



Postaf Response to the Royal Mail Request for Additional Allowed Revenue in 2011



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1 Summary

1.1 Postcomm should reject the application

As the application by Royal Mail for additional allowed revenue was submitted outside the consultation period it should be rejected in the first instance as part of the Price Control 2011.

Notwithstanding, Postaf considers the application should be rejected as it will have a severe impact on on-going bulk mail letter volumes, therefore potentially fail to meet the financial objective and impact on the sustainability of the USO.

1.2 Volume Impact

The conclusion that bulk mail letter volumes will be adversely affected is drawn in part from the research evidence on price elasticity for letter mail and comment by customers.

Direct mail customers broadly work to fixed budgets, therefore increases in prices will be offset by a corresponding reduction in volumes. The econometric data shows a price elasticity of around -1, supporting this view.

Transactional mail, whilst quite inelastic at around -0.1 to -0.2, will see volumes fall as the cost increases will be such as to either fully justify new IT and marketing process investment or where already completed trigger the push to transfer to paperless communications. This approach may take a little longer to enact but it will force a further step change in volume decline.

1.3 Royal Mail financial need

Postcomm has indicated that they believe that the request for an additional increase in allowed revenue of £100m is insufficient and that a figure of some £200m may be needed. Any uncertainty in the financial stability of Royal Mail will further impact Customer volumes.

To provide the required financial buffer Royal Mail and the Shareholder Executive should consider early asset disposal as a more sustainable route (and for potentially solving Brussels state aid concerns)

2 POSTAF opposes the application for additional allowed revenue

The application by Royal Mail was made on 13th October, after the close date for input to the consultation on the Price Control 2011. On that basis Postaf believes that it should not form any part of the consideration by Postcomm regarding this specific consultation and therefore be rejected.

If Royal Mail wish to make an application for further allowed revenue for 2011 then this could be considered by Postcomm, subject to consultation through a *separate* process.

Additionally, Postaf believes that Postcomm should reject the request for additional revenue on the simple basis that it is unlikely to achieve the objective of financial stability of the business and will further accelerate the on-going decline in volumes.

Postaf concerns are:

- Impact on Customers Volumes
- Impact on the sustainability of the USO
- That this level of funding is insufficient to overcome the predicted cash requirements of Royal Mail

3 Customer Volumes

The impact of any increase in pricing has to be weighed against any associated fall in volumes. The pricing elasticity of the UK bulk mail market has been the subject of several pieces of research based on volume data provided by Royal Mail. Analysis of that research supports the Postaf view that this current proposal would not be in the interests of both bulk mail users and Royal Mail.

3.1 Pricing Elasticities

Mail users have always wanted high quality of service coupled with the lowest possible prices. That truism has been clear to those involved in the industry for many years but has often been discounted as rhetoric and not based on fact.

A number of research papers have been presented recently, some by analysts at Royal Mail that shed some interesting light in support of this claim.

Broadly, the papers agree that pricing elasticities differ substantially based on letter mail *content type*. In summary the econometric models indicate that transactional mail has the lowest price elasticity at around -0.1 to -0.2, (quite inelastic). Direct mail is reported at -0.9 by Cazals et al and supported by estimates of -0.7 and -1.4 by Veruete-McKay et al. (Social mail is somewhere in the middle at -0.5, higher than transactional mail but still quite inelastic.) See references in section 7.

Translating this research to specific sectors.

3.2 DM Customers

With elasticity from the research of around -1 this implies that if the letter prices rise there will be a broadly corresponding fall in DM volumes.

The DM industry has always previously translated this into 'the budget is fixed so we will have to send less'. In other words the impact of price elasticity is critical to volumes.

Additionally substantial price increases will add further pressure to advertisers to consider other forms of direct advertising.

3.3 Transactional Customers

With transactional mail the story is markedly different. With a low price elasticity of between -0.1 and -0.2 from the research, if the letter price rises then broadly the customer will pay the extra.

Postaf has no dispute with this basic finding but does contend that the outcome will not be as predicted for reasons that the research could not determine (being based on historical activity).

The implication from the research, supported by the level for price elasticity, is that because the communication of transactional information is essential to the poster-client relationship, volumes will not change.

In the short term, transactional customers will pay the increase in prices; nevertheless this will be a short term gain for Royal Mail at the expense of the medium and long term volumes. Financial organisations can be relatively slow to change key communication processes, letter mail has been a traditional communication method and budgets to change legacy systems in customer communications have been a low priority.

That situation is changing and the proposed level of allowed price increases will translate into such significant budget increases that the investment in IT and marketing programmes to move customer communications to alternate platforms will be more easily justifiable.

Some organisations have already completed the IT investment and have just been slow to convert customers. Others still have to make the IT investment. One major bank has indicated that it has not *pushed* customers to move to online platforms previously but that they have the systems available and will now use the potential price increases as the lever to move customers online. Another bank, not so far ahead in their IT investment plan, indicated that the proposed letter mail cost increases easily made the case for that investment.

A major utility has indicated that such cost increases will mean that they will be focusing on materially increasing the number of customers using paperless billing.

4 Sustainability of the USO

Postcomm will be well aware from their own published reports that bulk mail products make up well in excess of 80% of Royal Mail letter revenues. The continuation and protection of that revenue stream is essential to on-going support the Universal Service Obligation. Sustainability of the USO social mail at some 7% of current revenue will become impossible.

Other remedies may be considered but none will likely prove palatable to any of the stakeholders should there be a further step function decline in letter volumes caused by this proposed cost increase.

5 RM Business Requirement

In their application of 13th October Royal Mail stated that “without appropriate mitigating action - Royal Mail faces the prospect of cash headroom reaching a level which could represent a risk to a business of this scale and with our cash outgoings.” Royal Mail’s financial health and the universal service are intimately linked and Royal Mail believes that “urgent action is now required to safeguard the financial sustainability of Royal Mail and therefore the Universal Service”.

Postcomm has suggested that from their analysis of the current financial data from Royal Mail that the £100m increase in revenue proposed would be insufficient to meet the short term needs of the business and that a level more like £200m was required.

This leads to the inevitable conclusion that there will be a further request for revenue support in the short term. The request for £100m is considered unacceptable for the reasons previously stated. A further £100m and the uncertainty engendered by the anticipation of such an application will have an even greater impact on bulk mail customers and their potential migration to other communication media.

Postaf proposes that any solution(s) to the need for funds be addressed in other ways by Royal Mail and the Shareholder Executive (SE). These are matters that are outside the remit of the regulator but nevertheless within their sphere of influence.

Even if willing, any form of direct loans by the SE would probably be considered as state aid by the EU and therefore not be viable. The disposal of a significant Royal Mail asset might be a more practical solution, the obvious example being GLS. This would provide significant cash to support the on-going business and ensure continuing support of the USO. (Additionally, it might achieve agreement with Brussels on the pension situation as proposed in the current Postal Services Bill.)

6 Conclusion

Postaf proposes that Postcomm reject the application for further allowed revenue as part of the determination of the Price Control 2011 for the reasons stated above.

Should Royal Mail believe they need additional allowed revenue for 2011 and beyond then any application to Postcomm should form the basis of a new, separate consultation.

7 Appendix

The references below present analysis of letter traffic by content and the associated pricing elasticity.

7.1 Letter Traffic Demand in the UK: An analysis by Product and Envelope Content Type

By Leticia Veruete-McKay*, Soterios Soteri*, John Nankervis¹ and Frank Rodriguez²

www.idei.fr/doc/conf/pos/papers_2010/veruete_mckay.pdf

7.2 Letter Traffic Demand in the UK: A Product and Envelope Content Analysis

By Leticia Veruete-McKay*, Soterios Soteri*, John Nankervis¹ and Frank Rodriguez²

Sixth Conference on “Regulation, Competition and Universal Service in the Postal Sector”

Toulouse France, March 25-26, 2010

www.idei.fr/doc/conf/pos/transparentes_2010/slides_veruete.pdf

7.3 UK Letter Mail Demand: a Content Based Time Series Analysis using Overlapping Market Survey Statistical Techniques

By Catherine Cazals³, Jean-Pierre Florens³, Leticia Veruete-McKay*, Frank Rodriguez² and Soterios Soteri*

www.idei.fr/doc/wp/2010/wp_idei_616.pdf

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