Stalked by the CAT

LESSONS FROM POSTAL INFRASTRUCTURE COMPETITION

In some industries, regulators consider encouraging "infrastructure competition" as this can deliver more significant longer term benefits to consumers. Typically, new entrants may require access to incumbents' infrastructure, which has led regulators to consider whether ex ante regulatory intervention is required to minimise the risk that the terms of such access are set in a way that distorts competition. However, such behaviour can also give rise to competition enforcement actions. All parties need to be alive to these possibilities, as illustrated by a recent Ofcom ruling that Royal Mail breached the Competition Act in relation to the prices it proposed to charge Whistl, an end-to-end postal delivery entrant. The decision was challenged in the Competition Appeal Tribunal but was upheld.

Infrastructure competition in network industries

Network industries often have the following structure:

- A "wholesale" infrastructure market, with an incumbent that is required to grant access to rivals, and may face a regulatory regime requiring them to offer such access at regulated terms (including prices).
- A "retail" market, historically with one provider, but subsequently opened up to competition from multiple retail providers obtaining access to the relevant wholesale inputs from the incumbent.

Regulators have considered that strengthening the degree of infrastructure competition, where entry is feasible and efficient, could deliver consumer benefits in the longer term, as a greater part of the supply chain would become competitive. Such potential competitive benefits typically come at a price of investment in overlapping and duplicative infrastructure, which is generally more costly than access based entry. Infrastructure competition also often involves new entrants deploying a 'dual' business model of both 'building', in less costly geographic areas, and 'buying' (access to incumbents' networks) in more costly ones. If entrants (or incumbents) do not believe that they will be able to make a return on their investment, they will be unlikely to invest in the first place.

Over the last decade, this issue arose in relation to the removal of Royal Mail's statutory monopoly over the last mile delivery infrastructure, thus allowing infrastructure competition and promoting the emergence of full end-to-end delivery rivals to Royal Mail. One of the access operators at that time – TNT Post, later renamed Whistl – decided to roll out its own delivery infrastructure in certain parts of the country. This set off a chain of events which ultimately led to Ofcom finding that Royal Mail had breached Chapter 2 of the Competition Act 1998 and fining it £50m. The Competition Appeal Tribunal (CAT) upheld Ofcom's decision in full last November.[1]

The Whistl case

For several hundred years Royal Mail had a monopoly over postal delivery. The Postal Services Act 2000 enabled other operators to carry out certain of Royal Mail's activities, one of which was the

[1] https://www.catribunal.org.uk/sites/default/files/2019-11/1299_RoyalMail_Judgment_Non_Confidential_Version_%5BCAT_27%5D_121119.pdf.

handling of bulk mail to be ultimately delivered through Royal Mail's postal operators (the "delivery network"). Several firms entered the bulk mail sector, the largest of which were TNT Post (subsequently renamed Whistl and referred to as such in this bulletin) and UK Mail. Bulk mail operators were able to purchase access to Royal Mail's delivery network at regulated prices. In 2006 the restrictions on bulk mail operators developing their own delivery networks were removed. From 2010 *ex-ante* regulation of access prices lapsed and was not replaced, within a wider context of privatisation plans for Royal Mail, although the historic access prices remained in place.

Whistl had demonstrated interest in becoming an end-to-end delivery operator, by setting up a rival infrastructure, since at least the mid-2000s. In 2012, the company established networks in four of Britain's 80 or so Standard Selection Code areas (SSCs) and expanded into two others in 2013. Its intention was to provide delivery in SSCs accounting for around 40% of UK households by 2018. To attract customers, who typically required national coverage, Whistl bought access to Royal Mail's delivery network to cater for those areas where it did not have its own network.

Originally Royal Mail set its access pricing on the same terms that had obtained in the price-regulated period ending in 2010. However, in January 2014 the company issued a new set of access prices through a series of five Contract Change Notices, to come into force at the end of March 2014. Whistl was concerned that the new pricing frameworks would give rise to an exclusionary effect on a rival end-to-end delivery operator, such as itself, and complained to Ofcom under the Competition Act 1998 that Royal Mail had abused its dominant position. Ofcom opened a competition complaint in April 2014 (which led to the suspension of the access prices) and ultimately found in a decision of August 2018 that Royal Mail had indeed abused a dominant position.[2] Royal Mail appealed several aspects of this ruling to the CAT, which rejected each ground of appeal in a judgment delivered in November 2019.[3]

The effect of the access price changes

Ofcom found that the proposed access prices had an exclusionary and discriminatory effect on rival end-to-end operators. This is because they included a rebate or discount which could be achieved by an access-only operator purchasing all of its access requirements from Royal Mail, but which could not be obtained by an end-to-end operator once it had expanded its own delivery network beyond a certain (low) proportion of the country. As a result, an end-to-end operator would be disincentivised to extend its network above this threshold, as in doing so it would lose the benefit of the rebate.

The exclusionary effect was magnified by the fact that the rebate applied to the entirety of an access seeker's volumes, not to incremental volumes above a certain coverage level. This meant that the loss of the rebate would have had a substantial effect on an end-to-end delivery entrant. For instance, suppose that the rebate was 1% of total price paid, and applied once an access operator had acquired more than 95% of their requirements from Royal Mail. An access customer thinking about switching part of its demand to an end-to-end newcomer with just over 5% of the market would lose the benefit of the rebate across all its access volumes. The end-to-end entrant would therefore need to compensate the customer by cutting price substantially on its own small volumes. Specifically, the price reduction would need to be 19% on the 5% of volumes that it serves, to make up for the loss of the 1% rebate on the 95% of volumes served by Royal Mail.

Ofcom outlined this mechanism in its decision and concluded that this pricing structure would have an exclusionary effect on end-to-end entrants, in a discriminatory fashion compared to an access-only operator which did not seek to enter delivery. Access-only operators that did not switch part of their demand to the end-to-end operator would continue to purchase 100% of their volumes through Royal Mail and so would retain the benefit of the rebate, while end-to-end entrants would lose this rebate (above a certain level of expansion). As a result, Ofcom found that the proposed pricing policy had an exclusionary effect only on potential end-to-end delivery entrants. In support of this analysis, Ofcom identified internal documents from Royal Mail setting out the anticipated effect of the policy on end-to-end rivals. Royal Mail expected these competitors to limit their expansion to a small proportion of the market in order not to lose the benefit of the rebate.

[2] https://www.ofcom.org.uk/__data/assets/pdf_file/0022/124591/01122-infringement-decision.pdf

[3] The CAT has rejected Royal Mail's request for permission to appeal (in January 2020). It is unclear at time of writing as to how Royal Mail will respond.

Shutting the stable door

At the same time as opening a Competition Act investigation, Ofcom launched a review to determine whether it was necessary to reapply a regulatory regime to Royal Mail's access prices to reflect the new possibility of infrastructure competition. In a provisional decision published in December 2014, Ofcom set out proposed restrictions on Royal Mail's pricing practices.[4]

As it transpired, these proposals never took effect because Whistl exited the end-to-end delivery market in May 2015, citing regulatory uncertainty arising from the Competition Act case, which at that point was unresolved. In the event, Ofcom took a further three years to publish its decision. Ofcom had identified in its regulatory review that there was no other plausible end-to-end delivery entrant and so the question of an appropriate access regime was moot.

In praise of ex-ante regulation

This discussion questions the resolution of such disputes through competition law enforcement alone, from the perspective of either infrastructure entrants or incumbents.

- Entrants may often be considering investing substantial sums to develop rival infrastructure. As mentioned above, entry may still require reliance on access to incumbent infrastructure, hence affecting the costs of entry.
- Similarly, incumbents may also have concerns that investments they have made or plan to make in new infrastructure will be undermined in the event of a rival's entry, and that there may be a lack of clarity about what commercial responses are appropriate and compliant with competition law.

Since competition law cases typically take several years to bring (whether under Article 102 TFEU, the Competition Act or equivalent national legislation), both new entrants and incumbents will face uncertainty as to whether any particular behaviour on the part of the incumbent would be sanctionable. This is unsatisfactory from the perspective of both parties. Instead, it may well be more attractive for regulatory bodies to set out *ex-ante* ex ante the terms of access, or set out clearly how they plan to resolve any dispute related to these terms, if there is no agreement between the parties.

Resisting anything but temptation

Two possible conclusions can be drawn from the Whistl case.

- There is an economic incentive for an incumbent to try to exclude a newcomer, which, if combined with the ability to do so, may not be deterred by the existence of ex-post competition enforcement. Equally, from an incumbent's perspective, there is likely to be a sense of frustration that historic investments it has made will no longer yield the returns anticipated, that its assets may become stranded, and that there is a lack of clarity as to how it may respond from a commercial perspective.
- *Ex-post* competition enforcement may not be the optimal policy tool for dealing with such situations. Ofcom ultimately brought a successful competition action against Royal Mail and defended it on appeal in the CAT, leading to a substantial fine for Royal Mail. However, Whistl abandoned its attempts to develop a rival end-to-end delivery business in 2015, and no alternative infrastructure competitor has emerged or is expected to emerge.

It is not clear that this state of affairs is helpful to anyone – incumbents, entrants, or even regulators. Although the direction of regulatory travel over the last decade has been away from *ex-ante* regulation and towards *ex-post* competition enforcement, this issue would appear to be one where, depending on the circumstances of entry, *ex-ante* regulation may have an important role to play.

[4] https://www.ofcom.org.uk/__data/assets/pdf_file/0029/78248/royal_mail_access_pricing_review.pdf

David Parker

david.parker@frontier-economics.com