EXTERNAL

Market and Financial Analysis Underpinning Postcomm's Decision Document on Market Opening, February 2005

A Review by Royal Mail

April 2005

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Executive Summary

Postcomm's Decision Document and Purpose of Royal Mail's Review

In Annex 2 of its decision document on market opening[1], Postcomm reported projections of the financial impact on Royal Mail of bringing forward the date of full market opening to January 2006 from its original planned date of April 2007. The results presented in that annex underpin Postcomm's conclusion that full market opening would be in the best interests of consumers and fully consistent with Postcomm's primary statutory duty to ensure the provision of universal postal service in the United Kingdom.

Postcomm has provided Royal Mail subsequently with a copy of the models underpinning its projections of the market and financial impact of market opening. Based on these models, Royal Mail has undertaken further modelling work on Postcomm's assessment of the financial impact of market opening to evaluate the effect on these estimates of alternative assumptions and projections. The results and implications of this work are reported in Royal Mail's review.

Significant Weaknesses in Postcomm's Analysis and Approach

Royal Mail's analysis has identified a number of significant weaknesses in Postcomm's analysis of the financial impact on Royal Mail of the full opening of the UK postal market and in its approach to meeting its primary statutory duty of ensuring the provision of universal service on a continuing basis.

1. A Realistic Range of Possible Market Outcomes Has Not Been Evaluated

Based on the model produced by Frontier Economics, Postcomm considers cases where entry will be almost entirely through downstream access with very little entry occurring through competitor end-to-end (E2E) services (bypass). This is important because the loss of contribution on an item of traffic that switches to access is significantly less than that on one that is lost to bypass. Postcomm's analysis does not report any cases where competitor E2E services in total gain much above 2% of the market by 2010/11. This is an extremely low figure. Nor, because it assumes that volumes grow steadily by 1% per annum, does it consider any cases where there is a decline in Royal Mail delivered traffic. Postcomm has therefore not tested a realistic range of possible outcomes for the market and market entry.

2. Postcomm's Model Understates the Financial Impact of A Given Level of Entry on Royal Mail

Through over simplification in its modelling approach, Postcomm's model does not address adequately the effects of changes in the mix of traffic over time, including those arising from cream skimming entry, and hence in the reduction in contribution per item. As a result, it understates the financial impact on Royal Mail of future prospects for the development of mail volumes and of a given level of entry into the postal market.

[1] Postcomm. February 2005. *Giving Customers Choice: A Fully Open Postal Services Market. A Decision Document.*

3. The Financial Impact on Royal Mail of Market Opening is Likely To Be Much Higher than Postcomm Projects

i. Postcomm's Central Case

Postcomm presents a central case in which all competitor E2E services together are projected to gain just 1.5% of the UK market in 2010/11and so Royal Mail is projected to deliver 98.5% of all mail in the USO area. About 15% of this is projected to be downstream access. In years prior to 2010/11, Royal Mail's share is higher. Postcomm's central case produces, in Postcomm's financial model, a profit from operations of £250m in 2010/11 (expressed in 2003/04 prices). Royal Mail's report contains a number of alternative projections using both Postcomm's financial model and a version extended by Royal Mail to deal more adequately with the impacts of changes in volume mix. In a case where competitor E2E services are assumed to gain a 5% share of the market in 2010/11 so that Royal Mail delivers 95% of all mail (15% of which is access), profit is projected to decline to £174m in Postcomm's model but to only £70m in the extended version of its model which allows more adequately for changes in volume mix and in contribution per item.

ii Postcomm's Higher Competitive Entry Case

Postcomm also presents a case where competitive entry is projected to be 50% higher. In this, competitor E2E services are projected by Postcomm to gain a little over 2% of the UK market in 2010/11and Royal Mail delivers just under 98% of all mail in the USO area (23% of which is access). This case produces, in Postcomm's financial model, a profit from operations of £145m in 2010/11 (expressed in 2003/04 prices). In a case where competitor E2E services are assumed to gain 7.5% share of the market in 2010/11 so that Royal Mail delivers 92.5% of all mail (23% of which is access), profit declines to £31m in Postcomm's model but to -£73m in the extended version. Even in this case, Royal Mail's delivered traffic in 2010/11 is only 1% less than its level in 2003/04.

iii Royal Mail's Cases

The main report also summarises results using Royal Mail's estimates of entry from its BPQ submission to Postcomm in January 2005 as part of Postcomm's price control review for the third price control period due to come into effect from April 2006. In Royal Mail's central case, where market volumes are projected to grow by 12% between 2003/04 and 2010/11 and Royal Mail is assumed to undertake extensive rebalancing of its prices, competitor E2E services are modelled to take about 9% of the market so that Royal Mail delivers about 91% of all mail (20% of which is access). Profit in 2010/11 using the extended version of Postcomm's model is £12m. In the low volume scenario in Royal Mail's BPQ submission to Postcomm, market volumes are projected to grow by 3% between 2003/04 and 2010/11 (with again Royal Mail assumed to undertake extensive rebalancing of its prices), competitor E2E services are modelled to take 16% of the market and Royal Mail delivers 84% of all mail (25% of which is access). This is the only case reported above where Royal Mail delivered volumes fall significantly; that is, by 14% by 2010/11 compared with 2003/04. In this case, profit from operations declines to 2010/11 -£394m, a decline that is projected to be much greater if extensive rebalancing of Royal Mail's prices were not to occur[2].

[2] These results, which use the extended version of Postcomm's model, are consistent broadly with those estimated through the full suite of Royal Mail's volume and financial models. It should be stressed that they do not replace the results from that more complete approach but are reported here for the purpose of comparison with Postcomm's results.

iv Financial Impact Likely to be Much Higher than Postcomm Project

These results illustrate the very wide range of financial outcomes possible for a plausible range of market outcomes: from competitor E2E services gaining share of under 2% to one of 16% in 2010/11. Potentially, too, competitor E2E services could gain a higher share of the mail market over the longer term than 16%. Postcomm has reported an assessment of the financial impact on Royal Mail for cases of continuing volume growth in total and very low E2E entry but it has not done so for cases where such entry is other than minimal nor allowed for the significant differences in volume growth across different products nor for the possibility of mail volumes declining overall. Accordingly Postcomm has not evaluated a realistic range of future possible outcomes for the UK postal market and the financial impact on Royal Mail of market opening is likely to be much higher than projected by Postcomm in its market opening decision document.

4. Postcomm Has Not Considered The Longer Term Nor Applied Clear Criteria

Postcomm has limited its consideration of the impact of market opening up to 2010/11. The conclusion that it reaches applies only up to that date but traffic volumes may be decelerating or quite possibly declining after 2010/11 so that the profit position after that time might weaken further. In Royal Mail's projections, also, there are further effects from entry after 2010/11 in addition to those included in the projections reported above.

Nor does Postcomm state a clear criterion by which it assesses the impact of market opening for it does not state the profit it considers necessary to sustain Royal Mail's ability to provide universal service on a continuing basis. From its conclusion regarding its higher competitive entry case it suggests that a figure of £145m in 2010/11 (measured in 2003/04 prices) in terms of profit from operations is adequate for this purpose. However it provides no evidence to support this assertion.

Conclusion: Postcomm Has Not Clearly Demonstrated That It Has Met Its Primary Statutory Duty

Postcomm states that it will consider how to allow for the financial impact on Royal Mail of market opening as part of its current price control review. Until its proposals are published it is not clear how it will do this nor what the implications may be, for example, for the level and structure of prices. However, from the analysis it has presented to date, its stated position is that it believes that, in all circumstances, Royal Mail will deliver at least nearly 98% of all mail in the current USO area and that market volumes will continue to grow so that Royal Mail's delivered traffic will continue to increase steadily under all scenarios for possible market growth and entry.

Postcomm has yet to specify mechanisms it will adopt to manage the risk of these beliefs proving to be incorrect whether these be through the structure of the price control or, if E2E entry proves to be significantly in excess of its assumptions for its market opening decision document, through additional means. Its approach has, therefore, failed to demonstrate clearly that it has met its primary statutory duty of ensuring the provision of universal service on a continuing basis.

Market and Financial Analysis Underpinning Postcomm's Decision Document on Market Opening, February 2005

A Review by Royal Mail

Main Report

Market and Financial Analysis Underpinning Postcomm's Decision Document on Market Opening, February 2005: A Review by Royal Mail

1. Introduction

1.1 In Annex 2 of its decision document on market opening[3], Postcomm reported projections of the financial impact on Royal Mail of bringing forward the date of full market opening to January 2006 from its original planned date of April 2007. The results presented in that annex underpin Postcomm's conclusion that full market opening would be in the best interests of consumers and fully consistent with Postcomm's primary statutory duty to ensure the provision of universal postal service in the United Kingdom.

1.2 Postcomm has provided Royal Mail subsequently with a copy of the models underpinning its projections of the market and financial impact of market opening[4]. Based on these models, Royal Mail has undertaken further modelling work on Postcomm's assessment of the financial impact of market opening to evaluate the effect on these estimates of alternative assumptions and projections.

1.3 This review reports the main points from Royal Mail's work. Section 2 summarises Postcomm's methodology in deriving its estimates and comments on key aspects of this. Section 3 draws on these comments and sets out the ways Royal Mail has sought to extend the framework Postcomm has used to assess the financial impact on Royal Mail of market opening. Royal Mail's work has been within the modelling framework developed and applied by Postcomm and makes use additionally of information provided in Royal Mail's BPQ submission to Postcomm in January 2005 as part of Postcomm's price control review for the third price control period expected to begin in April 2006. Section 3 also reports projections for the financial impact of market opening for a number of alternative cases and assumptions using both Postcomm's original model and the extended version. A final section of the review summarises and concludes, drawing out some of the main issues raised by Royal Mail's analysis using Postcomm's model and the extended version of that model.

1.4 A number of significant weaknesses are highlighted in Postcomm's analysis and approach. Postcomm states in its decision document that those issues will be addressed as part of its current price control review. However, this is an inadequate approach and raises concerns regarding Postcomm's ability to demonstrate clearly that in reaching its market opening decision it has also been able to meet its primary statutory duty of ensuring the provision of universal postal service on a continuing basis.

[3] Postcomm. February 2005. *Giving Customers Choice: A Fully Open Postal Services Market. A Decision Document.*
[4] The models were provided by Postcomm after the publication of its decision document in February 2005. Royal Mail had requested access to this information after the release of the consultation document in September 2004. (Postcomm. September 2004. *Revised Market Opening Timetable*).

2. Postcomm's Methodology

2.1 Postcomm's Approach to Modelling the Financial Impact of Market Opening on Royal Mail

2.1.1 There are three main stages in Postcomm's approach to modelling the financial impact of market opening on Royal Mail. First, Postcomm produces a projection of total mail volumes prior to the modelled impact of market opening; secondly, it applies an estimate of the impact of market opening on Royal Mail's mail volumes; and, thirdly, these projections are introduced into Postcomm's financial model of this component of Royal Mail's overall business to assess the financial impact of market opening on Royal Mail. Each of these stages is described and commented on briefly below.

Postcomm's Pre-liberalisation Volume Projection

2.1.2 Postcomm assumes that mail volumes grow at 1% per annum each year from 2004/05 to 2010/11 and this assumption is applied at the level of total traffic for the USO area identified in Royal Mail's regulatory accounts for 2003/04. For the case reported in Annex 2 of its decision document, the 2003/04 volume of traffic is reported by Postcomm as 20,890m items which cumulated at 1% per annum reaches a volume of 22,376m items in 2010/11[5].

Postcomm's Post-liberalisation Volume Projection

2.1.3 Postcomm's post-liberalisation volume projection is derived from Frontier Economics' Competitive Pricing Market Model (CPMM) and that model is outlined by Postcomm in Annex 2 of its decision document. Frontier Economics' model is based on an earlier version of Royal Mail's entry pricing model (EPM (2003)), which has been adapted and extended in a number of ways by Frontier Economics including a focus on mailings by large customers and the treatment of VAT status. For 2010/11 and the case reported by Postcomm, Frontier Economics' model projects that about 83% of total traffic will be Royal Mail end-to-end (E2E) traffic, about 10% customer direct access (CDA), about 5% entrant downstream access (EDA) and under 2% entrant E2E services (bypass). The volumes implied by these shares sum to the total traffic projection in stage 1.

Postcomm's Financial Model of Royal Mail's USO Area

2.1.4 The volume projections from Frontier Economics' model are input into Postcomm's financial model of Royal Mail's letters business consistent with the base for volumes given by information from Royal Mail's regulatory accounts for 2003/04 for the USO area. Revenue was £5,802m in 2003/04, total costs from operations £5,480m and profit from operations £322m. Postcomm makes an assumption that fixed costs were 37½% of total costs so that variable costs were 62½% in 2003/04. All projections are in 2003/04 prices with the implied average revenue (27.77p in 2003/04 calculated from total revenue divided by total volume) declining by 1% per annum and all costs declining due to increased efficiency also by 1% per annum[6]. Variable costs in the model are 16.40p in 2003/04 (from total variable cost divided by total volume). The

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[5] The corresponding figure in the 2003/04 Regulatory Accounts from which this and other base year data are taken is 20,794m items.

[6] Hence in nominal terms average revenue and costs rise by (RPI-1) % per annum.

average access price, access cost and hence contribution per item of access are assumed by Postcomm to have been 13.0p, 7.0p and 6.0p respectively in 2003/04 and these values are assumed also to decline by 1% per annum in real terms.

2.1.5 The average revenues and costs so derived are applied to the volumes projected by the Frontier Economics model and are the same in all cases irrespective of the extent of entry considered in the three cases presented by Postcomm. The difference between revenues and costs so projected produces the projections of profit from operations reported by Postcomm in table A2 of its decision document for its central forecast and in tables A3 and A4 respectively for the higher competitive entry and lower competitive entry cases.

2.2 Royal Mail's Comments on Postcomm's Framework

Pre-liberalisation Volume Projection

2.2.1 **Mix of Traffic.** The effect of Postcomm's assumption that total volume pre-liberalisation grows by 1% per annum is to assume implicitly also that each stream and segment grows at the same rate. However, in recent years, public tariff First Class and Second Class volumes have grown much more slowly than other (mainly presort) traffic. It is expected that these trends will continue and this pattern of growth is reflected in the projections contained in Royal Mail's BPQ submission to Postcomm in January 2005. Significant differences in the rate of volume growth across streams are important because of differences in absolute contribution per item by stream. Contribution per item in absolute terms is highest overall on First Class traffic and lowest on presort, mainly because of higher prices for First Class products. Over time, the change in the mix of traffic between public tariff and other (mainly presort) streams, which is very pronounced, can be expected to impact adversely on contribution in total. The use of an average assumption for volume growth implies that Postcomm's projection does not take account of this development and so overstates the positive effect of underlying growth in volumes on contribution implied by its annual average growth rate of 1% per annum[7].

2.2.2 **1% average growth in volume**. Over this period from 2003/04 to 2010/11, Royal Mail's central projection for the growth of volumes overall prior to the impact of competitive entry is an average of 1.6% per annum while its low volume projection implies an overall average of 0.4% per annum. However, while these averages are close to Postcomm's average of 1% the trajectory of Royal Mail's projection is different. Volume growth is expected to be above 1% in the early years of the projection period and slow thereafter with volumes pre-competitive entry projected to decline in the low volume case after 2007/08. Royal Mail's assessment is therefore that the position for traffic is likely to be deteriorating at the end of the period rather than stable as projected by Postcomm with implications for the position on volumes after 2010/11.

Post-liberalisation Volume Projections

2.2.3 **Frontier Economics' Competitive Postal Market Model.** Frontier Economics has developed a model for Postcomm to project the impact of competitive entry on Royal Mail's volumes. The model has been developed from an earlier version of Royal Mail's entry pricing model (EPM(2003)) and so incorporates a number of key elements of the EPM and retains much of its approach. This is welcomed as a significant step forward

[7] It is also not consistent with the current price control structure that within the licence explicitly recognises the significance of traffic mix.

for modelling the industry. These elements include a segmentation of traffic across a number of attributes including product, format and delivery type; the incorporation of price and non-price (quality) factors in determining the choice customers make between Royal Mail and entrant products; the modelling of competitor prices based on Royal Mail long run marginal costs (LRMC) by component of cost plus uplift factors which vary by the component of cost; a modelling of the choice for customers between access (either customer direct access or entrant downstream access) and E2E services; a non-linear switching function parameterised by a mean and variance of a statistical distribution; and the development or phasing of the impact of entry over a period of years. Although the detail of the approach followed by the CPMM varies in some of these areas, the overall approach remains similar to that in the EPM implying that entry tends to be higher into segments of traffic where competitors have a greater relative advantage compared with Royal Mail. One difference between the CPMM and EPM is that the CPMM focuses on competition for customers' mail in total or at least by product by customer. Both the CPMM and EPM, however, are primarily interested in projecting the extent of the loss of traffic by Royal Mail to entrants and whether a focus on loss of mail to customers helps model this more effectively is an open question.

2.2.4 There is a lack of evidence in the material provided by Postcomm to Royal Mail to underpin the calibration of some of the key assumptions in the CPMM. A critical area for both the EPM and CPMM is evidence on switching propensities where the source of the assumptions in the CPMM is not apparent. In the results used by Postcomm in its financial model it appears that, for the large customer component, the switching of volumes relates to the case where all of a customer's demand for an existing product switches or conversely all of that customer's traffic remains with Royal Mail. This approach tends to be sensitive to calibration values and relatively small changes in some assumptions may lead to significant changes to the volume of mail that switches from Royal Mail to entrants. Another area which is critical to projecting volumes in a given year is the set of assumptions made regarding the phasing or timepath of entry. As in the case of switching, no supporting evidence is provided on these assumptions.

2.2.5 **Projected pattern of entry.** The results from Frontier Economics' model, which are used by Postcomm, project very limited amounts of entry through competitor E2E services (that is, bypass). In the central case reported by Postcomm, the percentage of the total market in 2010/11 which is gained by entrants through bypass is only 1.5% while 15% of the market is either entrant downstream access or customer direct access. In Postcomm's central case, therefore, Royal Mail delivers 98.5% of all market volumes in 2010/11. Even in its high entry case, where entry volumes are 50% higher, bypass increases to only (1.5% x 1.5) or to a little over 2% so that Postcomm has not reported results for a case where Royal Mail delivers less than about 98% of total market volumes in 2010/11. Furthermore, because Postcomm assumes that volumes grow by 1% each year, delivered volume is higher in 2010/11 than 2003/04 even in its high entry case. Royal Mail's projections for bypass entry are higher as they are also for access. However, the more significant difference is the very low level of entrant E2E services projected by Frontier Economics' model and then input into Postcomm's financial model. The contribution impact of an item lost to bypass is much higher than one lost to access.

Postcomm's Financial Model of Royal Mail's USO Area

2.2.6 **2003/04 opening values.** An important assumption given the structure of Postcomm's financial model is that for the percentage of costs which are assumed to be invariant with volume. Postcomm assumes this equals 37.5% of total costs. The source of this assumption is not stated but the equivalent using Royal Mail's costing system is about 41%[8]. Access prices and costs for 2003/04 are notional for access did not commence until 2004/05 when the price in nominal terms was 13.0p[9]. This implies a lower figure of around 12.6p for the access price in 2004/05 in 2003/04 prices rather than around 12.9p as assumed by Postcomm and consequently that access prices throughout, which are calculated by the access price in 2003/04 prices in the preceding year deflated by 1%, are too high due to the overstated access price in 2004/05. Both of these changes to the percentage of costs that are fixed and the level of access prices reduce profit from operations as modelled by Postcomm[10].

2.2.7 **Average revenues and costs over time: cream skimming.** Average revenues and costs expressed in 2003/04 prices are deflated additionally at 1% per annum in all three sets of projections reported by Postcomm although the extent of the volume effects on Royal Mail differ by quite significant amounts across the cases. Although Frontier Economics' model is somewhat more averaged in its effects of entry on Royal Mail's volumes than those in the entry pricing model, its underlying design still implies a significant amount of cream skimming entry. Consequently traffic which has relatively higher contribution tends to be lost disproportionately from Royal Mail's E2E volumes while traffic with relatively lower contribution per item tends to be retained. This implies that, although the prices and costs expressed in 2003/04 prices for individual items can be deflated by 1% per annum, the resulting average revenues and costs calculated by dividing total revenues and costs by Royal Mail's projected remaining volumes should reflect this cream skimming effect. However, contribution per item is overstated in Postcomm's projections. Postcomm's financial model considers mail volumes in total and so does not address this issue explicitly as would be possible if its financial model were linked directly with the CPMM at the level of individual segments of traffic. Nor does Postcomm's approach to projecting average revenues and costs make an allowance for cream skimming effects of this type indirectly. As a result Postcomm overestimates contribution per item after the loss of volume due to competitive entry and hence overall contribution leading to an underestimate of the financial impact on Royal Mail of market opening.

2.2.8 **Phasing.** Postcomm's financial model assumes that costs respond immediately to changes in volumes. In Royal Mail's corresponding model, the business planning model (BPM), it is assumed that costs adjust over a three year period reflecting the fact that the full extent of cost variability applies over the long run rather than instantaneously. The basis for this set of assumptions on the phasing of cost adjustments has been set out in Royal Mail's BPQ submission to Postcomm. By contrast, revenues are lost in step with volumes. As a result, in a single year Postcomm's model tends to understate profit from operations when volumes are rising and overstate it when volumes are declining.

2.2.9 **Sustainable level of profitability.** Postcomm does not state the level of profitability that it believes is an adequate one to allow Royal Mail to be financially viable on a continuing basis. Prior to Postcomm's previous decision document on market opening in May 2002, Postcomm's consultant Andersen undertook such an analysis which was presented in terms of NPVs[11]. At that time, Royal Mail explained its concerns about the approach followed by Andersen which implied a minimum

[8] Variability is considered over the long run and is based on information used in estimating LRMCs.
[9] For a 0-60g letter taken to an inward mail centre and sorted to a delivery office.
[10] In the case of the higher fixed cost assumption, profit is lower when volumes are reduced (but higher when volumes are increased)
[11] Postcomm. January 2002. *Market Opening Proposal*, Appendix 1.

"threshold" value for Royal Mail of £2.2bn[12]. However, in its current decision document Postcomm has not provided any explicit guidance on the level of profitability it believes is required for sustainability. Implicitly it seems to consider that profitability from its high entry case (profit from operations of £145m in 2010/11 in 2003/04 prices) does not undermine the financial viability of Royal Mail to provide universal service. However, Postcomm provides no support for this view which would require it to set out the minimum figure it considers to be adequate to sustain the financial viability of the USO area.

2.2.10 **Other elements.** Postcomm's discussion in Annex 2 of its decision document notes that the assumption of 1% efficiency gain and hence declining cost per item in real terms may be less than it proposes as part of the price control review once it has received LECG's report to it on efficiency. This raises a number of related issues including the impact on Royal Mail's prices of assuming a higher level of underlying efficiency and the resulting effect on entry and volume mix. Postcomm also notes that prices in the price control will be set to take account of deficits, most notably that for pensions, so increasing rather than reducing Royal Mail's allowed revenue. The impact of the latter could outweigh the former. Full examination of these issues is required as part of the price control and has not been taken further in the extensions Royal Mail has added to Postcomm's financial model. However, as Postcomm notes, they are central to the issue of financial viability.

[12] Consignia. April 2002. *Postcomm's Proposals for Promoting Effective Competition in UK Postal Services, January 2002: A Response by Consignia plc*, Appendix 1; Consignia. August 2002. *Postcomm's Decision Document on Promoting Effective Competition in UK Postal Services: a Response by Consignia on Technical Issues and Management of Risks.*

3. Results from Extended Postcomm Framework

3.1 Extensions by Royal Mail to Postcomm's Framework

3.1.1 Section 2 highlighted a number of areas where it is desirable to extend Postcomm's framework and evaluate the impact of alternative assumptions. Accordingly, Royal Mail has extended Postcomm's framework to allow an evaluation of a fuller range of assumptions and projections. It is stressed that Royal Mail does not consider this to be a substitute for its own framework which is based on explicit linking of impacts through its ILTM/EPM/BPM set of models. However, extending Postcomm's framework is a useful way to evaluate alternative assumptions and their impact on the results Postcomm reports in Annex 2 of its decision document. After briefly outlining the ways in which Postcomm's framework has been extended this section also reports two sets of results using the extended model. First, the model is applied to gain greater insights into the impact of various inputs and assumptions into Postcomm's central and high entry cases; and, secondly, the model is used to assess the extent of differences from Royal Mail's central and low volume scenarios reported to Postcomm in the January 2005 BPQ submission. As stressed above, the results are presented for comparative purposes and do not in any way replace those provided to Postcomm as part of the BPQ submission.

3.1.2 Royal Mail has developed Postcomm's framework in two main ways to assess the effect of its comments in section 2 on Postcomm's projections of the financial impact of full market opening on Royal Mail. First, the financial model has been extended to allow for three separate streams of E2E traffic rather than Postcomm's approach which has a single stream that includes all such traffic. The three streams are First Class public tariff mail, Second Class public tariff mail and other (mainly presort) traffic. The pattern of growth across these streams, which is slowest for Second Class traffic and most rapid for other (mainly presort) traffic, follows that set out in Royal Mail's BPQ submission in January 2005. However, to allow direct comparisons with Postcomm's results there is a pro rata adjustment such that the total growth in volumes averages 1% per annum over the period as a whole to 2010/11 rather than 1.6% per annum as in Royal Mail's BPQ submission.

3.1.3 Various assumptions have been made to create a base for 2003/04 which corresponds to Postcomm's but which identifies separately each of the three streams of traffic. Total volume in 2003/04 is assumed to equal the figure used by Postcomm (20,890m items) with the other (mainly presort) volume equal to that underpinning the BPQ submission to Postcomm and First Class and Second Class mail, which are reported on a revenue derived basis in the Royal Mail volume models, increased pro rata to match the overall total for operational volume. The division of revenues between the three streams is identified in the same way. The share of variable costs to each stream is given by its share of total LRMCs in the 2003/04 base of the entry pricing model (EPM (2004)). Volumes have been projected forward so that the overall average growth rate aligns with Postcomm's assumption of 1% growth per annum. Postcomm's model and the extended version then both project the same total volume of mail in 2010/11. However, the projection has a profile and trajectory in line with the BPQ submission. On this basis, overall growth pre-competitive entry is projected to peak at 2.0% in 2005/06 and thereafter decelerates to reach 0.2% in 2010/11. By stream of traffic, other (mainly presort) traffic averages growth of 2.8% per annum, First Class –0.2% per annum and Second Class –1.7% per annum. The impact of the totals for access and bypass given by the CPMM on the pre-competitive entry volumes of the three streams has been calculated using information from EPM (2004).

Over 75% of access and over 60% of bypass is projected to originate from the other (mainly presort) stream which has the lowest contribution per item of the three streams, particularly compared with First Class items.

3.1.4 A second way in which Postcomm's model has been extended is with regard to the impact of cream skimming on average revenues and costs. Contribution per item of retained Royal Mail E2E traffic has been reduced compared with Postcomm's assumption of there being no cream skimming effect in the pattern of entry. An allowance for cream skimming has been developed using information from EPM (2004). Average revenues and costs of E2E items prior to competitive entry and with competitive entry for each of the three streams of traffic have been extracted from EPM (2004). In each case the gap between the average revenue from a stream of traffic and its average cost has narrowed appreciably. Information on the average revenue of a stream with and without competitive entry can be used to calculate an elasticity of average revenue with respect to Royal Mail's E2E volume which allows, very approximately, a way to capture the cream skimming effect of entry within Postcomm's model. A similar approach has been used to calculate an elasticity of average cost with respect to Royal Mail E2E volume. These elasticities have been applied in addition to the underlying 1% per annum decline to real average revenues and average variable costs for each of the three streams and so amend these values. A similar approach could be applied even if all mail is considered as a single stream[13].

3.1.5 The base year data, treatment of values in 2003/04 prices and model remain, in all respects other than those outlined above, as in Postcomm's model with the two exceptions noted in section 2. First, the assumption for the percentage of costs which are fixed over the long run has been revised from 37.5% to 41% in line with Royal Mail costing information. Secondly, 13.0p is the access price in 2004/05 in nominal terms so that in 2003/04 prices its value is 12.60p. It is this value that has been reduced by 1% per annum to 2010/11.

3.1.6 An additional area that was highlighted in section 2 is the phasing of cost changes as volumes change. Rather than extend the model further to show the impact of the time required to adjust cost levels to volumes, underlying trends can be seen more clearly by putting this adjustment lag to one side. However, these impacts are included in a full operational financial model such as the BPM and can have appreciable effects in individual years. During a period of declining E2E volumes such changes can be significant and are additional to the reductions in profit from operations reported in the following sub-sections.

3.2 Results from Postcomm and Extended Postcomm Financial Models

3.2.1 A summary of the main results is reported in table 1. These relate to profit in 2010/11 as market opening at its greatest. The table records Postcomm's projections from the CPMM of the share of the market retained by Royal Mail (E2E and "delivered" where delivered is given by E2E traffic plus access) in 2010/11; the change in the volume of traffic handled by Royal Mail against the base of 2003/04; and two projections of profit from operations based respectively on Postcomm's financial model and Royal Mail's extended version of Postcomm's financial model.

[13] The adjustment for cream skimming has been applied to E2E items only although there is a case also for applying a similar adjustment for access items.

Table 1

Results from Postcomm and Extended Postcomm Financial Models[1]

	Market Retained by Royal Mail in 2010/11, %		Change in volumes 2010/11 relative to 2003/04 Base, %		Profit from operations, 2010/11, £m 2003/04 Prices	
	E2E	Delivered	E2E	Delivered	Postcomm	Postcomm Extended[2]
Pre-liberalisation	100.0	100.0	7.2	7.2	460	389
Post-liberalisation: Postcomm cases using CPMM:						
-Central case	83.1	98.5	-11.0	5.6	250	174
-High entry case (central x1.5)	74.6	97.7	-20.0	4.7	145	76
Variants of Postcomm cases with Higher Bypass:						
-Central Case but bypass assumed to be 5% in 2010/11[3]	80.1	95.0	-14.1	1.8	174	70
-High entry case but bypass assumed to be 7.5% in 2010/11[4]	70.2	92.5	-24.7	-0.8	31	-73

[1] See text. 2003/04 Base from RM Regulatory Accounts: Profit from operations £322m; revenue £5802m; costs from operations £5480m; operational volume 20890m items. All projections for Royal Mail volumes are from the CPMM and Postcomm and for profit for operations are from Postcomm's financial model.
[2] See text. Intermediate stages: CPMM entry, no cream skimming, 37.5% fixed cost: £275m; CPMM entry, with cream-skimming, 37.5% fixed cost: £191m; CPMM entry, with cream skimming, 41% fixed cost: £174m.
[3] As CPMM entry except bypass entry of (08/09: 1.1%; 09/10: 1.4%; 10/11: 1.5%) replaced by (08/09: 2%; 09/10: 3.5%; 10/11: 5%)
[4] As CPMM entry multiplied by 1.5 except bypass entry of (08/09: 1.7%; 09/10: 2.1%; 10/11: 2.3%) replaced by (08/09: 3%; 09/10: 5.25%; 10/11: 7.5%)

3.2.2 The first row reports the position projected by Postcomm for 2010/11 pre-liberalisation. By assumption, Royal Mail retains all traffic which with growth of 1% per annum implies an increase in volumes of just over 7% by 2010/11 compared with the base year of 2003/04. In Postcomm's model, volume growth of 1% per annum for mail volumes considered as a whole offsets the impact on revenue of a real price reduction of 1% per annum so that total revenue measured in 2003/04 prices is unchanged. This is so also for variable cost so that real variable costs in total remain unchanged over the period as well. However, real profit increases from £322m in 2003/04 to £460m in 2010/11 because fixed costs are assumed also to decline by 1% per annum[14]. This allows real average costs to fall. A similar effect occurs in Royal Mail's extended model but real profit rises only to £389m[15]. The reason that this figure is lower than Postcomm's is that the higher contribution items, First Class and Second Class, are projected to grow much more slowly than the lowest contribution category, other (mainly presort) mail, so that a half of the gain in profit from operations arising from improved efficiency is lost to an adverse change in the mix of traffic. It is important to incorporate some aspect of the change in the mix of traffic that causes contribution to decline relative to contribution if all traffic were to grow at the same rate. This requires projecting volumes for the major categories of mail separately[16].

3.2.3 The second row of table 1 records Postcomm's central projection for volume and the financial impact of market opening on Royal Mail. Although Postcomm projects an appreciable loss of E2E traffic such that Royal Mail retains about 83% of the market in 2010/11 and, after allowing for volume growth, E2E volumes fall by about 11%, nearly all of this decline in E2E volumes is traffic that is projected to switch to Royal Mail's downstream access. In Postcomm's central case Royal Mail continues to deliver over 98% of all mail in the USO area and, because of continuing growth in the market, Frontier Economics and Postcomm project that Royal Mail's delivered volumes will continue to grow as well.

[14] Assuming RPI inflation of about 2.5% per annum over the period, in nominal terms profit from operations is projected by Postcomm to be about £550m in 2010/11 for the pre-liberalisation base.
[15] This initial step of the comparison retains Postcomm's assumption for fixed costs being 37.5% of total costs.
[16] Clearly, in this special case where revenue and variable costs remain constant in real terms, if the volume of higher contribution items were to grow more rapidly than low contribution items, the increase in profit would exceed the gain in efficiency from the reduction of fixed costs.

3.2.4 Profit from operations falls from £322min 2003/04 to £250m in 2010/11 in Postcomm's projection[17]. Postcomm states that: *"The forecasts and analysis presented here suggest that Royal Mail will be able to finance its universal service obligations when the UK postal market is fully open to competition"* [18]. The corresponding figure for the central case from the extended version of Postcomm's model developed by Royal Mail is £174m compared with £250m.

3.2.5 Three factors contribute in the extended Postcomm model to the reduction in profit from the pre-liberalisation figure of £389m: projected entry from the CPMM, Royal Mail's estimate of cream skimming and Royal Mail's assumption of fixed cost at 41% rather than 37.5%. In the extended model over 75% of access volume originates from other (mainly presort) traffic on which contribution per item is the least of the three streams in the model and virtually none of it from First Class where contribution is highest. As a result and as reported in table 1, the impact of entry without allowing for cream skimming is smaller than in Postcomm's more averaged model. However, including an estimate for cream skimming produces a financial impact that is somewhat larger than Postcomm's estimate. The change in the assumption regarding the fixed cost percentage from 37.5% to 41% further increases the projected financial impact in 2010/11 of market opening on Royal Mail as reported in table 1.

3.2.6 The third row of table 1 reports results from Postcomm's high entry case which assumes that entry is 50% higher than in its central case. In this case Royal Mail's E2E volume is projected to decline to about 75% of the total market but, because nearly all E2E losses represent Royal Mail items that transfer to access, Royal Mail is projected to continue to deliver nearly 98% of all mail in the UK. Consequently, even in Postcomm's high competitive entry case, traffic delivered by Royal Mail still grows by about 5% in 2010/11 compared with 2003/04. Profit is projected by Postcomm to decline to £145m compared with £250m in its central case, the difference being relatively small mainly because nearly all of the additional loss of E2E traffic in the high entry case is projected, as in Postcomm's central case, to switch to access. Postcomm comments with respect to the high entry case that *"Furthermore, even if Postcomm's forecast of competitive entry were increased by 50%, Postcomm believes that Royal Mail would still be able to finance its universal service obligations up to and including 2010/11"*[19]. In the extended Postcomm model, the high competitive entry case in 2010/11 produces a profit of £76m, also about £100m less than the central case and again a comparatively small change because of Postcomm's projection that lost E2E traffic would transfer almost entirely to access with virtually no development of competitor E2E services.

3.2.7 Even in its high entry case, then, Postcomm projects that barely 2% of the market will be served through competitor E2E services in 2010/11. Although the CPMM and accompanying assumptions may lead Postcomm to assess that bypass is very unlikely, it is surprising that Postcomm has not considered a case where the possible extent of this form of entry is at least a little higher than 2% of the market as defined by Postcomm. For example, for 2003/04 Postcomm estimated that entrants already had about 0.3% of this measure of the market and it has already issued several licences to competitors which allow them to offer E2E services[20]. Countries with a laxer regulatory regime than the UK, such as Sweden and New Zealand, have levels of entry above 2% and others where the market has been opened for a substantial period of time such as Spain and Argentina have levels of competitor activity well

[17] This is the result Postcomm reports in table A2 of its decision document.
[18] Postcomm. (February 2005) p.45.
[19] Postcomm. (February 2005), p.45
[20] Postcomm. September 2004. *Competitive Market Review: Proposals for Consultation.*

above this[21]. To provide an indication of the impact of additional E2E entry in Postcomm's model a variant of Postcomm's central and high competitive entry cases has been tested in its model and also in the extended version. Under this variant, bypass in the central case has been increased from 1.5% in 2010/11 to 5.0% and in the high entry case from 2.3% in 2010/11 to 7.5%. Full details are reported in table 1.

3.2.8 The results of these cases are shown in the fourth and fifth rows of table 1. In the central case, by assumption Royal Mail continues to deliver 95% of all mail in the USO area and, as overall volumes are projected by Postcomm to grow by 7%, even in this case delivered volumes rise by 2% between 2003/04 and 2010/11. Profit from operations is projected to decline to £174m compared with £250m in Postcomm's central case. In the extended Postcomm model, profit from operations for this case is £70m in 2010/11 compared with £174m in the central case, a larger decline compared with the central case projection in Postcomm's model. This is because entrants' E2E services are projected to displace Royal Mail First and Second Class services to a greater extent than access (although the main effect of bypass by far is still on other (mainly presort) traffic) and the effects of cream skimming are more pronounced with entry through E2E services rather than access. The high entry case, where competitor E2E providers serve 7.5% of the market in 2010/11, is reported in the fifth row of table 1. Royal Mail by assumption retains 92.5% of delivered traffic in 2010/11 and delivered volumes decline very slightly (by less than 1%) compared with the base year of 2003/04. In Postcomm's model profit from operations in this case is projected to be £31m in 2010/11 compared with £145m in its high competitive entry case. In the extended version of Postcomm's model, profit on operations is -£73m in 2010/11 compared with a profit of £76m in Postcomm's high competitive entry case, again a larger decline in profit than produced by Postcomm's model.

3.3 Information Used in Royal Mail's BPQ Submission Cases in the Extended Version of Postcomm's Financial Model

3.3.1 The second application of the extended version of Postcomm's financial model has used projections prepared by Royal Mail in developing its BPQ submission to Postcomm in January 2005. The results of applying these projections are reported in table 2. It should be stressed that these results do <u>not</u> replace those developed by Royal Mail from its full suite of models but are presented to allow an indication of differences with Postcomm results using Postcomm's modelling framework. The first two rows report results for Royal Mail's central case which incorporates extensive rebalancing of product prices. Pre-competitive entry and with prices assumed to rise overall by RPI-1% per annum, volumes in this case are projected to rise by about 12% between 2003/04 and 2010/11 or an average of 1.6% per annum with growth slowing appreciably to under 1% per annum in 2010/11. In the extended version of Postcomm's model profit from operations in real terms rises from £322m in 2003/04 to £510m in 2010/11 in this case. This is more than the equivalent figure in table 1 (that is, £389m) due principally to additional volume growth and, to a lesser extent, the higher percentage of fixed cost (41% instead of 37.5%) which acts to raise contribution when volumes are growing compared with a lower percentage of fixed costs.

3.3.2 In the central case for volumes in Royal Mail's projections in the BPQ submission, Royal Mail's E2E products retain about 72% of the market, downstream access is

[21] Recent information (in all cases for 2003) on overall shares of the postal market held by universal service providers indicates the following: Sweden, Posten AB, 93% so implying entrants have 7% market share; New Zealand Post, 95% (entrants 5%); Spain, Correos, 90% (entrants 10%); and Argentina, Correo Argentino, 34% of all types of postal deliveries (entrants 66%). All data are from national regulator and company published sources.

about 20% of the market and competitor E2E services about 9%[22]. With projected volumes increasing by 12% between 2003/04 and 2010/11, delivered traffic is projected to increase by about 3% and E2E volumes to decline by just under 20%. Applying the extended version of Postcomm's model, this case results in profit from operations in 2010/11 of £12m measured in 2003/04 prices. Even though projected volumes pre-competitive entry are higher than those projected by Postcomm, this outcome is significantly worse than the financial impact projected in its central case (that is, £250m). This is principally because of the higher level of bypass entry compared with Postcomm's central case as well as the form of entry which incorporates an allowance for the effects of cream skimming. This decline in profitability is projected to be much greater if extensive rebalancing of prices were not to occur.

Table 2

Information used in developing January 2005 BPQ Submission applied to Extended Postcomm Financial Model[1]

	Market Retained by Royal Mail in 2010/11, %		Change in volumes 2010/11 relative to 2003/04,%		Profit from operations, 2010/11, £m 2003/04 prices
Royal Mail Scenarios	E2E	Delivered	E2E	Delivered	
Central Case:					
- Pre-competitive entry	100.0	100.0	11.9	11.9	510
- Post-competitive entry	72.0	91.4	-19.4	2.4	12
Low Volume Case:					
- Pre-competitive entry	100.0	100.0	2.5	2.5	299
- Post-competitive entry	59.0	84.3	-39.5	-13.6	-394

[1] See text. 2003/04 Base from Royal Mail Regulatory Accounts: Profit from ooperations £322m; revenue £5802m; costs from operations £5480m; operational volume 20,890m items.

3.3.3 Results based on the low volume scenario developed for the BPQ submission are reported in the third and fourth rows of table 2, again for the assumption that prices and costs overall rise by RPI-1% per annum but with extensive rebalancing of Royal Mail's prices. In the low volume scenario, volumes grow by a little over 2% in total over the period from 2003/04 to 2010/11 with First Class volumes in particular declining more rapidly than in the central case. As a result, pre-competitive entry on this scenario, profit from operations measured in 2003/04 prices is projected to decline from £322m in 2003/04 to £299m in 2010/11. This compares with £510m in the central case. Here, slower growth in volumes together with an adverse change in the mix of traffic away from higher contribution per item traffic (particularly First Class mail) of itself results in a significant decline in profit prior to any impact from competitive entry.

3.3.4 The final row of table 2 reports the projections for the low volume scenario in 2010/11 including the impact of competitive entry. In this projection, Royal Mail retains about 59% of the total market through its E2E services, about 25% of traffic is downstream access (CDA or through entrant services) and 16% is served by competitor E2E services. Consequently, with slower volume growth and a smaller share of the overall market, delivered volumes decline by about 14% between 2003/04 and 2010/11 and E2E volumes by nearly 40%. Profit after operations in 2010/11, measured in 2003/04

[22] Rounded to the nearest integer values which do not sum to 100% due to this rounding.

prices, is projected at -£394m, very significantly below the Postcomm low volume case (£76m on comparable basis from table 1). Note that although this is about £400m less than the central case of £12m reported in row 2 of table 2 about a half of this difference is due to the projected pre-competitive entry profit of £299m compared with £510m and so is caused by a much poorer underlying position for volume growth irrespective of the extent of competitive entry. The remainder of the difference arises from higher entry particularly bypass as the impact of additional access on contribution is much less than of bypass. Again, the decline in profit is projected to be much greater if extensive rebalancing of Royal Mail's prices were not to occur.

4. Summary of Main Points and Conclusions

4.1 Summary of Main Points

Significant Weaknesses in Postcomm's Analysis and Approach

4.1.1 There are a number of significant weaknesses in Postcomm's analysis of the financial impact on Royal Mail of the full opening of the UK postal market and in its approach to meeting its primary statutory duty of ensuring the provision of universal service on a continuing basis.

A Realistic Range of Possible Market Outcomes Has Not Been Evaluated

4.1.2 Based on the model produced by Frontier Economics, Postcomm considers cases where entry will be almost entirely through downstream access with very little entry occurring through competitor end-to-end (E2E) services (bypass). This is important because the loss of contribution on an item of traffic that switches to access is significantly less than that on one that is lost to bypass. Postcomm's analysis does not report any cases where competitor E2E services in total gain much above 2% of the market by 2010/11. This is an extremely low figure. Nor, because it assumes that volumes grow steadily by 1% per annum, does it consider any cases where there is a decline in Royal Mail delivered traffic. Postcomm has therefore not tested a realistic range of possible outcomes for market entry.

Postcomm's Model Understates the Financial Impact of A Given Level of Entry on Royal Mail

4.1.3 Through over simplification in its modelling approach, Postcomm's model does not address adequately the effects of changes in the mix of traffic over time, including those arising from cream skimming entry, and hence in the reduction in contribution per item. As a result, it understates the financial impact on Royal Mail of future prospects for the development of mail volumes pre-competitive entry and of a given level of entry into the postal market.

The Financial Impact on Royal Mail of Market Opening is Likely To Be Much Higher than Postcomm Projects

4.1.4 In Postcomm's central case in 2010/11, all competitor E2E services together are projected to gain just 1.5% of the UK market and so Royal Mail is projected to deliver 98.5% of all mail in the USO area, of which about 15% is projected to be downstream access. In years prior to 2010/11, Royal Mail's share is higher. Postcomm's central case produces, in Postcomm's financial model, a profit from operations of £250m in 2010/11 (expressed in 2003/04 prices). Table 1 in section 3 reports a number of alternative projections using both Postcomm's financial model and a version extended by Royal Mail to deal more adequately with the impacts of changes in volume mix. In a case where competitor E2E services are assumed to gain a 5% share of the market in 2010/11 so that Royal Mail delivers 95% of all mail (15% of which is access), profit is projected to decline to £174m in Postcomm's model but to only £70m in the extended version of its model which allows more adequately for changes in volume mix and in contribution per item.

4.1.5 In Postcomm's higher competitive entry case in 2010/11, competitor E2E services are projected by Postcomm to gain a little over 2% of the UK market and Royal Mail delivers just under 98% of all mail in the USO area (23% of which is access). This case produces, in Postcomm's financial model, a profit from operations of £145m in 2010/11 (expressed in 2003/04 prices). In a case where competitor E2E services are assumed to gain 7.5% share of the market in 2010/11 so that Royal Mail delivers 92.5% of all mail (23% of which is access), profit declines to £31m in Postcomm's model but to -£73m in the extended version. Even in this case, Royal Mail's delivered traffic in 2010/11 is only 1% less than its level in 2003/04.

4.1.6 Table 2 in section 3 summarises results using Royal Mail's estimates of entry from its BPQ submission to Postcomm in January 2005 as part of Postcomm's price control review for the third price control period due to come into effect from April 2006. In Royal Mail's central case which incorporates extensive rebalancing of its product prices and where market volumes are projected to grow by 12% between 2003/04 and 2010/11, competitor E2E services are modelled to take about 9% of the market so that Royal Mail delivers about 91% of all mail (20% of which is access). Profit in 2010/11 using the extended version of Postcomm's model is £12m. In the low volume scenario in Royal Mail's BPQ submission to Postcomm, market volumes are projected to grow by a little over 2% between 2003/04 and 2010/11, competitor E2E services are modelled to take 16% of the market and Royal Mail delivers 84% of all mail (25% of which is access). This is the only case reported above where Royal Mail delivered volumes fall significantly; that is, by 14% by 2010/11. In this case, profit from operations declines to 2010/11 -£394m, a decline which is projected to be much greater if extensive rebalancing of Royal Mail prices were not to occur.[23]

4.1.7 These results illustrate the very wide range of financial outcomes possible for a plausible range of market outcomes: from competitor E2E services gaining share of under 2% to one of 16% in 2010/11. Potentially, too, competitor E2E services could gain a higher share of the mail market over the longer term than 16%. Postcomm has reported an assessment of the financial impact on Royal Mail for cases of continuing volume growth in total and very low E2E entry but it has not done so for cases where such entry is other than minimal nor allowed for the significant differences in volume growth across different products nor for the possibility of mail volumes declining overall. Accordingly Postcomm has not evaluated a realistic range of future possible outcomes for the UK postal market and the financial impact on Royal Mail of marketing opening is likely to be much higher than projected by Postcomm in its market opening decision document.

Postcomm Has Not Considered The Longer Term Nor Applied Clear Criteria

4.1.8 Postcomm has limited its consideration of the impact of market opening up to 2010/11. The conclusion that it reaches applies only up to that date but traffic volumes may be decelerating or quite possibly declining after 2010/11 so that the profit position after that time might weaken further. In Royal Mail's projections, also, there are further effects from entry after 2010/11 in addition to those included in the projections reported in section 3.

4.1.9 Nor does Postcomm state a clear criterion by which it assesses the impact of market opening for it does not state the profit it considers necessary to sustain Royal Mail's ability to provide universal service on a continuing basis. From its conclusion

[23] These results, which use the extended version of Postcomm's model, are consistent broadly with those estimated through the full suite of Royal Mail's volume and financial models. It should be stressed that they do not replace the results from that more complete approach but are reported here for the purpose of comparison with Postcomm's results.

regarding its higher competitive entry case it suggests that a figure of £145m in 2010/11 (measured in 2003/04 prices) in terms of profit from operations is adequate for this purpose. However it provides no evidence to support this assertion.

4.2 Conclusions

Postcomm Has Not Clearly Demonstrated That It Has Met Its Primary Statutory Duty

4.2.1 Postcomm states that it will consider how to allow for the financial impact on Royal Mail of market opening as part of its current price control review. Until its proposals are published it is not clear how it will do this nor what the implications may be, for example, for the level and structure of prices. However, from the analysis it has presented to date, its stated position is that it believes that, in all circumstances, Royal Mail will deliver at least nearly 98% of all mail in the current USO area and that market volumes will continue to grow so that Royal Mail's delivered traffic will continue to increase steadily under all scenarios for possible market growth and entry.

4.2.2 Postcomm has yet to specify mechanisms it will adopt to manage the risk of these beliefs proving to be incorrect whether these be through the structure of the price control or, if E2E entry proves to be significantly in excess of its assumptions for its market opening decision document, through additional means. Its approach has, therefore, failed to demonstrate clearly that it has met its primary statutory duty of ensuring the provision of universal service on a continuing basis.