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Abstract

At the end of October 2018, Ofcom issued its first abuse of dominance infringement decision and fine under the Competition Act 1998 against Royal Mail. Perhaps surprisingly, Ofcom did not examine the behaviour as either a margin squeeze or a refusal to supply, the types of cases one would expect in post (and communications) services. Instead, it looked at it under the old-fashioned banner of price discrimination. We consider that the way Ofcom approached the analysis is unlikely to provide helpful guidance to the industry and critically does not provide a useful basis for concluding whether Royal Mail's behaviour has led to exclusion and consumer harm.

Keywords

Abuse of dominance, margin squeeze, postal services, price discrimination, Ofcom.

1. Introduction[*]

After almost five years of investigation, on the 26 October 2018, Ofcom issued its first infringement decision under the *Competition Act 1998* (Ofcom, 2018).[1] It found that Royal Mail (RM), the UK postal incumbent, abused its dominant position in the market for delivery of bulk mail and issued a £50 million fine. Ofcom found that RM deliberately excluded Whilst, known as TNT at the time of the complaint, by engaging in price discrimination. The case is currently under appeal to the Competition Appeal Tribunal (CAT).[2]

This article is organised as follows:

- Section 2 provides some context to postal services which is helpful to better understand Ofcom's decision;
- Section 3 summarises the approach taken by Ofcom in this decision;
- Section 4 critically assesses Ofcom's decision; and
- Section 5 provides some final remarks.

We consider this decision a step backwards in the way competition authorities[3] approach exclusionary behaviour. By examining RM's behaviour as price discrimination, Ofcom failed to consider all aspects of RM's behaviour. Furthermore and critically, the adopted framework made Ofcom unable to conclude whether RM's behaviour led to the exclusion of an entrant, at least as efficient as RM, or Whistl exited because it could not match RM's economies of scale. Ofcom should have examined this case as a margin squeeze, taking into account that Whistl's plan was to self-supply bulk mail in densely populated areas and rely on RM's delivery services elsewhere to provide nationwide bulk mail delivery services to its business customers. Hence, the new terms and conditions that RM announced in January 2014 could be thought as potentially squeezing Whistl's margins in a market for providing nationwide delivery services to bulk mail consumers by increasing its charges for essential inputs.

2. Postal services

The provision of postal services is a simple business. It consists of the supply of two main types of postal services for letters (and small packages):[4]

- Universal Service Obligation (USO) services, which include mail, sent by consumers, collected from pillar-boxes throughout the UK and delivered nationwide as well as internationally. RM is the Universal Service Provider (USP) and does not face any competition. USO services can be thought of as a natural monopoly (at least for collection); and

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[*] I worked in the initial phase of this case, covering the period from January to September 2014. This article is solely based on information contained in the non-confidential published decision. I am grateful to Cento Veljanovski for helpful suggestions and comments. However, the views and opinions expressed in this paper are the sole responsibility of the author and do not necessarily reflect those of my past, current or future employers. The responsibility for any remaining error clearly remains with the author.

[1] Ofcom, CW/01122/01/14, Discriminatory pricing in relation to the supply of bulk mail delivery services in the UK, 26 October 2018, available at *https://www.ofcom.org.uk/__data/assets/pdf_file/.../01122-infringement-decision.pdf*. We refer to this decision as Ofcom, 2018.

[2] Case 1299/1/3/18, Royal Mail plc v Office of Communications, available at https://www.catribunal.org.uk/cases/12991318-royal-mail-plc.

[3] Ofcom has concurrent powers with the Competition and Markets Authority (CMA) in the communication, broadcasting and postal sectors.

[4] There are also parcel services, where competition is very strong, which are not discussed and not relevant for understanding this case.

- Bulk mail services whereby businesses, such as utility companies, banks, government departments and advertisers, send large quantities of mail. Differently from USO services, bulk mail is collected at the senders' premises and delivered everywhere. Bulk mail consisted of 53% of all mail volume in 2013-14.[5]

Simplifying, there are two main elements for each of the above services:

- Collection of mail. Mail is collected by the USP at pillar-boxes, while bulk mail is collected from the business customers' premise. Therefore, USO mail requires a much more extensive collection network than bulk mail. RM is the sole provider for USO mail, while since 2006, entry has been possible and there is now strong competition in bulk mail collection. The so-called 'access operators' collate bulk mail and in almost all cases hand it over to RM to deliver it. They have gained a significant share of mail collection and, for example, in 2014 Whistl had the largest share of bulk mail collection, while RM only came third; and
- Delivery of mail. RM uses the same network to deliver both USO and bulk mail, exploiting economies of scope, while any entrant into the delivery market will only use its network to deliver bulk mail. RM delivered almost the entire totality of bulk mail with a share of 98%[6] and delivery accounted for 90% of all bulk mail revenues.[7]

Ofcom decision concerned RM's proposed 2014 new terms and conditions under which access operators obtained bulk mail delivery services from RM. In particular, the key question was whether RM's behaviour led to exclusion of access operators, such as Whistl, which entered the provision of delivery services in some, but still relied on RM's delivery services in other areas. The critical feature is that any access operators need to offer delivery nationwide. Hence, even if Whistl planned to deliver its bulk mail to over 40% of UK postal addresses, it still had to rely on RM for the remaining proportion of addresses.

Whistl's entry plan

Whistl, the largest UK access operator, is a subsidiary of TNT, the Dutch postal incumbent and an entrant in many European postal markets.[8] In 2012, Whistl announced a plan to start the roll-out of its own bulk mail delivery network in the UK. It planned to cover 42% of all UK postal address by 2018.[9] By March 2014, it had already rolled out in London, Manchester and Liverpool covering about 7% of UK postal addresses.[10] During and even after completing its roll-out, Whistl would have continued to rely on RM to deliver the bulk mail it collected but delivered in areas where it: (a) did not have its own network; and (b) even where it had rolled-out, if its consumers still preferred to rely on RM for delivery.[11]

Ex ante access regulation

The terms and conditions at which Whistl and other access providers gain access to RM's delivery services have been subject to a light touch *ex ante* regulation by Ofcom, known as the USP Access Condition. This gives RM significant freedom to modify its access terms and conditions following

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5 Ofcom, 2018, para 2.29.

6 Ofcom, 2018, Figure 2.1.

7 Ofcom, 2018, para 2.32.

8 In some countries, alternative delivery networks, such as those of TNT, cover a large proportion of postal addresses. For example, in Italy TNT's network covers more than 70% of postal addresses.

9 Ofcom, 2018, para 2.37.c.

10 Ofcom, 2018, paras 2.39 and 7.17.

11 The proportion of customers that choose Whistl to deliver their mail in these areas is referred to as the "conversion rate".

consultation with access operators.[12] RM has revised its terms and condition on a yearly basis. Since the opening of this case, Ofcom also consulted on whether this *ex ante* regulatory access regime should be modified.[13] The consultation identified a concern that RM may use (a) the "zonal tilt" – i.e. its relative delivery charges in London, Urban, Sub Urban and Rural zones – and/or (b) the so-called "price differential" - i.e. higher delivery charges for access operators that enter into the delivery market - as tools to discourage entry. The zonal tilt and the price differential are the same key issues as in the abuse of dominance case we cover in this article. Ofcom did not implement the proposals to address the above concerns because, following Whistl's exit from the delivery market in June 2015, it determined that it would not be proportionate to do so. Ofcom explained that the "*proposals were intended to address particular concerns associated with competition in end-to-end letter delivery*" but, because it did not consider "*there is likely to be another end-to-end entrant of sufficient scale and scope to provide a significant level of letter delivery competition to Royal Mail in the foreseeable future, it would not be appropriate and proportionate to implement the 2014 proposals.*"[14]

3. Ofcom's decision

Historically, RM has offered bulk mail delivery services to access operators under three different "price plans" (Table 1). Two of the plans - National Price Plan One (NPP1) and Averaged Price Plan Two (APP2) - offered delivery services at a uniform charge irrespective of where the mail was delivered. Access operators had to meet more stringent conditions to qualify for NPP1 than for APP2. The third plan, Zonal Price Plan Three (ZPP3), had different charges that should reflect the average costs of delivery in each of the four main zones – i.e. London, Urban, Sub Urban and Rural.

On 10 January 2014, after consulting with the industry, RM proposed to unilaterally change the terms and conditions of its price plans (henceforth we refer to these as the "January 2014 changes").[15] Although the latter were supposed to come into force in April 2014, they were suspended at the time Ofcom opened its investigation and, ultimately, never implemented.

The main January 2014 changes were:

- The introduction of a price differential - historically, all plans have been priced at a "*broadly equivalent rate*".[16] This meant that there was no difference in the prices of the two national price plans - NPP1 and APP2 – and the weighted average of the zonal charges under ZPP3 was "*broadly equivalent*" to the uniform charge under either national plan. The January 2014 changes meant that the price of APP2 and ZPP3 increased by 1.2% relative to that of NPP1;[17]
- Changes to the zonal tilt - the January 2014 changes meant that under ZPP3 the prices of London and Urban zones, where Whistl planned to enter and deliver its own mail, were substantially reduced while those of Sub Urban and Rural zones, where Whistl planned to rely on RM to deliver its mail, significantly increased;[18] and

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[12] Ofcom, 2018, paras 2.46-2.48.

[13] Ofcom, Royal Mail Access Pricing Review – Proposed amendments to the regulatory framework, 2 December 2014, available at https://www.ofcom.org.uk/__data/assets/pdf_file/0029/78248/royal_mail_access_pricing_review.pdf.

[14] Ofcom, Review of the Regulation of Royal Mail - Statement, 1 March 2017, para 5.12, available at https://www.ofcom.org.uk/__data/assets/pdf_file/0033/97863/Review-of-the-Regulation-of-Royal-Mail.pdf.

[15] Ofcom, 2018, para 1.17.

[16] Ofcom, 2018, para 3.50.

[17] Ofcom, 2018, para 3.56.

[18] Ofcom, 2018, Table 3.4.

- The introduction of more stringent conditions an access operator had to meet to remain on a national price plan - NPP1 and APP2 - became more difficult to meet, especially for access operators that engaged partially in self-supply of delivery services.

Table 1: RM's price plans before modification and main January 2014 changes

Price Plan	Description	Proposed 2014 changes
NPP1	A national plan with a single price per mail item, irrespective of where the letter is delivered. Eligibility required the customer adhering to a postal profile with minimum letters volumes to be sent to each Standard Selection Codes (SSC)[19] (National Spread Benchmark) and separately to urban addresses within each SSC (Urban Density Benchmark). Customers needed to prove that they used all reasonable endeavour to meet both benchmarks; otherwise, RM could imposed a surcharge. Mail must be posted across almost all parts of the UK in order to meet both benchmarks.	New forecasting obligations were introduced. If the customer failed to improve them, RM could remove the customers from NPP1 and transfer it to ZPP3. Surcharges were also possible. RM reduced the margin of tolerance for both the National Spread Benchmark and the Urban Density Benchmark, making it more difficult to meet them and for an access operator to remain on this price plan.
APP2	A national plan with a single price per mail item, which was equivalent to that under NPP1. Eligibility required the customer to prove to RM that it was reasonably likely that it would meet the Zonal Posting Profile (ZPP), requiring to mail to the four zones in the same proportion as RM, but, unlike APP2, not to post across all of the UK. If the ZPP conditions were not met, RM could automatically transfer the customer on ZPP3 and impose surcharges.	The price increased by 1.2% (or 0.25p per item) relative to NPP1, where previously there was no difference. The ZPP requirements were considerably tightened and the automatic transfer to ZPP3 was made easier, also making it more difficult for an access operator to remain on the plan.
ZPP3	A pay-as-you-go zonal plan. Prices varied by zone, but needed to be "*broadly equivalent*" to national prices (i.e. the weighted average of ZPP3 zonal prices is equivalent to the uniform APP2 price, with the weights equal to the proportion of mail delivered by RM to the four zones). Prices varied across zones (this was known as the "zonal tilt"): London (+10% relative to NPP1/APP2 national price), Urban (-12%), Sub-Urban (0%) and Rural (14%).	The price increased by 1.2% (or 0.25p per item) relative to NPP1, where previously there was no difference. The zonal tilt was modified as follows: London (-25% relative to national price), Urban (-25%), Sub-Urban (+10%) and Rural (+44%).

Intent is king

Ofcom dedicated a considerable part of its decision[20] to show that RM's intention was to thwart Whistl's entry into the provision of bulk mail delivery. Ofcom concluded that RM pursued "*a deliberate strategy to limit delivery competition from its first and only significant competitor, Whistl*."[21] RM justified its behaviour on the ground that it had to protect its ability to deliver services under the USO. In essence, this meant that competition in bulk mail delivery would have reduced RM's profits and ability to cross-subsidise the USO. Ofcom did not accept the argument, as this was part of its regulatory function.[22] Indeed, Ofcom's primary duty in postal services is securing the provision of the USO, while promotion of competition should only be pursued where appropriate. The key piece of evidence Ofcom relied on was a RM's internal document containing the table reproduced in Figure 1.[23] It shows that RM opted for a version of the price differential and zonal tilt (Scenario 2) which was almost identical to the one it

[19] SSCs refer to Three-digit Standard Selection Codes, represented by the first three digits of the five-digit Standard Selection Codes and are used to aggregate five-digit Standard Selection Codes into 83 larger, separate contiguous areas.

[20] Ofcom, 2018, Sec. 4.

[21] Ofcom, 2018, para 1.24.d.

[22] Ofcom, 2018, para 7.14.f.

[23] Ofcom, 2018, Fig. 4.3 and 7.5.

proposed though, ultimately, never implemented.[24] It involved both a positive price differential and a zonal tilt with lower charges in London and Urban zones and higher elsewhere relative to the previous charges. Overall Scenario 2 led to RM's lowest loss of market share (1.4%) and profit loss (£40m) by halting Whistl's entry plan altogether. Scenario 2 (shown in green in Figure 1) applied a *"price incentive"* (i.e. a price differential) for NPP1 of 0.2p[25] and a "*significant zonal tilt*" and anticipated that Whistl would "*[s]witch to [NPP1] and stay there*", confining itself to a '*small scale operation*' in the bulk mail delivery market.[26] Instead, doing nothing (Scenario 0) would lead to the largest market share (9.4%) and profit (£240m) loss for RM (together with Scenario 4).

Figure 1: Key document in Ofcom's decision

The best combination of actions is to apply a moderate price incentive on PP1 and make a significant change to the zonal tilt which improves our competitiveness in London

	Scenario					
	0	1	2	3	4	5
Description	Do nothing and wait for market to develop without defending USO	Apply moderate "value" justified incentive on PP1 and moderate zonal tilt	Apply moderate "value" justified incentive on PP1 and significant zonal tilt	No changes to zonal tilt which allows stretched "value" justified PP1 incentive	Apply moderate "value" justified incentive on PP1 and stretched zonal tilt	Do not offer PP1 incentive and just change the zonal tilt
Price incentive for the National Price plan	None	0.3p	0.2p	0.5p	0.1p	None
Zonal price difference (tilt) vs national average price (0%)	Urban: -12% Suburb: 0% Rural: 14% London: 10%	Urban: -25% Suburb: -1% Rural: 44% London: 0%	Urban: -25% Suburb: 10% Rural: 44% London: -25%	Urban: -12% Suburb: 0% Rural: 14% London: 10%	Urban: -25% Suburb: 23% Rural: 44% London: -50%	Urban: -25% Suburb: 10% Rural: 44% London: -25%
Likely outcome for Direct Delivery operator (#)	Stay on PP2 and grow to 20+ SSCs	End on PP2 and grow to 20+ SSCs	Switch to PP1 and stay there *	End on PP2 and grow to 20+ SSCs	End on PP2 and grow to 20+ SSCs	End on PP2 and grow to 20+ SSCs
Market share loss	9.4% By 2017	5.9% By 2017	1.4% By 2014	7.3% By 2017	9.4% By 2017	6.5% By 2017
RM revenue loss	£240m	£160m	£40m	£190m	£240m	£170m

(#) A DD operator would switch to PP1 to start with for all scenarios 1-4
(*) It is not profitable for DD operator to switch back to PP2 at any point
All of these assume no major investment is available to the entrant and that the entrant needs 10% profits in any expansio[redacted]

10 Strictly confidential - USPA5 sensitive Royal Mail

Source: Royal Mail, Options for protecting the USO – Draft discussion document, October 2013, 13 November 2013, slide 10. (RM0960)

Prior to the investigation RM also assessed whether it could and, if so how, prove that the introduction of a price differential was objectively justified – i.e. cost-based.[27]

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24 Ofcom, 2018, para 7.125.b.

25 The proposed increase was 0.25p.

26 Ofcom, 2018, para 7.125.

27 Ofcom, 2018, paras 4.58-4.100.

Market definition and dominance

Both the market definition and dominance assessments appeared relatively uncontroversial. Ofcom defined the relevant market as the provision of bulk mail delivery services in the UK.[28] RM was dominant with a market share in excess of 98%.[29] Ofcom noted that Whistl, even in the areas (denominated SSCs at a granular level) where it had entered, had only gained on average a 16% share of all locally delivered bulk mail.

A hybrid abuse or price discrimination

In different parts of the decision, Ofcom alludes to RM's behaviour constituting a new or not yet well-defined abuse: "*a further type of 'hybrid' case*".[30] Ofcom reported that Whilst had identified five features in the January 2014 changes that would negatively affect its performance: (1) the price differential; (2) the surcharges applied to NPP1; (3) changes in the zonal tilt; (4) stricter conditions on APP2; and (5) the NPP1's requirement to provide bulk mail forecasts to RM.[31] However, Ofcom made it clear that its main concern was with the price differential.[32] As a result, Ofcom did not consider any of the other January 2014 changes (as per Table 1) as being capable of having a material impact in excluding Whistl. Ofcom examined RM's behaviour solely as price discrimination: "*in introducing the price differential, Royal Mail applied dissimilar conditions to equivalent transactions with its access operator customers, charging higher prices for the same bulk mail delivery services when supplied under the APP2/ZPP3 price plans than it charged under the NPP1 plan.*"[33] This approach explains why a large part of the decision is devoted to discussing why the services offered under RM's price plans were "*equivalent transactions*" and assessing RM's cost justification for the 1.2% price differential.[34] In essence, RM argued that the forecasting obligations access operators had to meet under NPP1 would have allowed it to save on costs relative to APP2/ZPP3. However, Ofcom concluded that it "*does not accept Royal Mail's argument that the price differential was explained or justified by the requirement for only NPP1 customers to provide forecasts. Among other matters: (a) the class of customer (NPP1 customers) that was obliged to provide forecasts would not in fact have provided valuable information of the type needed to make the cost savings identified; and (b) the classes of customers that may in fact have such valuable information to provide (APP2 and ZPP3 customers) were neither required to nor incentivised to provide it.*"[35]

According to Ofcom, the key issue was that, due to the NPP1 restrictions, which were tightened as a result of the January 2014 changes, an access operator that intended to enter the delivery market, such as Whistl, had to switch from NPP1 to APP2/ZPP3 and incur the 1.2% price differential. This was because by entering Whistl would have had either to pay surcharges or be automatically transferred from NPP1 to more expensive price plans.[36] Ofcom argued that there was a tipping point beyond which an entrant into delivery would be put at a disadvantage and it would be forced on the APP2/ZPP3 and

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[28] Ofcom, 2018, para 6.2.

[29] Ofcom, 2018, para 6.3.

[30] Ofcom, 2018, paras 5.45 and, in particular, 7.172-7.181.

[31] Ofcom, 2018, para 4.171.

[32] Ofcom, 2018, para 7.4. RM instead argued that analysis carried out by its economic advisers indicated that the price differential would have accounted for less than 20% of the total estimated impact of the January 2014 changes, whereas 80% of the impact would have come from other changes introduced by the January 2014 changes (Ofcom, 2018, para 7.246.d).

[33] Ofcom, 2018, paras 7.7.a, but also 7.44-7.45 and 7.65-7.78.

[34] Ofcom, 2018, para 7.65-7.122.

[35] Ofcom, 2018, para 7.122.

[36] Ofcom, 2018, paras 7.47-7.64.

higher prices.[37] Ofcom considered RM's price differential as "*making entry significantly more difficult and therefore less likely to occur*" because NPP1 would be no longer available to a delivery entrant, therefore, "*likely to cause harm to consumers.*"[38]

A price-cost test is neither necessary, required nor relevant

Ofcom claimed that a price-cost test - sometimes also referred to as the As Efficient Competitor (AEC) test - was neither "*necessary*", "*not required as a matter of law*", not "*relevant*", nor "*appropriate in this case.*"[39] It, therefore, rejected the need for a price-cost test by arguing that: "[g]*iven the nature of the discrimination in issue, the type of foreclosure effect we are concerned with, and the prevailing conditions of competition in the market at the time this conduct took place, it is neither necessary nor appropriate for us to carry out an AEC test (or any other type of price-cost test) in assessing the likely effect of the price differential (contrary to the submissions of Royal Mail).*"[40]

Ofcom explained that price-cost test *"have been found relevant by the CJEU in situations where a dominant undertaking has engaged in 'low-pricing practices' (such as selective prices, predatory prices or some types of margin squeeze), designed to retain or win new customers. That is not the type of conduct at issue here. Royal Mail raised the price of the price plan that was available to end-to-end competitors."*[41] *Ofcom carried on to state that "neither is this case a potential example of margin squeeze involving the relationship between Royal Mail's upstream and downstream prices and costs."*[42]

Even though Ofcom rejected the need and usefulness of a price-cost tests, the decision seems to criticise RM for having undertaken an Equally Efficient Operator (EEO) test[43] and, instead, argued in favour of a Reasonably Efficient Operator (REO) test[44]: *"*[t]*he prohibition of an abuse of dominance also protects the emergence of competition by 'less efficient' operators, which may still exert competitive pressure on the dominant undertaking to the benefit of consumers. Price-cost tests of any design therefore cannot identify the foreclosure effects with which we are concerned in this case*."[45] Ofcom further argued that: "[t]*he EEO test advanced by Royal Mail is based on Royal Mail's costs, which its own advisers appear to acknowledge are not likely to be similar to those of an entrant*"[46] and confirmed this by stating that "[e]*ach of the scenarios examined by Royal Mail's advisers is still based on Royal Mail's downstream costs (using an adjusted version of Royal Mail's LRAIC model, see paragraph 5.46 of the FTI report). Royal Mail does not seek to model the actual costs of a new entrant to assess the impact of the price differential on a competitor in that position.*"[47]

Because Ofcom refused to run an EEO price-cost test, it assessed materiality by looking at the likely or expected impact of the price differential on Whistl's business plan profits. This was estimated as the total volume of letters that Whistl forecast to deliver over the period 2014-18 multiplied by the 0.25p

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37 Ofcom, 2018, para 7.56.

38 Ofcom, 2018, para 7.139.

39 Ofcom, 2018, paras 7.182-7.202 and, in particular, 7.191-7.192.

40 Ofcom, 2018, para 7.139.

41 Ofcom, 2018, para 7.184.

42 Ofcom, 2018, para 7.196.

43 The EEO test uses the dominant firm's own costs to assess whether the dominant firm could trade profitably if it faced the upstream prices it offered to its downstream rivals and the downstream price it charged to its own consumers.

44 Differently from the EEO, see footnote 43, the REO makes use of the cost of a reasonably efficient rival instead of the dominant firm's own costs.

45 Ofcom, 2018, para 7.184.

46 Ofcom, 2018, para 7.200.a.

47 Ofcom, 2018, para 7.200.b.

price differential.[48] Once discounted, these additional charges were estimated at £28.9 million[49] and then, among other metrics, these were compared against Whistl's expected discounted EBIT of £52.7 million over the same period. Hence, the impact of the price differential was estimated to reduce Whistl's EBIT by 55%.[50] Ofcom acknowledges, "*that other changes introduced by the CCNs* [the January 2014 changes], *which are not the subject of this Decision, would also have had an adverse impact on Whistl's profitability*", hence, its estimation was conservative.[51] Ofcom judged that this impact was "*material*" and "*likely*" to make entry "*significantly more difficult*", though, it also claimed, "*not impossible or totally unprofitable.*"[52]

Effects

Whistl initially continued its roll-out, but then halted it in November 2014. It eventually abandoned it, unwind its limited initial roll-out and ultimately exited the delivery market altogether in June 2015. Ofcom linked Whistl's decision to exit to losing the commitment to invest in its plan to roll-out its delivery network by one of its main investors, LDC, part of Lloyds Banking Group, and the fact that Ofcom's investigation carried on longer than originally expected. Ofcom concluded that RM's price differential (alone) was: "*a material contributing factor (among other factors) to: the disruption of LDC's decision to complete its agreed investment in Whistl in January 2014; and Whistl's decisions to reduce and then suspend parts of its planned further roll out of its end-to-end delivery operations",* although Ofcom has *"not found it necessary to make any findings in this Decision as to (i) the causes of Whistl's exit; or (ii) the extent to which that exit could be attributed to the introduction of the price differential.*"[53]

4. Assessment

Several aspects of this decision appear reasonable. It is highly likely that RM was able to engage in exclusionary behaviour, given its dominance. Ofcom's analysis of RM's internal documents also strongly suggests that RM had the intention to exclude Whistl. RM's claim that there was an objective justification for introducing the price differential appears weak and so is its justification that the January 2014 changes were required to protect the USO, which instead was Ofcom's primary duty. Furthermore, the fact that the January 2014 changes were never implemented, because the opening of an investigation suspended them, as per RM's price plan contractual conditions, does not imply they could not have led to exclusion. Indeed, the impact of the announcement and the opening of what proved to be a lengthy investigation might have created sufficient uncertainty to deter Whistl from further rolling out and LDC from investing further.

A useful way to assess whether a dominant firm's behaviour could lead to exclusion and harm consumers is to consider whether (1) a dominant firm has the ability to behave anti-competitively – i.e. it is dominant; (2) it has an incentive to behave in that way; and (3) its behaviour is capable or likely to result in anti-competitive effects. However, Ofcom's analysis halted at ability.[54] There was no attempt to consider RM's incentives, despite these seemed particularly strong. Delivery accounts for 90% of the

48 Ofcom, 2018, Table 7.1.

49 Ofcom, 2018, para 7.152

50 Ofcom, 2018, para 7.156.

51 Ofcom, 2018, para 7.159.

52 Ofcom, 2018, paras 7.163 and 7.165.

53 Ofcom, 2018, paras 7.230-7.231.

54 Although it is unclear why ability was necessary according to the decision, as Ofcom argued that "[a]n abuse of dominant position does not even necessarily have to involve the use of the economic power conferred by its dominant position" (Ofcom, 2018, para 5.16).

value of the vertical chain, Whistl planned to roll-out to over 40% of UK addresses representing about 49% of the total volume of bulk mail. Although Whistl would have not delivered even all the mail it collected (it never envisaged to get to a 100% conversion rate), in the future it could have offered delivery services to third parties, threatening further RM's dominance. Hence, it seems likely that RM had strong incentives to exclude new entrants in delivery. Furthermore, Ofcom dismissed the need to look at the likely effects of RM's behaviour in purely legal terms: "*in order for conduct to be abusive, the case law, guidance and relevant decisional practice establishes that that it is not necessary to show concrete effects or the potential elimination of all efficient competition.*"[55]

However, the main flaw in Ofcom's approach is that it does not allow fully testing whether a delivery operator, as efficient RM, was excluded from partially entering into the delivery market. This is for a number of reasons. First, Ofcom examined the RM's behaviour purely as price discrimination. By doing so, it ignored, among others, the effect of the changes in the zonal tilt. The evidence in the decision shows that the effect of the zonal tilt was at least as important as that of the price differential. Second, Ofcom concluded that the price differential would have more than halved Whistl's profits. However, this in itself cannot tell us whether this was a significant impact because we do not know if Whistl was as or less efficient than RM in delivery nor whether halving its expected profits was sufficient to lead to Whistl's exit. Testing for exclusion could be undertaken in this case only by also running an EEO price-cost test. Third, Ofcom failed to consider what would have been RM's legitimate competitive reaction to Whistl's entry. This shows that there also another way of characterising RM's behaviour, as predation in the areas where Whistl planned to enter and excessive pricing where Whistl continued to rely on RM for delivery. RM's allegedly anti-competitive response to Whistl's entry did not involve a profit sacrifice and, critically, Ofcom's *ex ante* regulatory obligations facilitated it. The reminder of this article expands on these points.

The changes in the zonal tilt matter as much as the price differential

The information in Ofcom's decision, reporting the details of RM's internal documents, illustrates how the January 2014 changes in the zonal tilt had a very similar impact on RM's profits as the price differential. Therefore, Ofcom should not have ignored the former. Figure 2 recasts the scenarios assessed by RM's internal document, reproduced in Figure 1, using the same information. It takes Scenario 0, or "do nothing", where RM did not change the terms and conditions of its price plans in reaction of Whistl's entry. Scenario 0 entailed a market share loss of 9.4% for RM[56] and shows how the other scenarios performed relative to it. For example, under Scenario 2 RM would only lose 1.4% market share and hence it would be better off relative to "do nothing" by 8%. Scenarios were defined by:

- the level of the price differential (ranging from 0.1p to 0.5p); and
- an indicator of the extent of the zonal tilt taken as the difference between the prices in zones where Whistl planned to enter (London and Urban) and those where it would have relied on RM's service to deliver its bulk mail (Sub Urban and Rural).[57] The lower this value the larger was the zonal tilt between the relevant scenario and the "do nothing" scenario.

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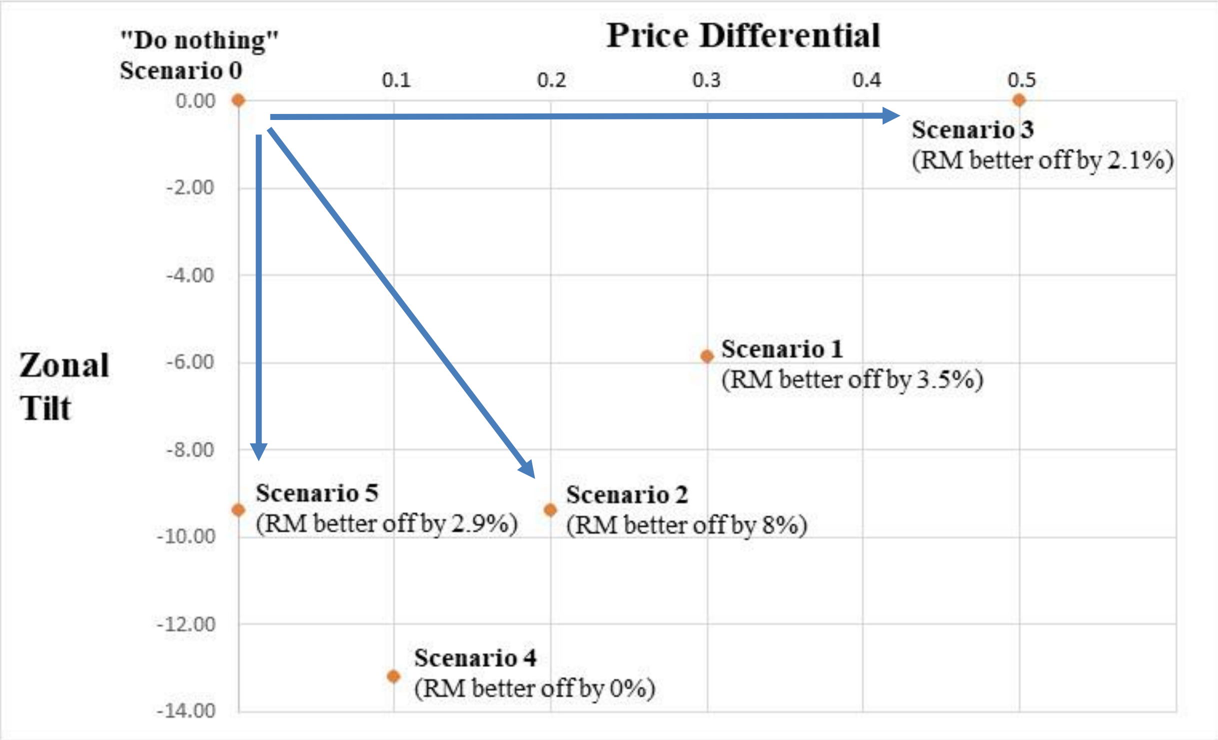
[55] Ofcom, 2018, para 5.73.

[56] RM's internal document (Figure 1) assessed the impact of the different scenarios in terms of loss of both market share and profits. As the values of the two indicators are almost perfectly correlated (0.99), we have chosen market share loss as the key indicator of the impact of each scenario relative to Scenario 0.

[57] For each scenario, we have taken the weighted average of the prices of London and Urban zones (where Whistl planned to enter) and those of Sub Urban and Rural zones (where Whistl would have relied on RM). For weights we used the traffic volumes in each zone as a proportion of total nationwide traffic (Ofcom, 2018, para 3.8). We subtracted the two to obtain a measure of the difference in prices. We then set the "do nothing" Scenario as zero and rebased all other scenarios.

Figure 2: The impact of the price differential and zonal tilt on RM's market share



Source: author calculations based on information in Figure 1.

In order to separately show the impact of the changes in the zonal tilt and price differential in isolation, compare Scenario 0 with:

- Scenario 5 where RM changed only zonal tilt in the same way as in the actual proposal, but did not introduce a price differential. RM was better off by 2.9% by acting only on the zonal tilt relative to the "do nothing" scenario; and
- Scenario 3 where RM only introduced a price differential, whose magnitude was double relative to that adopted, but did not modify the zonal tilt. RM was better off by 2.1%. Assuming, only for illustration, that the impact of the price differential on RM's market share was linear, had RM only introduced a 0.25p price differential RM would have been better off by just over 1%. The impact is much lower than acting on the zonal tilt alone.

This simple comparison shows that in isolation either the price differential or the zonal tilt were expected to reduce the impact of Whistl's entry on RM's market share. However, the results may also indicate that the zonal tilt may be a more effective tool than the price differential.

Scenarios 1, 2 and 4 describe RM's strategies that involve both introducing a price differentials and changing the zonal tilt. All the changes to the zonal tilts considered share a common feature: lower prices in London and Urban zones and higher prices Sub Urban and Rural zones relative to the do nothing scenario. Ultimately, in January 2014 RM opted for a solution very similar to that described in Scenario 2. The zonal tilt was identical, but a price differential adopted was of 0.25p instead of the 0.2p used in Scenario 2. RM opted for the latter because it was the best at limiting its loss of market share. Under Scenario 2 RM was better off by 8% relative to the "do nothing" Scenario and acting on a single tool. Scenario 1 was also better than using only one tool (Scenarios 3 and 5), while Scenario 4 had no impact on RM's market share. Hence, in two scenarios out of three, RM was better off by acting on both the zonal tilt and the price differential than either doing nothing or relying on only one tool.

Why RM's behaviour should be assessed as a margin squeeze

Given that both the price differential and the zonal tilt were part of RM's "*deliberate strategy*" to exclude Whistl, Ofcom should have examined RM's behaviour in a way that considered all January 2014 changes. The appropriate approach would have been to undertake a price-cost test to assess whether RM engaged in a margin squeeze. In order to show this, it is useful to first consider Whistl's decision to enter the delivery market and roll-out to more than 40% of UK premises prior to the January 2014 changes. Define:

AC_{APP2}	-	the access charge paid under APP2 (including surcharges and other terms and conditions such as the relevant benchmarks);
AC_{NPP1}	-	the access charge paid under NPP1 (including surcharges and other terms and conditions such as the relevant benchmarks);
AC_{ZPP3}	-	the access charge paid under ZPP3 (including surcharges and other terms and conditions);
Q	-	the overall volume of mail delivered by Whistl;
C_{WH}	-	Whistl's cost of delivery where it planned to roll-out its network (almost entirely in London and Urban zones);
π_{WH}	-	Whistl's normal return for its investment in delivery services; and
A	-	the proportion of mail Whistl self-delivers. We abstract here from the fact that even if Whistl had a network in an area it may not deliver all of the mail it collects (the "conversion rate" mentioned above).

The fact that prior to the January 2014 changes Whistl decided to enter meant that it believed that its overall delivery costs would be lower, if it entered than if it remained an access operator. If it entered Whistl's overall delivery costs would be the weighted average of its own delivery costs and the charges it would have to pay to RM, as shown by the right-hand side of expression (1). Instead, if Whistl entered it could have remained on APP2, at least initially, but it would have probably had to shift to ZPP3 as its roll-out progressed. If Whistl decided not to enter and remained an access operator, it would prefer to be on APP2 rather than on NPP1 because, although prices were identical, APP2 had less stringent conditions than NPP1. Whistl would have entered if:

$$(1)\ \underbrace{AC_{APP2} * Q}_{\substack{\text{Cost of delivery} \\ \text{if Whistl remained} \\ \text{an access operator}}} > \underbrace{\pi_{WH} + Q * \alpha * C_{WH} + Q * (1 - \alpha) * AC_{APP2/ZPP3}}_{\substack{\text{Cost of delivery} \\ \text{if Whistl self-supplied delivery for } \alpha \\ \text{of its mail}}}$$

In essence, Whistl would have partially entered delivery, if this resulted in lower total costs of delivery, including obtaining a normal return on its investment (π_{WH}).[58]

[58] This could be interpreted as the cost of capital of the investment in the roll-out.

Consider now how the January 2014 changes would have modified Whistl's options and choice. If Whistl decided not to enter and remained an access operator, it would have opted for NPP1, instead of APP2 as in expression (1) because the introduction of a price differential meant that NPP1 became 1.2% cheaper than APP2. Hence, Whistl's entry decision would change to:

$$(2)\ \underbrace{AC_{NPP1} * Q}_{\text{Cost of delivery if Whistl remained an access operator}} > \underbrace{\pi_{WH} + Q * \alpha * C_{WH} + Q * (1 - \alpha) * AC_{APP2/ZPP3}}_{\text{Cost of delivery if Whistl entered into delivery for } \alpha \text{ of its mail}}$$

Expression (2) can be interpreted as a margin squeeze price-cost test. It asks whether an entrant as efficient as RM in delivery under an EEO test, would be able to trade profitably if it faced the terms and condition RM offered to its access operator rivals that entered into delivery. To see this, consider the usual price-cost test whereby a margin squeeze arises when:

$$(3)\ P_R - P_W - C_R < \pi$$

where:

- P_R - the price at which RM would sell nationwide delivery services to itself and to access operators with a similar mail distribution profile. This is NPP1, as RM clearly meets all the conditions and post-January 2014 changes NPP1 would be the cheapest option;
- P_W - the wholesale price of the essential input Whistl needs in order to deliver nationwide – i.e. almost all consumers demand nationwide delivery. This consists of either the charges and surcharges under APP2 or those under ZPP3 for Rural and Sub Urban zones only;
- C_{RM} - RM's incremental cost of delivering bulk supply mail (mostly in London and Urban zones); and
- π_{RM} - RM's normal profits or cost of capital for the relevant delivery services.

Rearranging the terms in (2) above, gives expression (4), which shows that a margin squeeze occurs when:

$$(4)\ \underbrace{(AC_{NPP1} * Q)}_{P_R} - \underbrace{Q * (1 - \alpha) * AC_{APP2/ZPP3}}_{P_W} - \underbrace{Q * \alpha * C_{RM}}_{C_{RM}} < \underbrace{\pi_{RM}}_{\pi_{RM}}$$

Expression (4) shows that (2) and (3) are equivalent. In essence, RM may have squeezed Whistl's profit margin in providing nationwide bulk mail delivery services. The mechanism involved a number of elements:

1. reducing Whistl's ability to remain on the cheapest tariff NPP1 as it rolled-out in London and Urban zones by tightening the contractual requirements to remain on NPP1;
2. increasing the price of APP2 by the 1.2% price differential and also making it more difficult for Whistl to remain on APP2 by tightening the contractual requirements; and
3. when, because of further roll-out Whistl could have not continued on APP2 as per point 2. above, increasing the prices for the essential input of Sub Urban and Rural delivery under ZPP3 - i.e. by acting on the zonal tilt.

Note that the costs and returns in expression (4) are RM's, while in considering Whistl's entry decision in (1) and (2), we referred to Whistl's own delivery costs and returns. This is because it is standard to use an EEO test in price-based abuses of dominance, despite Ofcom's decision seemingly hinting at an REO being preferable.[59] Instead, an entrant will decide whether to enter based on its own costs and expected returns.

The failure to use a price-cost test prevented Ofcom from establishing whether RM engaged in exclusionary behaviour or Whistl exited because it was not as efficient as RM. The latter is not merely a theoretical possibility. Ofcom argued that RM enjoyed strong economies of scale, which Whistl may have not been able to match under an EEO.[60] Therefore, RM's alleged behaviour is best assessed as an attempt to squeeze the margins that an equally efficient entrant into delivery in London and Urban zones could make in delivering bulk mail nationwide (the downstream market) when facing both RM's charges for delivery (1) to Sub Urban and Rural zones (the upstream market where RM was dominant);[61] and (2) nationwide on the basis of NPP1.

An implication stemming from the above interpretation of RM's behaviour is that Ofcom's decision to define the geographic upstream market as delivery to the entirety of the UK would be incorrect. The upstream market in a margin squeeze case is where a competition authority needs to find dominance. The above discussion implies that the geographic upstream market should have been narrower than national. It could have been defined as delivery into Sub Urban and Rural zones, where Whistl did not plan to enter. This would have allowed Ofcom to distinguish between the indispensable inputs in upstream market - i.e. delivery in Sub Urban and Rural zones - and the downstream market(s) where Whistl attempted to enter and the alleged abuse took place - i.e. nationwide delivery of bulk mail.

At what level of roll-out would a price squeeze result in exclusion?

Had Ofcom examined RM's behaviour as a margin squeeze, an interesting conceptual issue may have arisen. Ofcom hinted at this issue,[62] but its failure to adopt a rigorous framework prevented it from considering it in full. As Whistl rolled out its delivery network according to its plan, it would have relied less and less on RM's delivery services. Instead, at some stage it would have delivered a substantial proportion of its bulk mail volumes. In particular, if (an as efficient) Whistl had rolled out in

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59 This despite quoting passages from the *Intel* (Ofcom, 2018, para 5.25) and *Post Danmark II* (Ofcom, 2018, 5.53) European courts' judgements that make explicit reference to the AEC or EEO test.

60 Ofcom, 2018, para 7.199.

61 RM was also dominant in the downstream market, though this is not a necessary condition for a margin squeeze finding.

62 For example, Ofcom noted that "[t]he total access payments the operator would need to pay to Royal Mail would gradually decline as it switched an increasing proportion of its delivery requirements to its own network" (Ofcom, 2018, para 7.142.a) or "that if Whistl had expanded its bulk mail delivery operations in line with its business plan, the additional cost associated with the price differential would have fallen slightly over time (as it would have been using Royal Mail's delivery services for a lower proportion of its access volumes)." (Ofcom, 2018, para 7.151; see also para 7.145).

progressively more costly zones, it would been able to "save" on RM's prices to deliver mail to addresses in these gradually more expensive zones. In other words, in theory it is possible that at some point in its roll-out plan Whistl could have rolled itself out of a price squeeze. However, a key question is to interpret evidence from a price cost test that shows negative margins at lower level of roll-out, but not at or around 40% of all UK postal addresses, as envisaged in Whistl's plan. Assuming that an entrant reaches a minimum viable scale (MVS) in terms of coverage, it should be entitled to positive margins at any level of its coverage beyond the MVS.

Ofcom's ex ante obligation enhanced or created the incentives to exclude

There is an alternative way of interpreting RM's January 2014 change in the zonal tilt. It could consist of two abuses: predation where RM faced entry in London and Urban zones and excessive pricing where Whistl had to rely on RM for delivery in Sub Urban and Rural zones. A simple example can illustrate this. Suppose the price of the national plan APP2 was 100. Using the "do nothing" scenario zonal tilt, the weighted average price of London and Urban would be 95 and that of Sub Urban and Rural 106.[63] RM, facing entry by Whistl in the London and Urban zones, was entitled to reduce its delivery prices to match competition. Indeed, it reduced the weighted average price in these two zones from 95 to 75. This is a normal competitive reaction, which benefits consumers, as long as 75 is not predatory. As RM did not face entry in the Sub Urban and Rural zones, the weighted average price for those two zones should have remained unchanged at 106, implying a decline in the national APP2 price to 91 (this is the weighted average of the four zones). This reaction and reduction in the weighted average national is expected, as entry would have led to price reductions in the zones where RM faced entry, but not in those where it did not.

However, *ex ante* regulatory obligations (Table 1) required the zonal prices under ZPP3 to be "*broadly equivalent*" to national prices - i.e. the weighted average of ZPP3 zonal prices must be equivalent to the nationally uniform APP2 price. This meant that if RM reduced its London and Urban zonal prices to react to entry, it must correspondently increase the Sub Urban and Rural zonal prices so that the price of APP2 remained 100, instead of declining to 91. This meant that regulation forced RM to increase the weighted average Sub Urban and Rural zonal prices to 124.

Therefore, the effect of the "*broadly equivalent*" *ex ante* obligation was to make entry deterrence more effective, as RM did not have to sacrifice any profits to respond to entry and ultimately consumers did not enjoy any of the lower prices they should expect from an increase in competition.[64] One could venture further and argue that it is precisely this *ex ante* obligation that increased RM's ability and strengthened its incentive to act on the zonal tilt to exclude Whistl by removing the profit sacrifice that responding to competition should entail. Overall not a good outcome for consumers.

As mentioned in Section 2, Ofcom concluded that both the zonal tilt and the price differential were likely to deter entry when it considered them in an *ex ante* regulatory context. It did not revise them because it considered entry into delivery unlikely after Whistl's exit. This can hardly be a valid reason not to reform *ex ante* regulatory obligations that create perverse incentives. Critically, it is surprising that both the zonal tilt and the price differential were considered to deter entry into delivery for *ex ante* purposes, but only the price differential was thought of having the same effect in the *ex post* abuse of dominance case. Conceptually, the effect should be the same regardless whether it is considered *ex ante* or *ex post*.

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[63] These weighted average prices were estimated using as weights the traffic volumes in each zone as a proportion of all traffic – see footnote 57.

[64] Under the January 2014 changes, if Whistl had entered into delivery, this would have resulted in a price increase. Not only Whistl would have faced the 1.2% surcharge, but it would have also faced a substantial increase in Sub Urban and Rural prices.

5. Conclusions

Ofcom could have made better use of its first infringement decision to provide clear guidance on its approach to exclusionary behaviour. This was a rare case in network industries where incumbents faced entry in their core upstream business. While it is not a unique case in postal services, no other network industry, such as telecoms, has yet faced upstream entry to this extent. However, the approach, analysis and information in Ofcom's decision do not allow the reader to conclude whether an exclusionary abuse has taken place. This would have been possible only if Ofcom had framed the case as RM potentially abusing its upstream dominant position in Rural and Sub Urban zones by engaging in a margin squeeze in a downstream nationwide bulk mail delivery services market.

RM's intent and strategy were clearly exposed by its internal documents and correspondence. However, Ofcom did not take into account that the same internal documents also made it clear that RM's exclusionary strategy did not rely solely on the price differential, but also on the changes to the zonal tilt and other ancillary terms, such as the requirement thresholds for an access operator to remain on NPP1 and APP2. Ofcom ignored all elements of RM's behaviour, but the price differential, as they could not fit well under a price discrimination label. The decision's main shortcomings, which we summarise below, stem directly from this.

First, we illustrated how the best way to assess RM's behaviour was to consider all elements of RM's strategy as exclusionary behaviour. RM's own internal documents showed that both the price differential and the changes to the zonal tilt contributed to reduce the impact of Whistl's entry on RM's profits under most scenarios. Surprisingly, Ofcom had indicated that both the zonal tilt and the price differential could be used to deter entry, when it reviewed them under an *ex ante* regulatory context. It is unclear why this should not also be the case *ex post*. Second, the best way to consider all aspects of RM's behaviour and strategy would be as a margin squeeze and through a stylized price-cost test such as that described by expression (4). This would have been an additional, but critical, element of the analysis. In particular, by opting for a formalistic price discrimination approach Ofcom put itself in the unenviable position of being unable to conclude whether RM's behaviour led to the exclusion of an entrant as efficient as RM or Whistl exited because it was not as efficient as and could not match RM's economies of scale. Lastly and in addition, Ofcom failed to acknowledge that its own *ex ante* regulatory obligations strengthened RM's incentives to engage in exclusionary behaviour. In particular, the obligation that the (weighted average) of RM's zonal prices be "*broadly equivalent*" to the national tariff allowed RM to engage in exclusionary practices without incurring a significant profit sacrifice.

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