

The Impact on the Development of Competition in the UK Postal Sector of Approving Retail Prices which are not Cost-justified

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Royal Mail has proposed to the Postal Services Commission (“Postcomm”) that it be allowed to introduce geographically disaggregated retail prices (“zonal prices”) for certain products not included in the Universal Service Obligation.

Postcomm evaluates such proposals within the terms of Condition 21, paras 17-19 of Royal Mail’s licence; in relation to its statutory duties; and in relation to the provisions of the European Postal Services Directive, which require transparency and non-discrimination of special tariffs offered by universal service providers.¹

Postcomm’s consultants have concluded that there are defects in the aggregation of particular geographical areas into zones, across which prices would, if Royal Mail’s proposals were accepted, be differentiated. In particular the consultants

¹ UK and European competition law apply as well.

conclude that two of the zones identified by Royal Mail, for which different prices are proposed, have costs which are indistinguishable from one another.

Section 5(1) of the Postal Services Act 2000 requires Postcomm to 'exercise its functions in the manner which it considers is best calculated to further the interests of users of postal services, whenever appropriate by promoting effective competition between postal operators.'

Postcomm has asked me to set out what I consider to be the likely consequences for the development of effective competition of

- i) zonal retail prices which are constructed in a way which does, or alternatively does not, reflect zonal costs:
- ii) constructing a set of zonal retail prices for services in circumstances where the zones adopted do not match the zones adopted for the geographically differentiated prices of access products (i.e. wholesale

products supplied by Royal Mail to competitors selling the same retail services).

It is clear that, because the zonal retail prices have not been introduced, it is not possible to use empirical data to evaluate their effect on competition. As a result the analysis which follows relies upon standard *a priori* economic reasoning.

Section 1. The impact on competition on the relationship between zonal prices and costs.

It is important to be clear in this discussion about how costs are defined. In a perfectly competitive market (a useful, if unrealistic benchmark for any discussion of regulated pricing), the prices which determine firm entry and exit decisions equal the common marginal costs of existing operators (the period over which the marginal costs are taken – short-run or long-run – depending on contract duration, among other things). The operation of this price signal is part of the process of ensuring both productive and allocative efficiency in the market. In other words, it ensures that total costs of producing any given output are

minimised and that the level of output produced is determined in an optimal way by customer demand.

In setting regulated prices, especially when the firm's revenues have to cover all its costs (ie the firm is not in receipt of a subsidy), an alternative costing approach normally governs either price setting by the regulator, or the regulator's evaluation of prices proposed by a dominant operator. This is based on long-run marginal cost (LRMC), augmented by a share of fixed costs, with the operator's common or overhead costs being recovered through some mark-up formula by means of which overheads are spread across all products. A common choice for this purpose is the equi-proportionate mark-up rule (EPMU) in which overhead costs are allocated in proportion to existing costs.² Postcomm makes it clear that this is the approach used to set the 'reference prices' which act as a proxy for costs in investigating the cost-reflectiveness of zonal prices.³

The issue considered below is whether prices that are not cost-justified distort competitive entry; in other words, the focus is on the relation between a proposed set of prices and costs of production, as defined above. Variations or distortions in this relationship can be described either as departures from cost-

² Postcomm recognises that alternative common cost allocation principles exist (e.g. Ramsey prices).

³ See Postcomm, *Royal Mail Retail Zonal Policy Application*, 2007, paragraphs 5.10-12.

reflectivity or as a particular form of discrimination (or both). In an ideal world the efficient entry signal would be marginal cost, rather than the pricing principle set out above. However it is likely that the latter simply scales up marginal cost. For this reason, I consider that the criterion adopted in evaluating zonal price relativities is closely enough related to that implied by the marginal cost benchmark to allow the analysis to proceed. Accordingly I shall examine the impact of zonal prices formed, accurately or otherwise, in this way on incentives to enter the relevant market.

The absolute and relative levels of Royal Mail retail zonal prices have consequences for both customers and competitors. Individual customers would always prefer lower prices for themselves, but aggregate efficiency across customers in the various zones is probably best achieved by setting prices equal to (or based upon) costs: otherwise, some zones would over-consume and others under-consume the service. For this reason, errors in setting cost-reflective prices are highly likely to harm consumers in aggregate.

Zonal prices also impact upon competitors' entry decisions. In practice, some kind of aggregation of geographical areas into zones is necessary, in order to control the transaction costs associated with a multiplicity of different prices.

Quite what the optimal number of zones should be is not known; it would depend upon the degree to which underlying cost observations form natural clusters, the transactions cost associated with increasing the number of zonal prices and the scale of the geographical area in which competitors find it feasible to enter. It is my understanding that Royal Mail did not provide to Postcomm any cluster analysis of its delivery costs data as part of the evidence supporting its application. In the absence of such an analysis the discussion has to go ahead against the background of Royal Mail's proposal for a small number of zones.

If zonal prices were cost-reflective within a chosen price structure, then at the same level of aggregation, a competitor with the same relative cost structure as Royal Mail would have no preference over where it entered. This result would be different if the entrant had a comparative advantage in a particular zone, but this would be beneficial as it would mean that entrants would tend to go where they had a comparative cost advantage.

Now suppose that regulated prices are not cost-reflective within a chosen price structure, and consider the cases of two areas – a 'high margin' area where prices are set higher than average relative to costs, and a 'low margin' area where the opposite is true.

In a 'high margin' area, entry will be attractive, not only to entrants with costs as low as or lower than those of the incumbent, but possibly to other less efficient operators as well. As a result, a higher cost producer might replace a lower cost producer. Postcomm has expressed its hostility to this type of entry.⁴

Conversely in 'low margin' areas, entry will be discouraged and customers will lack choice, even though they will be 'rewarded' with relatively low prices.

Is it thus clear that breaking up a zone where costs are the same (as Royal Mail is alleged to have done with zone A and zone B) into two separate zones with different prices will precisely create artificial high margin and low margin zones, with the deleterious consequences described above: it will skew entrants towards particular areas.

Equally, if the opposite error has been made, as Postcomm's consultants assert is the case for the London zone, so that two areas with different costs are placed in the same retail price zone, then competitors may shun the high cost area, yet succeed in displacing Royal Mail as supplier in the low cost area, even if their own costs are higher than those of Royal Mail.

⁴ *Op. Cit.* in fn 3, para 3.14.

How big is this risk in practice? It clearly depends upon:

- the size of the error;
- the responsiveness of entry to price, i.e. the degree to which entry is deterred or artificially promoted by the erroneous pricing; if no entry would have occurred with 'correct' prices, the consequence of error, in terms of lost competition, would be zero; the same would be true if entry were not enhanced in high margin areas.

The discussion above has been framed in terms of an error which might either be innocent or the result of an exclusionary strategy adopted by the firm introducing zonal pricing. (For the avoidance of doubt, I have not considered whether Royal Mail is applying such a strategy or not, and I have not considered whether Royal Mail is applying such a strategy, and have no opinion to offer on this matter.) How would an exclusionary strategy be affected? If a firm felt itself vulnerable to entry in some areas but not in others, it would rationally seek, if it were constrained to a given average revenue⁵, to set prices relatively low where entry was threatened, recovering the shortfall where entry was improbable. In this scenario, prices would be contrived to maximise the distortion of competition.

⁵ Note that Royal Mail Licence condition 21, at para 19, requires zonal pricing to be revenue neutral. In other words, it allows or requires the making up of lower prices in some areas by higher prices elsewhere.

How might one assess the risks of harm to competition associated with prices which innocently or strategically deviate from costs? As noted above, the first variable to consider is the likely scale of the departure from accurate cost-reflection. This would have to be considered over the period for which zones would be established, and take account of the possibility that the variation in zonal prices might change over time. The second aspect is the sensitivity of entry to departures of prices from costs. Observation of how entry has occurred to date may provide some guidance here. The *status quo* is one of geographically averaged prices – a case of significant departure from cost-reflectiveness. If the data showed a preponderance of entry in areas characterised by a high price-cost margin, then it is reasonable to infer that the extent of entry is responsive to that margin and that errors in setting it are likely to have a distorting effect on competition.

In practice, however, the position is complicated by the co-existence of entrants offering end-to-end and access-based services, which rely upon Royal Mail for final delivery to the customer's premises. The implications of this are considered below, but the conclusions of this section can be summarized as follows:

- errors in establishing zones for zonal pricing and/or in determining price relativities in different zones can distort competition;

- the degree of distortion depends upon the size of the error and the sensitivity of entry to the price-cost margin;
- under certain circumstances, zones can be chosen and relative prices set in ways which deliberately exclude competitors.

Section 2. Different zones for retail and access prices

As noted above, postal competitors can enter the market either by providing an end-to-end service or by carrying out their own retailing, sorting and trunking activities and relying on Royal Mail for final delivery to the customer. So far the vast bulk of competitive services have used access to Royal Mail's delivery service.⁶ But this varies across services and may change in the future. It is thus important to encourage competitors to make efficient 'make or buy' decisions – i.e. to use their own facilities where they are cheaper and Royal Mail's where they are cheaper. In other words, retail and access prices must be co-ordinated, and such co-ordination is necessary across zones as well as on average. If, as in this case, the only or main source of zonal variation in cost lies within the access product (final delivery), then it would be natural to expect the retail and the access price zones to coincide. This is not the case in Royal Mail's proposals.

⁶ See Postcomm, *Postcomm's Strategy Review: the Postal Market 2010 and Beyond*, 2007, pp. 9-10.

Instead there are cases where access prices fall in one zone and retail prices (in the same area) fall in two, and the reverse.⁷

How might this affect entrants' strategies?

This is illustrated in figure 1, which shows the level of regulated retail and access prices – in each case in three zones (A, B and C for retail and A', B' and C' for access). In the figure it is assumed that the underlying cause of cost variation lies in the access product (i.e. local delivery), and that the access zones are correctly delineated. However, retail price zones are incorrectly drawn, and do not accurately reflect cost differences.

It is evident from the figure that in two areas marked X and Y, entry incentives are distorted.

⁷ *Op.Cit.* in fn 3, para 7.27.

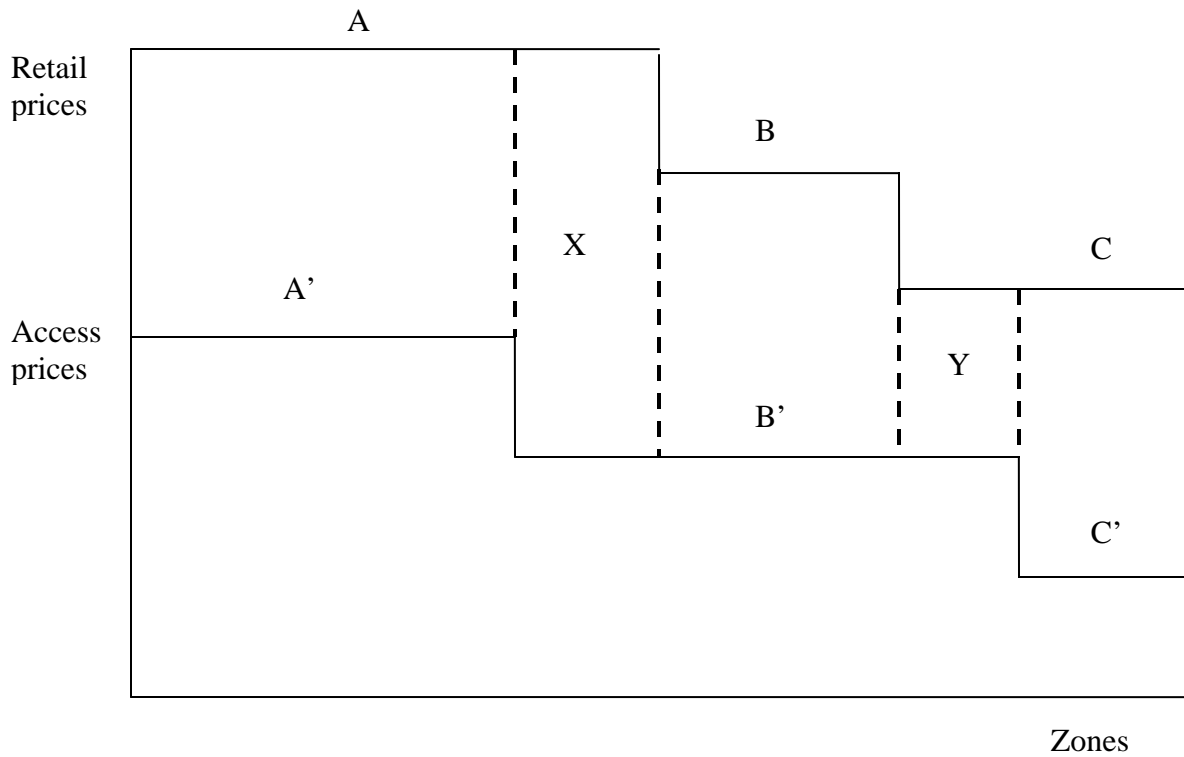


Figure 1.

In X, the exaggerated margin between retail and access prices will encourage inefficient entrants to ‘arbitrage’ the low access and high retail prices, by buying the cheap access product and selling into the dear retail market. In Y, conversely, access-based competition, which may be more efficient, is precluded by a combination of a cost-based access price and a retail price which is set too low.

It is clear that the same problem will arise if retail prices are correctly set, while the error lies in the 'zoning' of access prices. Indeed on the assumption above, that cost differences reside in the access service, any discrepancy in the zones is evidence of distortion in the mode of competition.

Again the question arises as to how significant this additional factor is. The answer depends upon the degree of discrepancy between the wholesale and retail zones, the degree to which incentives to build or buy are distorted and the sensitivity of entrants' behaviour to such distorted incentives.

It could be argued, both in relation to this issue and more generally, that a further element is the loss of confidence by entrants in the certainty and predictability of the commercial environment in which they operate, if it contains elements of irrationality and, particularly, if they are uncertain about future changes. Reduced predictability and certainty in the market would in turn discourage entry.

Section 3 Summary and conclusions

This paper has shown that an imperfect choice of zones for the application of zonal retail prices, can introduce distortions into the competitive process,

artificially enhancing it in some areas and holding it back in others. Zonal pricing can also be used by an incumbent as a strategic weapon against competitors. Finally, discrepancies in the zones chosen for access prices and retail prices can distort the form of competition which emerges- end-to-end or based on Royal Mail's access products. In my opinion, zonal prices based on flawed data are capable of having an adverse effect on competition

Data indicating the scale of these effects are not available, as zonal retail prices have not been introduced. But it may be possible to infer the likely scale from other observations, notably the pattern of competition to date.