this backdrop, our analysis of the challenges for Postcomm over the next 18 months is structured into five parts:

- Section 2 emphasises the importance of assessing accurately Royal Mail's revenue requirement for the first year of the new price control and looks at the sort of analysis that Postcomm will need to undertake in order to determine the company's overall income;
- Section 3 goes on to examine how the regulator should deal with uncertainties around volumes, costs and revenues when designing robust price control arrangements;
- having looked at Royal Mail in totality, Section 4 focuses on the prices of individual products and examines how much freedom the business should have to vary prices in response to competition;
- Section 5 concentrates on quality of service and assesses what Postcomm can do to safeguard the standards that customers expect of Royal Mail; and
- Section 6 concludes.

2. Royal Mail's revenue requirement

During any review of a monopoly business, a regulator's main task is to determine the revenue that an efficient owner requires in order to provide the services that are prescribed by its licence. The same task is no less important in an industry like the postal sector where new entrants can come in to challenge the incumbent and where a business's monopoly will be eroded over time. In this situation, a regulator's assessment of the dominant firm's revenue requirement serves dual purposes:

- first, it enables the regulator to arrive at a price cap which prevents the dominant firm from abusing its market power in those segments of the market where competitive threats are weak; and
- second, these same prices then set an important, 'efficient' benchmark for potential competitors who will only find it profitable to enter the market if their services cost less to produce than the incumbent.

These twin pressures generally tend to push in the same direction rather than conflict with each other. A regulator, for example, that wrongly sets the incumbent company's revenue requirement too high is likely to find that customers pay too much in the short term while erroneously encouraging less efficient operators to enter the market. On the other hand, a regulator that wrongly sets the company's revenue requirement too low is likely to jeopardise the monopolist's financial position and deter entry that would otherwise be to the long-term benefit of customers.

For these reasons, by far the most important challenge that Postcomm will face in its review is to arrive at an accurate assessment of Royal Mail's overall costs and associated profit requirement. A similar exercise was carried out during the last review in 2002/03 but suffered from several weaknesses. In particular, it is apparent that Postcomm's final conclusions lacked:

- a robust, economic methodology for setting Royal Mail's price caps;
- an explicit allowance for profit, potentially reducing prices below a level that would have allowed for efficient new entry into the market; and
- convincing evidence to justify the regulator's conclusions on efficiency and cost reduction.

The starting position is therefore one in which there is considerable scope for the regulator to improve upon the approach adopted at the previous review. The key challenges it will face are described below.

Methodology

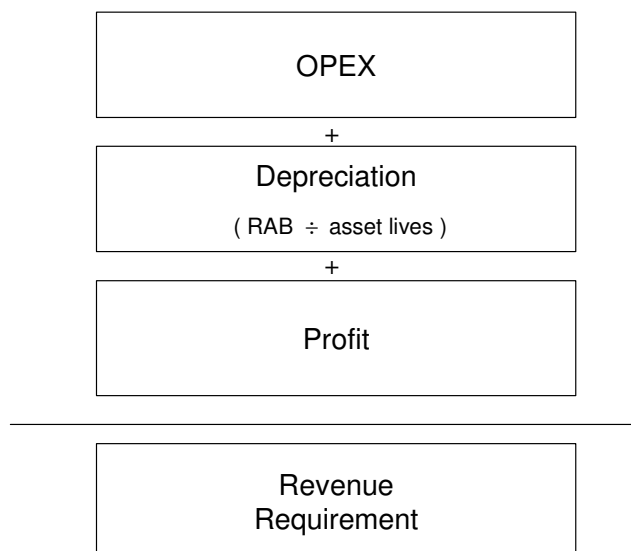
The most important decision for Postcomm to get right is its choice of framework for assessing Royal Mail's revenue requirement. Postcomm's March 2004 consultation document correctly points out that most other regulators have harnessed a relatively simple building block model that calculates a company's annual revenue requirement as the sum of three components:

- forecasts of the company's operating expenditure (OPEX);
- depreciation over time of the company's capital expenditure (CAPEX); and
- an allowance for an appropriate level of pre-tax profit.

This model, illustrated graphically in figure 1 below, is simple to use, familiar to investors and, most importantly, is based on the incontrovertible economic logic that a company should seek to recover its OPEX as it is incurred, its CAPEX over the useful life of the assets that are purchased, and in doing so earn an annual return that is commensurate with the risk

that the company bears. Indeed, it is the same logic that any other player in the postal sector would use to determine their own revenue needs and, hence, their prices. As a result, it serves both of the dual objectives highlighted at the beginning of this section.

Figure 1: The building block methodology



We strongly endorse Postcomm's arguments that this building block model provides a suitable basis for assessing Royal Mail's revenue requirement. Although the individual components within the model will inevitably become the subject of extensive debate, we consider it to be in the interests of all parties that the regulator puts in place a familiar, transparent and sound economic framework as the overall foundation for the review.

OPEX

As most of Royal Mail's revenue requirement is needed to cover OPEX, it is inevitable that a considerable proportion of Postcomm's work over the course of the review will go into analysing Royal Mail's cost base in order to establish the 'efficient' cost of the providing the products that are to be regulated by the price control formula. The key to this work is breadth: by looking at efficiency from a number of different directions and assembling as much evidence as possible, Postcomm must try to get to a position where it does not need to place undue reliance on any one piece of work when reaching a final judgment about the costs it should allow in its building block calculations.

Unlike the last review, where Postcomm relied almost exclusively on a series of reports prepared by WS Atkins, the regulator has already indicated that it will draw on a range of techniques in order to understand how efficient Royal Mail currently is and, hence, the scope for the business to make future cost savings. This may include:

- benchmarking;
- bottom-up investigations into Royal Mail's business plan; and
- 'top-down' analysis of productivity trends across similar industries.

Experience in other regulatory reviews indicates that the most informative type of work a regulator can carry out is benchmarking. In the postal sector, benchmarking can take a variety of different forms:

- internal benchmarking of OPEX incurred at each regional mail centre;
- international benchmarking of Royal Mail's OPEX against postal service providers overseas; and
- process benchmarking of corporate overheads against similar-sized companies from outside the postal sector.

In all three exercises, the key challenges are ensuring that cost data from each company or part of the company is reported on a consistent basis, thereby ensuring comparability, and subsequently controlling for external factors, such as differences in scale, operational requirements or regional wage differences, which would otherwise give a misleading picture of relative efficiency. Neither of these obstacles should, however, be insurmountable if Postcomm allows sufficient time for the analysis to be undertaken and if it recognises upfront that none of the techniques can provide a 'perfect' answer in its own right.

On this latter point, Postcomm may find it helpful to consider how far work can be carried out jointly with Royal Mail so that there is a common understanding of the robustness of the benchmarking work. By way of comparison with another industry, the recent ORR review of Network Rail saw the regulator and the company appoint a single set of independent consultants between them to carry out studies of efficiency. This meant that both parties were able to agree from the outset what analysis would be carried out, what scope the work would have, which consultants should be appointed and when their reports should be produced. It also meant that both the company and the regulator had unlimited opportunity to comment on the consultants' work while it was being carried out. Ultimately, this approach produced genuinely independent and impartial analysis of the company's expenditure and enabled ORR to secure an unprecedented degree of consensus around a challenging efficiency target.

If Postcomm is able to reach a similar position in its review of Royal Mail, it can reduce significantly, compared to its last review, the weight that it places on 'bottom-up' assessments of efficiency. Although examination of a company's accounts and business plan by external consultants is helpful for the purposes of cost allocation between products, it is not by itself a particularly robust way of looking at efficiency. As such, the role for bottom-up efficiency work should be confined to providing a cross-check on the results of benchmarking analysis.

Depreciation

Unlike OPEX, Royal Mail's CAPEX is comprised of one-off investments in assets that are used to serve customers over a period of several years. It is not generally appropriate to expect customers to pay for these investments as they are made, but instead to spread the cost of CAPEX over the life of the assets so that customers pay the upfront cost gradually over the period that the assets provide useful service.

This is a different philosophy from the one that Postcomm adopted at the last review, when CAPEX was passed through to customers pound-for-pound in the year that it was expected to be incurred. While the rationale for this approach was never really made clear, the economic case for moving from pay-as-you-go to a model that spreads the cost of CAPEX over time is extremely strong. There are, however, several issues that the regulator will need to address in making the transition:

- the first difficulty comes in establishing an initial 'regulatory asset base' or 'RAB' to ensure that Royal Mail recovers the cost of investments that have been made prior to the start of the new control period. This will require analysis of the business's historical expenditure and ultimately some judgment from Postcomm about the residual value of old assets;

- in undertaking this calculation, the regulator will need to take great care with CAPEX during the current control period (2003/04 to 2005/06). Having chosen at the last review to allow Royal Mail to recover the cost of this investment in full as it is incurred, it would not be appropriate to include this expenditure within the initial RAB for the next control period; and
- going forward, the regulator must establish a transparent set of rules to determine how the RAB rolls forward from one year to the next. These rules ought to include a mechanism for indexing the RAB for inflation, a depreciation policy, and a mechanism for adjusting the RAB to reflect actual rather than forecast CAPEX at the end of the control period.

In an industry that is to be exposed gradually to increasing competition, it may initially seem the role of the RAB is less important than in industries that are genuine natural monopolies. However, for as long as there is a need for price regulation, it is vital that Postcomm has a consistent and transparent methodology for signalling how it will profile costs and revenue across control period. To the extent that the RAB meets this need, the benefits of clarity around the regulator's calculations should not be underestimated.

Return

In most other regulated industries, the profit that a company earns is calculated as a return on the RAB. It is far from clear, though, whether the same methodology is applicable in Royal Mail's case, partly because the RAB will be a very artificial construct (as a result of Postcomm's approach to CAPEX during 2003/04 to 2005/06), but mainly because Royal Mail is not an asset intensive business. As a consequence, allowing a return on the RAB measured by, say, the capital asset pricing model (CAPM), is likely to understate the compensation that the company requires for the risk that it bears in carrying out its activities.

In these circumstances, Postcomm must look at other ways to determine the appropriate amount of profit for the company to earn. During the last review, there was some discussion about the margin on turnover that the company should make and the extent to which this margin should be consistent with the margins earned by firms conducting similar business. Although such an approach does not have the theoretical roots of the CAPM, it does provide a practical way for the regulator to establish a 'typical' range for profits for a business with Royal Mail's characteristics. As such, it provides a useful benchmark for Postcomm to refer to.

Another approach entirely is to examine the business's ability to absorb cost and revenue shocks using financial modelling. By analysing the sensitivity of Royal Mail's profits to unexpected events, Postcomm can determine what initial level of profit puts the business in a position where it is financially robust to a range of scenarios that might confront an efficiently-run operator. Although the precise composition of the scenarios to be examined can be a matter of some debate, this type of modelling work is the only way that Postcomm can take any sort of comfort that it is discharging its statutory duty to have regard to the business's ability to finance its activities.

In practice, Postcomm will probably need to look at all three approaches (return on capital, margin on turnover and financial modelling) before making final decisions. The figure that it eventually settles on has enormous significance for the business, for new entrants and for consumers and should therefore be based upon as much evidence as the regulator can gather so as to minimise the scope for error. Here it is perhaps worthwhile drawing some parallels with two companies that bear certain financial similarities to Royal Mail – Railtrack and NATS. Among all of the regulated utilities, these two companies have the highest 'operational gearing' in the sense that their annual profit is relatively small compared to the annual operating costs and turnover of the business. They also happen to be the only two

companies whose price controls have had to be reopened and reset after the business hit financial difficulties.

In order to avoid a similar fate in the postal sector, Postcomm must assure itself that the profit it allows Royal Mail in the building block calculations is sufficient to enable the company to deal with risk. This in turn forces all involved in the review to do some very hard thinking about the extent of the business's exposure to risk – the subject of the next section of this paper.

3. Dealing with uncertainty

Unlike normal businesses, the amount of risk that a regulated company is exposed to is determined almost exclusively by its regulator and the manner in which the regulator chooses to regulate prices.

For Royal Mail, the key risks in coming years relate to cost (the business's ability to meet efficiency targets set by the regulator) and volume (the extent to which the business will lose market share and revenue to new entrants). Both have potentially major implications for the company's profitability and will need to be scrutinised carefully before Postcomm can be confident that it has a framework for regulating prices that is strong enough to be able to withstand unexpected changes affecting the business.

In other regulated industries, volumes are normally quite stable and regulators have been able to develop a fairly standard approach to incentives and risks around costs involving:

- control periods in which price paths are fixed for a period of five years;
- pass-through to customers of cost savings in the form of lower prices at the end of the five-year period; and
- efficiency carry-over mechanisms to deal with the dilution of incentives to reduce costs towards the end of each control period.

If it were not for the fact that Royal Mail faces significant uncertainty over future volumes, a similar approach would almost certainly be applicable in the postal sector and uncertainty would not be a major issue. However, the situation Postcomm must deal with is complicated by the fact that it will be impossible to predict Royal Mail's market share with any confidence before the new control is set. Since some costs are sensitive to volumes, the regulator cannot confidently predict either the revenue that Royal Mail will require in later years of the control period or the customer base from which the business will be able to collect that revenue. It must therefore allow a degree of flexibility so that both overall revenue and prices can be adjusted as out-turn volumes become apparent.

Addressing this issue takes Postcomm into territory that has yet to be explored thoroughly by other regulators. Its challenge is to ensure that an efficiently run licensee maintains sufficient revenue to remain profitable and so discharge its universal service obligations irrespective of its eventual market share, yet remains constrained from earning monopoly rents in captive parts of the market. Some of the options that Postcomm might consider are discussed below.

Price control design

The standard approach to dealing with volume risk in regulated industries is to design companies' RPI – X control formulae in such a way as to bring about an 'appropriate' exposure to volume risk. Here there is an important distinction to be made between:

- a pure price cap, in which some average price is fixed regardless of volume and, hence, a doubling of volume above the level assumed by the regulator leads to a doubling of revenue (and so on);
- a pure revenue cap, which fixes the amount of revenue that a firm can recover from customers irrespective of the volume it sells; and
- a hybrid revenue/price cap, which lies somewhere between the two previous alternatives and allows the company to recover an initial fixed amount of revenue *plus* an additional amount for each unit sold to customers.

Generally speaking, a company is exposed to least volume risk when the balance between the price and revenue control components in its RPI – X formula matches the ratio of

variable to fixed costs within the business's cost structure. It is this logic, for example, which saw ORR going to considerable lengths in 2000 to measure Railtrack's cost structure and eventually impose a 77:23 hybrid revenue/price cap control on the company (77% of the company's revenue requirement being recoverable from customers regardless of the number of trains that run and 23% being volume dependent, in line with an apparent 77:23 ratio of fixed to variable costs within the company).

A similar approach could be developed and applied to Royal Mail through the current review. Postcomm would first need to decide how much volume risk the company should be exposed to, i.e. how much its profit should vary according to market share, and then design a RPI – X formula accordingly. If Postcomm felt it appropriate to minimise the company's exposure to volume risk, the weight given to revenue- and price-driven elements in the formula should roughly match the ratio of fixed to variable costs. If on the other hand, the regulator wants overall profit to decrease when market share falls and, conversely, to increase when volumes rise (so as to give the company an incentive to compete with new entrants) the weight placed on the price-driven component of the formula should be greater than the proportion of costs that are variable.

While simple enough on paper, there are however likely to be considerable practical difficulties in pursuing this approach:

- at present, the control written into Royal Mail's licence takes the form of a tariff basket. This tends to restrict Postcomm to setting a pure price cap unless the regulator is prepared to amend the licence to include instead a formula which regulates the average price Royal Mail may charge for each item delivered;
- in order to be confident that it has provided the correct volume incentives, Postcomm would need to be able to accurately measure Royal Mail's cost structure and to determine the balance between fixed and variable costs. In practice, this will be extremely difficult; and
- perhaps most importantly of all, the model is a linear one that assumes that costs fall by a constant amount whenever volumes drop. In practice, this assumption is quite unrealistic. Firstly, cost savings are likely to differ according to the product category in which volumes are being won or lost. Secondly, an initial 5% fall in volumes may have relatively little impact on costs, while a reduction from 80% to 75% market share may allow for significant savings to be made.

When these difficulties are taken into account, the best outcome that Postcomm can hope to achieve is a very rough correlation between the effect that changes in volume have on costs and the corresponding impact through the price control on revenue. Even this may, though, represent a significant improvement on the current position in which Royal Mail faces the prospect of seeing revenue fall in proportion to any decrease in market share without capturing the benefit of an equal reduction in costs. As NATS showed two years ago, setting a pure price cap for a network business whose volumes are prone to considerable fluctuation can result in financial distress for the company concerned together with an unexpected financial burden on the customers it serves.

A different form of regulation

An alternative approach to the one more conventionally used by regulators is to allow Royal Mail to earn a given amount of profit per item delivered. This form of regulation would guarantee the company overall profitability during times of falling market share, whilst providing the company with incentives to compete fiercely for volumes in order to earn a higher *level* of profit.

In a sense, such an approach could be described as a version of rate-of-return regulation, modified for use in a liberalised market. By guaranteeing the business an appropriate profit margin, Postcomm would be allowing Royal Mail to pass through its actual costs to customers, regardless of whether or not management had been able to deliver improvements in efficiency over time. As such, the main incentive that the business would have to make cost savings would come, not through regulation, but from the consequences of losing market share to new entrants. If new entrants are expected to be effective competitors, it may be argued that these incentives are reasonably strong and that this approach strikes a good balance between safeguarding Royal Mail's financial position and encouraging efficiency savings over time. If, though, Royal Mail is expected to retain significant market power across most parts of the market, it is unlikely that this form of regulation would be an acceptable constraint on the business's monopoly power.

Shorter regulatory lag

In the event that Postcomm finds all other approaches unworkable, it is likely to be forced into keeping the period between price reviews shorter than in other industries. This can be done:

- explicitly, by committing to review Royal Mail's price control formula after a period of two or three years; or
- implicitly, by building into Royal Mail's licence mechanisms which allow for interim reviews and/or logging up of unrecovered costs to the next full price review.

Both paths can be said to harm incentives to be efficient and may also be seen as introducing a high degree of regulatory risk to the business. However, these downsides must be traded off against the certainty that comes from the knowledge that costs and volumes cannot depart too far from the assumptions made by the regulator in this review before another review takes place. In a business where universal service obligations are of paramount importance but where even small volume forecast errors can have a considerable effect on profitability, it may be that the benefits of this certainty outweigh the considerations that would normally apply to other regulated businesses.

Individual price caps

One alternative that should be ruled out right from the start is a move to regulate separately the prices of individual products and having only limited regard to the overall revenues that the business is making. This approach, which Postcomm hints at in its March 2004 consultation document, suffers from a fundamental weakness in that it assumes the price that Royal Mail should be allowed to charge for one product can be determined independently from the revenue that the business is earning from other products. In fact, there are many joint costs involved in the provision of a network for distributing letters across the country and a fall in the contribution which one product makes to these joint costs ought to be made up by increased contributions from other products.

It is therefore vital that all parties involved in the review recognise that it is the overall amount of revenue which Royal Mail collects that is the appropriate focus for RPI – X regulation. As the next section shows, rules governing changes in individual prices can also be established to meet other goals, but not to the extent that they prevent Royal Mail from recovering enough revenue to enable it to maintain a core network that allows it to discharge its universal service obligations.

4. Pricing

When focusing on pricing, Postcomm's task is to decide how much freedom the company should be allowed when setting prices for individual products. On the one hand, if individual prices are constrained too tightly it may become impossible for Royal Mail to earn sufficient revenues in the event that it loses unexpectedly high volumes to competitors, thus jeopardising the business's financial position. On the other hand, allowing the company too much flexibility to adjust prices may be seen by new players as a deterrent to entry, potentially limiting the extent of competition within the sector.

Until now, the regulator has dealt with these conflicting objectives by placing each of Royal Mail's products into one of three categories, each regulated in a different way.

- the first group comprises products where there is already effective competition among providers and where no price regulation is necessary;
- the second group contains those products where competitive pressures are likely to grow stronger over time, but competition is not yet sufficiently well established to enable price controls to be removed; and
- the final group is made up of products where competition is unlikely to play a significant role for the foreseeable future and where regulation will remain essential.

In addition, the regulator also sets specific limits on the price of first and second class stamps. As part of its review, Postcomm will need to review whether these controls remain adequate. It will also have to consider how to deal with proposals from Royal Mail for new products and new tariff structures. The main principles the regulator should adhere to are set out below.

The need for a competition test

The distinction between those products for which there is effective competition and those where effective competition is not yet established is absolutely key to the way in which the industry is regulated. Within the first group, the consequences of placing any form of price regulation on products for which the incumbent is already competing fiercely with new entrants can be very detrimental. In particular, if price caps are wrongly set at too low a level, regulation is likely to deter companies from competing in the market, thus causing customers to suffer in the long term.

For this reason, Postcomm's review will need to include a careful product-by-product analysis of the current state of competition and, hence, the need to subject individual products to price regulation. While there is no single test to show whether or not effective competition has been established, Postcomm should try to develop a framework which brings together analysis of market share, market concentration, pricing behaviour and entry barriers into an overall assessment of competitive pressures. This framework should be as transparent as possible in order to minimise the extent to which Postcomm's classification of products is open to dispute.

Prohibition of 'predatory' pricing

Among those products where effective competition is not yet established, it is inevitable some form of price regulation will be required in order to keep Royal Mail's market power in check. Actions by Royal Mail which exploit this market power by raising the general level of prices are relatively easy to control through the imposition of the overall price/revenue cap outlined in sections 2 and 3. There is no obvious reason why Postcomm should then go on to cap the price of individual products in parallel to the overall cap, unless there are wider social reasons for doing so (see below).

What requires more thought are actions which lower prices in order to deter entry in the short term and thereby entrench Royal Mail's dominant position over the longer term. Here, Postcomm has two choices. Either it can apply the relatively narrow definition of predatory pricing as applied in EU and UK competition law (i.e. that prices must remain no lower than the average variable cost of providing the product in question) or, alternatively, it can take a broader view of the detrimental effect on competition of large price reductions by Royal Mail in segments of the market that are opening up to competition. If the regulator prefers the latter interpretation, controls that constrain Royal Mail from reducing prices on individual products by more than the reductions offered on other products may be appropriate.

Social obligations

The one area in which allowing Royal Mail unrestricted flexibility to increase prices may cause problems is in relation to those products where Royal Mail is deemed to have wider social obligations. At present, for example, the business is constrained from increasing the price of first or second class stamps by more than a given amount.

Here, Postcomm's explicit duty to have regard to the interests of certain vulnerable customer groups becomes relevant. However, this duty does not justify extending individual product price regulation to each and every service that Royal Mail offers, but instead suggests that the price of a very small number of the most widely used products should be constrained so that they do not become unaffordable to low-income groups.

Over-constraining

If Postcomm does proceed to place price floors on some products and price caps on others, it is essential that it carries out one final check to ensure that all of the constraints it places on the business are internally consistent. In particular, the regulator must satisfy itself that the regulation of individual product prices does not put the Royal Mail in a position where there is a possibility that it might not be able to recover its full revenue requirement as determined by the business's overall price/revenue cap.

In practice, it is this last principle which constrains the regulator from imposing individual price caps on more than a very small handful of products.

5. Service Quality

A final, very important strand of work during the review will focus on quality of service and the incentives that Royal Mail faces to encourage it to improve its service to customers.

In any regulatory review, there is a trade off to be made between providing strong incentives for efficiency and ensuring that cost reductions do not come at the expense of deteriorating service standards. In the postal sector, the regulator's task is made somewhat easier by competition and the consequences to Royal Mail in terms of market share of being seen to provide an inferior service relative to new entrants. However, regulatory incentives remain vital in those parts of the business where competitive pressures will be weak and particularly in relation to Royal Mail's universal service obligations, where competition will not be a substitute for regulation.

Regulators of monopoly businesses typically establish a wide variety of incentives around quality of service, rather than focusing on just a single incentive mechanism. These measures may include:

- compensation schemes for customers that experience poor service;
- setting of overall service standards and regular publication of a licensee's performance against these targets;
- imposing high-level adjustments to price controls as part of each periodic review to reward/penalise financially out-turn quality of service; and
- taking enforcement action in the event that service declines to unacceptably poor levels.

Postcomm's existing approach to incentivising better quality of service comprises most of these elements and is generally consistent with best practice in other industries. Despite this, Royal Mail's performance in recent years has been disappointing with the business posting consecutive year-on-year deteriorations in service standards and consistently missing Postcomm's targets.

With this poor record coming at a time when the business has announced growing profits, it is important that Postcomm should review whether the regulatory regime is providing appropriate rewards for quality of service, particularly relative to the financial rewards that come from cutting costs. Two main options present themselves:

- the first involves Postcomm increasing the financial rewards and penalties associated with performance in an effort to give service standards greater financial importance to the business; and
- the alternative is to leave existing financial incentives in tact and instead focus on 'softer' intervention that puts pressure on Royal Mail to deliver better service without resorting to more stringent financial penalties.

The approach that Postcomm should adopt depends ultimately on what it considers to be the root cause of deteriorating performance during recent years. One view is that Royal Mail's management do not take customers needs seriously enough and put profit ahead of good service. With this perspective, the first option highlighted above would seem to be the most appropriate way to reinforce the importance of performance.

An alternative explanation of events of the last three years is that Royal Mail's management have been working hard to turn around a financially imperilled business. During this time, the need to restore profitability has been paramount. While quality of service may have suffered temporarily, the structural changes that have been made to the business enable the company to move towards sustainable improvements in service standards in a way that would not have been possible if the status quo had remained. As a consequence, there is no

need to adjust the financial rewards and penalties associated with quality of service – in fact the existing regime has had exactly the effect intended by forcing management to take action now to arrest a long-term deterioration in the business's ability to discharge its obligations.

On balance, there is probably more truth in the latter explanation. However, that does not mean to say that Postwatch and Postcomm should hold back from undertaking a detailed review of existing incentives and assuring themselves that all targets and financial rewards/penalties are set at an appropriate level. Similarly, the regulator should continue to make public and transparent Royal Mail's performance against service targets and take tough action if the recent turn-around in the company does not translate quickly into better service. In this respect, the next 12 months will be key: if Royal Mail is unable during this time to improve its recent sub-standard performance, it will be difficult for the regulator to avoid imposing stringent sanctions on a now profitable business.

6. Conclusion

In examining the issues that Postcomm will confront in its review of Royal Mail, two consistent themes are seen to emerge:

- first, the implications of price regulation for competition and the ability of new entrants in challenging Royal Mail's dominant position; and
- second, the importance of ensuring that an efficiently run Royal Mail continues to have sufficient revenue to support its universal service obligations, even at times when the business is losing market share.

In both of these areas, Postcomm must exercise great care if it is to ensure that the market develops in a manner that delivers maximum benefit to customers. It is in everyone's interests that Royal Mail should become financially strong once again and continue to invest in a high quality national distribution network – nothing the regulator does should jeopardise progress towards this outcome. At the same time, it would be inappropriate to protect Royal Mail from competition which will ultimately push the business on to greater efficiency and better service.

While the approach that Postcomm will use to resolve this trade off will only become apparent during the course of its review, this paper has identified several key pieces of the jigsaw. They include:

- the need for a robust and economically sound overall framework for assessing Royal Mail's revenue requirements;
- the importance of gathering as much evidence as possible on efficiency and profit levels so as to improve the basis for the final judgments that the regulator must make in these areas;
- the benefits of introducing a mechanism that allows for adjustments to prices and revenues as Royal Mail's volumes change over time; and
- the dangers of over-regulating individual products' prices to the detriment of Royal Mail's overall financial position.

Provided that Postcomm recognises these principles at an early stage in its review, we feel confident that the regulator can deliver a price control which will meet the needs of all the industry's stakeholders.