6 Views of the main parties

Contents

Page

Introduction

6.1. This chapter summarizes the views of the main parties provided in written submissions and at hearings. Neopost provided a main written submission on behalf of both main parties. Ascom also provided a written submission which supplemented Neopost's with views of its own. In response to our market questionnaire, Neopost submitted a response on behalf of both parties, but supplemented by information which concerned only itself, and similarly Ascom provided a supplementary response. The material submitted on behalf of both parties is included in the summary of Neopost's views set out in this chapter, and in the summary of Ascom's views we make clear which parts of Neopost's views also reflect Ascom's position. Each replied separately to a financial questionnaire we sent them, and the responses to those are reflected in Chapter 4.

The views of Neopost

The rationale for the transaction

6.2. Neopost told us that the merger would create a stronger rival to the dominant UK and global supplier, Pitney Bowes. Of the five major franking machine suppliers in Europe and worldwide, Pitney Bowes was by far the largest, with the biggest revenue base and the widest patent portfolio; it accounted for about 62 per cent of installed franking machines worldwide, and in 2000 for an estimated 50 to 60 per cent of UK sales, twice the sales of Neopost and AMS combined.

6.3. Neopost explained that Pitney Bowes had an 80 per cent market share in the USA and maintained a close association with the USPS which set the pace for change in the industry worldwide. The new range of Internet-capable, digital ink-jet machines that Pitney Bowes was set to launch later in 2002 and in 2003 would further strengthen its position in the market.

6.4. Neopost argued that the combined company would be able to offer a broader range of products, gain more brand recognition, cut manufacturing costs, rationalize R&D efforts, strengthen product development and become more efficient in marketing, distribution and production. The merger would boost price competition and innovation, particularly in new technologies.

6.5. Francotyp and Frama, which each accounted for an estimated 5 to 10 per cent of UK sales of franking machines, would continue to offer competitive alternatives in the UK market. Alternative forms of postage—including stamps, pre-stamped envelopes and bulk mail—as well as the operators likely to enter the postal services market following the liberalization of postal services, would all act as a constraint on franking machine prices.

6.6. Neopost argued that the concerns raised by the MMC in 1986 were no longer relevant (see Appendix 3.3). Prices had fallen; there was a high degree of price competition among the suppliers which would intensify after the merger; there was a rapid pace of technological change; Frama and Francotyp had significantly increased their shares of the UK market; postal regulations had changed, introducing independent maintenance providers; and postal liberalization would increase competition between different document delivery systems, which would have an impact on the use of franking machines.

6.7. Neopost argued that AMS was a strong, established supplier, committed to the franking machine industry. Its existing R&D programme and sales and service network would give synergies to the combined company from AMS's high levels of service, expertise in marketing in the public sector, and a range of products which would complement those of Neopost. A combined distribution network would also make the merged company more competitive with Pitney Bowes; and combined production volumes would lead to economies of scale and the possibility of negotiating lower prices from component suppliers. In addition, efficiencies by rationalizing the production of different models were likely.

Market definition

6.8. Both Neopost and Ascom said that, although there were low-volume, medium-volume and high-volume franking machines, the relevant product market included all franking machines. This was

because there was a high degree of demand-side substitutability between different franking machines and, while machines at the low and high ends of the volume range would not necessarily be regarded as substitutes, there was a chain of substitution between different volume segments.

6.9. For example, customers processing around 100 letters a day might choose either a low- or medium-volume machine, depending on price, usage patterns and other preferred features (for example, accounting systems). Similarly, customers who processed larger volumes of mail might use two medium-volume machines instead of one high-volume machine. As an example, Neopost said that it had recently started marketing two medium-volume ink-jet machines, rather than a single high-volume machine, to high-volume customers. Thus, any attempt to raise price in one volume segment would draw competition from another segment and have 'ripple effects' through all segments.

Alternatives to franking machines

6.10. Neopost outlined the alternatives to franking machines. These were mainly postage stamps and bulk (or 'permit') mail, although electronic transfers were becoming increasingly important. Electronic transfers might take the form of hybrid mail, whereby documents were transferred electronically, prior to being printed and delivered locally; or simply the use of email to send documents that bypassed the postal system completely.

6.11. Stamps and prepaid mail competed directly with the smallest franking machines sold to customers mailing around 10 to 20 letters a day. Many businesses currently used stamps and might be converted to become first-time buyers of franking machines. However, they were also the quickest to turn back to the use of stamps if franking machine prices increased. In the context of Royal Mail's current meter migration programme, significant numbers of franking machine users were estimated to have returned to stamps. Neopost believed that, in the event of the introduction of the euro, many low-volume users would turn back to stamps, as they would be unwilling to pay the cost of converting their small franking machines to the euro.

6.12. In the mid- and high-volume sectors, franking machine suppliers competed with bulk mail methods actively promoted by Royal Mail. These included the PPI system, in which companies pre-printed postage-paid envelopes. To qualify, a business had to spend over £5,000 a year on unsorted mail (around 70 letters a day, or 17,500 a year), or £4,000 on sorted mail (around 60 letters a day, or 15,000 a year). Royal Mail also operated a system, Packet Post, used for home shopping, in which customers could get a bulk mail contract for 5,000 or more packets a year for unsorted packets and 4,000 for sorted packets.

6.13. In 2001, Neopost told us that permit mail and other revenue accounted for 57.5 per cent of Royal Mail's total revenue, up from 33 per cent in 1997; and that during that same four year period, metered (ie franked) mail had decreased from 36 per cent of Royal Mail revenue to 23.5 per cent (see Table 5.5).

6.14. Neopost told us that bulk mail methods offered certain competitive advantages over franked mail. Postage rates might be up to 30 per cent lower than those applicable for franked mail, and Royal Mail offered customers credit facilities for 20- to 30-day periods, whereas it required payment of postage in advance for franked mail. These advantages were expected to increase, as the increasing use of digital technology by postal operators in the bulk mail system would provide greater accountability, and marketing information derived from customers would become increasingly important in a competitive postal services market. This would increase the level of competition between bulk mail and franked mail.

Postal liberalization

6.15. Neopost submitted that postal liberalization would put further competitive constraints on franking machine suppliers. At present, franking machines could be used to pay for postage only on Royal Mail services and not those run by other companies. Liberalization of UK postal services commenced in 2000 with the establishment of PostComm, which in turn licensed Consignia, the Government-owned company that owns Royal Mail, to provide postal services in the UK. Other companies could now apply for a licence to deliver mail in what was previously the reserved area of mail weighing under 350g and costing less than £1.

6.16. PostComm had granted licences to postal service providers other than Royal Mail. For example, Hays had recently been granted a licence to deliver first class letters in certain cities in the UK. Hays also offered another postage solution competing with franked mail: Hays DX Service, which was a document exchange service for business-to-business mail throughout Europe. Companies delivered mail to a local collection point where they could also collect incoming mail.

6.17. Neopost told us that Hays delivered over 1 million items a day and that Hays claimed users could save up to 30 per cent compared with Royal Mail postage rates. In addition, Business Post had been granted a licence as a postal consolidator to collect unfranked business mail in a number of locations around the UK, sort the mail and transfer it to Royal Mail for local delivery. This process would continue, as PostComm had just announced plans to remove all restrictions on market entry by 2006. Starting in 2002, the first phase would involve granting several new licences, exposing up to 40 per cent of the mail market (by volume) to further competition. From 2004, up to 70 per cent of mail (by volume) would be liberalized, and all restrictions would be removed by 2006. The current threshold for competing services of any item weighing more than 350g would be reduced to 100g by 2003 and to 50g in 2006, creating further opportunities for the growth of alternative systems.

6.18. The end of Royal Mail's monopoly on conventional postal services and the development of alternative document delivery systems meant that franking machines would have to meet competition from alternative postage solutions that these operators might provide. As new postal operators became licensed to collect and deliver mail, the amount of mail that was franked for delivery by Royal Mail was likely to decrease, as these operators would be likely to prefer contract payment schemes rather than franked mail. This would reduce demand for franking machines and would be consistent with experience elsewhere: Neopost said that in two recently liberalized markets, New Zealand and Sweden, demand for franking machines had fallen.

Changes since the MMC report

6.19. Recalling the conclusions of the 1986 MMC report (see Appendix 3.3), Neopost said that the UK franking machine market had changed considerably since then and was now significantly more competitive. Neopost made several points in support of this contention. These are set out in paragraphs 6.20 to 6.30.

Price levels

6.20. Whilst the 1986 report found that prices for franking machines had risen faster than the general price index, Neopost told us that the average price paid by customers since 1993, the period for which it had pricing records, had fallen. In addition, recent products had offered customers new technologies, new services and functions previously unavailable to them. In support of this contention, Neopost submitted information showing that Neopost's average achieved selling price had fallen from 1993 to 1995, then risen until 1999 before falling sharply to 2001.

6.21. Questioned about this, Neopost agreed that comparisons over time were difficult to make because of the range of different products sold and changes in the mix of sales. Where old models had been replaced by new ones, however, the replacement model tended to have a lower price. The reason for the fall in Neopost's average selling price in the last two years was the introduction and growth in sales of its new entry-level machine, the IJ25, which had a lower price, and offered fewer features, than any previous model. There had been increases in the prices of Neopost's larger machines but they had been marginal because of competitive pressure from Pitney Bowes.

6.22. For the market as a whole, the average selling price for franking machines since 1996 had remained relatively constant in nominal terms, according to FEI figures. Neopost said that the average selling price of a franking machine across the whole franking machine sector had been broadly constant over the period 1996 to 2001 when in a similar period—1995 to 2001—UK inflation, based on the Retail Price Index, had been 18.7 per cent.

Discounts

6.23. Discounts were now widespread. They were individually negotiated for each customer, and the range of discounts offered varied considerably. Some offered by Neopost were around [✂] per cent with an average of [✂] per cent for direct sales and more for larger customers. This compared with an average discount of only 5 per cent in 1986. About [✂] of transactions involved discounts, and a higher percentage for larger accounts.

6.24. Neopost agreed, however, that it was difficult to compare the present incidence and level of discounts with the position in the mid-1980s. (We note that the 1986 report referred to average discounts of 5 to 7 per cent for small users, but said that discounts of 20 to 30 per cent were common for large customers.[1])

Exchanging price information

6.25. Suppliers' practice of exchanging information about recently implemented price increases had been highlighted in paragraph 2.34 of the 1986 MMC report. Neopost said that the practice had ended before the report was completed and this sort of information had not been shared for about 15 years. This lessened the likelihood of price increases being followed and stimulated greater price competition. Other suppliers' list prices were relatively easy to obtain, but the high variability in discounts made it very difficult for competitors to find out what final prices were being paid by customers.

New technology

6.26. There had also, Neopost argued, been major changes in technology since 1986, starting with electronic machines replacing electromechanical ones and, more recently, the transition to digital technology. Whilst new products were being introduced in 1986, the pace of product development had been slow and piecemeal, with none of the companies having an entire range of revolutionary new products such as Pitney Bowes was about to launch.

6.27. The change from electromechanical to electronic machinery was not so fundamental or revolutionary as the current transition to digital and Internet-based technologies. Recent changes involved the companies concerned investing in R&D to market new models more quickly and provide a more up-to-date range, responding both to the evolving requirements of posts and the need to keep pace with new initiatives being developed by Pitney Bowes. This was another way in which the market had been reinvigorated.

6.28. The transition to digital technology entailed substantial investment to develop new products, and involved considerable skills, resources and partnerships with other industries, such as the computer industry. The timeframe for generating revenue from new products was also now much shorter because of the decertification process (see paragraphs 6.101 to 6.103 on meter migration), rapid development of technology and the need to match the new Pitney Bowes lines.

Market share changes

6.29. Despite this quickening pace of change, however, smaller competitors within the franking machine market were still unable to challenge Pitney Bowes effectively. After AMS entered the UK market in 1969, it had taken till 1986 to build its share of the market to 10 per cent. AMS's contracts with The Stationery Office—now lost to Pitney Bowes—had been a key factor together with sales of its mechanical machines which were now being decertified. More recent entrants to the UK market, Frama and Francotyp, had together increased their combined share of the market since 1986 to about 10 per cent. Neopost itself had suffered a decline in share of sales over this period from 37 per cent down to 21 per cent in 2000, although there had been an upturn in 2001. At the same time, Pitney Bowes had moved from 50 per cent to between 50 and 60 per cent.

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[1]See paragraphs 9.31 and 9.32 of the 1986 report.

Royal Mail regulations

6.30. Finally, Neopost explained that, since the 1986 report had concluded that some of the Royal Mail regulations were having an anti-competitive effect by conferring an advantage on established suppliers, there had been changes in the regulations and Royal Mail had authorized independent companies to inspect, repair and maintain franking machines, thereby increasing competition in the market. Moreover, new forms of delivery were likely in the near future with the imminent liberalization of Royal Mail, as set out in paragraphs 6.15 to 6.18.

Stronger competition with Pitney Bowes

6.31. Neopost stressed the current dominance within the market of Pitney Bowes and argued that the merger would allow this leadership role to be challenged by the combined company. Neopost told us Pitney Bowes had spent about £80 million on R&D in 2000 and planned to assume a £172 million pre-tax charge as it migrated to a new technological standard of networked mailing systems. This latter sum was almost [✂] times Neopost's entire annual R&D budget. Pitney Bowes' new range, to be introduced in 2002 and 2003, comprised at least ten new products covering the entire spectrum of franking machines. Neither Neopost nor AMS currently had a full range of products that could compete head-on with this new generation of machines.

6.32. The most significant factors in Pitney Bowes' dominance of the franking machine industry were its large patent portfolio, heavy R&D spending, high brand recognition, full range of products, large distribution network and efficiencies of scale. The merger would allow Neopost/AMS to challenge Pitney Bowes more effectively for leadership (see paragraphs 6.4 and 6.7).

6.33. In the UK, Neopost currently had only around 40 per cent of the turnover of Pitney Bowes, but had a sales force about [✂] the size: this demonstrated Pitney Bowes' advantage in successfully marketing its products and reflected the lower brand recognition of Neopost. The merger would give Neopost a larger sales network in more countries worldwide, enabling it to provide greater coverage and compete more aggressively with Pitney Bowes. The merger would also give Neopost a larger number of machines installed and a stronger range of products. Neopost was authorized to use the Ascom brand only for a limited period of time post-merger, and intended to conduct all business under the Neopost brand in the future.

6.34. The merger would enable Neopost to devote its resources to raising the profile of a single brand across a full range of franking machine products and customers in the UK, strengthening the reputation and recognition of the Neopost brand, offering customers a sizeable and more effective alternative to Pitney Bowes, and in turn improving quality and prices.

6.35. The merger would allow Neopost to combine its R&D budget with AMS's, enabling it to focus resources and develop a global R&D strategy to create the next generation of digital products. Neopost could achieve economies of scale, lower its production costs and spread product development costs over a larger volume of sales.

6.36. These improvements would enable Neopost to offer a sizeable alternative to Pitney Bowes, particularly in new product development. The merger would help put an end to the current situation, where there was one dominant company with control over leading-edge products.

Licence agreements with Pitney Bowes

6.37. Neopost described how Pitney Bowes had developed an important portfolio of IPRs, with by far the largest number of patents—over 3,300—in the franking machine industry. Many of these patents related to broad concepts rather than specific technological improvements. Smaller competitors were frequently dependent on these patents, needing to enter into cross-licensing arrangements with Pitney Bowes to produce competitive machines. This allowed Pitney Bowes to impose costs on its competitors, including the costs of defending and settling even questionable patent infringement claims.

6.38. Pitney Bowes had also worked closely with the USPS to develop standards that would apply to the next generation of franking machines. Pitney Bowes was the only franking machine supplier represented on the steering committee of the USPS's Mailing Industry Task Force, and was therefore better able than any of its competitors both to influence and to be aware of the new technologies that would be mandated by the USPS. Pitney Bowes habitually claimed patents over the technology which resulted from developments led by the USPS.

6.39. As an example, Pitney Bowes had claimed patents over technology surrounding the new IBI postmark specified by the USPS, a technology that all competitors would need to rely on if and when the new technology was adopted globally by postal regulators. In the UK, Neopost mentioned that new digital postmark specifications were being discussed by Royal Mail with a view to implementation in the next five years. As a result, Neopost expected to encounter similar problems with Pitney Bowes in the UK over IPR infringement to those currently being experienced in the USA.

6.40. The merger would enable Neopost and AMS to combine their patent portfolios and research capabilities, and hence to negotiate more favourable licensing arrangements with Pitney Bowes or to navigate around Pitney Bowes' patents.

6.41. We asked what use Pitney Bowes had made of the provision—mentioned in the 1986 MMC report—allowing it to select up to eight patents developed by Alcatel/Neopost at any time up to 2020 and require non-exclusive licences to exploit them. Neopost told us that the two agreements referred to had been amended in 1993. They covered North America and the rest of the world respectively. Both would now terminate in December 2002, although any non-exclusive licences taken out on selected patents as a result of the agreement would continue for the lifetime of the patents concerned.

6.42. Neopost told us that Pitney Bowes had options to select up to eight of Neopost's 400 patents. Of Pitney Bowes' 3,300 patents, Neopost had options to license up to three in the field of franking machines, and five patents in total. Neopost told us that the Pitney Bowes patents would not give it any material benefit in the future due to the significant changes in technology and postal requirements. Pitney Bowes had claimed several new patents which were not covered by the licensing agreement. Neopost would continue to incur costs in developing solutions that worked around Pitney Bowes' patents or would have to negotiate further licence arrangements.

Tacit coordination

6.43. In further written and oral submissions, Neopost supplied the results of work done for it by Frontier Economics on tacit coordination. The main arguments of the Frontier Economics study were that tacit coordination was unlikely to develop in the franking machine market because of the lack of product homogeneity; the absence of price transparency; the high degree of technological innovation and competition from non-franking alternatives such as stamps and bulk mail; and the fact that there would be a variety of parameters of competition. These market characteristics suggested that firms in this sector would find it hard to develop tacitly a mutual understanding of the aspects to be covered by a coordinated arrangement. These arguments are set out in more detail in paragraphs 6.44 to 6.48.

6.44. Firms had several alternative dimensions on which to compete—sales effort, service and new technologies—and it would be difficult to develop an agreement based on all these.

6.45. Products were heterogeneous and product development was continuous, adding to the complexity of forming an agreement. Franking machines ranged widely in price, currently from £400 to £18,000, and included any number of extra features, including automatic weighing systems, accounting systems, bar-code scanners, and software systems to connect to the customer's business, the supplier or the postal carrier. Even within the same size segment, machines had many different features. Introducing a new generation of machines incorporating new digital technologies such as ink-jet printing, IBI and Internet connections had created even further product differentiation. Moreover, they were sold on different terms by each supplier including purchase, rental and lease terms involving different contract lengths, service contracts and guarantee periods, and were often supplied together with other mailroom equipment and software systems. Thus, there was significant scope for differentiation in terms and conditions of supply as well as in products.

6.46. Customers were heterogeneous, and there was no obvious division of customers by which a 'customer-sharing' agreement could be formed. In addition, around 10 per cent of machines were sold by competitive tender to corporate and public sector customers, who used considerable countervailing buyer power to obtain significant discounts off list prices.

6.47. Liberalization would add to uncertainty about future developments and would further increase the competitive challenges and opportunities faced by suppliers of franking machines. As mentioned above, in the next few months, Postcomm was expected to grant licences to new postal service providers enabling them to compete to collect and/or deliver up to 30 per cent of mail in the UK. The volume of franked mail was likely to diminish as a result, as would the demand for franking machines. At the same time, these changes might create opportunities for suppliers to offer innovative franking products to the new postal service providers, thereby opening up a new niche in the market. Smaller suppliers in particular might benefit considerably from these opportunities. For example, Neopost told us that Francotyp had already sought to exploit these changes by developing new features on its franking machines which were designed to allow users to process mail both for Royal Mail and for independent service providers. This trend could be expected to continue as further changes to the postal delivery market created opportunities and challenges for franking machine suppliers.

6.48. Information about prices was not shared among the players in the market. Although franking machine suppliers had list prices, sales agents were given considerable discretion to negotiate discounts, and machines were rarely sold at actual list prices. Suppliers, therefore, did not have ready access to information about the competitors' actual market prices, and could not easily detect price cutting by a competitor.

Competition between Neopost and AMS

6.49. Neopost also provided us with the results of a survey which Frontier Economics had carried out of Neopost's sales force. It asked about the bidding process for franking machine contracts during the first quarter of 2002. One hundred and sixty-five questionnaires were completed by Neopost salespersons. The key results were that:

— Neopost mainly competed against one or two rival bidders.

— In the sample of cases Neopost had [✂] AMS as its only rival bidder. In most cases where there were only two bidders Pitney Bowes was the other supplier involved.

— Introducing the first rival bidder seemed to be the main competitive constraint on Neopost's pricing, in terms of discounts offered.

— Adding further rivals did not significantly alter the discount offered.

Further information about this survey is given in Appendix 5.2.

Benefits of merger

6.50. Besides being able to challenge Pitney Bowes more effectively, Neopost saw other benefits from the merger.

Complementary strengths

6.51. Neopost would benefit from marketing its products to high-volume users and in providing the high level of service that AMS customers expected. Moreover, AMS had a skilled sales force in marketing in the public sector, where Neopost had not been so successful. On the other hand, AMS currently lacked a very low-volume product offering, and when its digital products were launched, it would lack a medium-volume machine. Neopost could fill these significant gaps. The parties would also benefit from combining their respective IPRs, giving them the possibility of marketing a wider range of products and the opportunity to develop new technology within the scope of these existing patent rights.

Distribution

6.52. Neopost drew attention to Pitney Bowes' distribution system which was many times larger than either Neopost's or AMS's. In the USA, for example, Pitney Bowes had [✂] direct sales representatives compared to Neopost's direct sales force of [✂] and distributor network of [✂], and AMS's direct sales force of [✂] and distributor network of [✂]. In the UK, Pitney Bowes had around [✂] direct sales representatives (including those bought in with the acquisition of Secap), while Neopost had [✂] and Ascom had [✂]. Although a combined Neopost/AMS would still be a fraction of the size of Pitney Bowes globally, it would be better placed in the UK to use the greater coverage of the combined distribution network to compete for business at Pitney Bowes' accounts.

Scale efficiencies

6.53. Neopost reminded us that Pitney Bowes' scale gave it considerable efficiencies in the production of franking machines and related products. After the merger, Neopost saw a combined Neopost/AMS having production volumes [✂] per cent higher than Neopost had at present, which would allow Neopost to place larger orders with component suppliers and give it the potential to negotiate lower prices from suppliers. The larger production volumes would also lead to lower per-unit production costs. Moreover, as a result of unifying and rationalizing the product ranges, Neopost would reduce the number of models that had to be separately certified by posts around the world.

6.54. Neopost expected that, as a result of these cost savings, it would be better able to produce machines that were customized with integrated features that were better adapted to particular models. Neopost would also be able to reduce sales costs, as it would be able to sell combined products in fewer sales visits. These advantages were already enjoyed by Pitney Bowes, and the merger would give Neopost better scale efficiencies, making it more competitive with Pitney Bowes.

6.55. In addition, Neopost expected to achieve greater efficiencies in the production of AMS models. Neopost currently sourced its low-volume machines from China and assembled its medium- and high-volume machines in France. This allocation of production allowed Neopost to achieve the lowest-cost, most efficient production. After the merger, Neopost would seek to bring these efficiencies to the production of AMS models, although there were as yet no precise plans on this.

Geographic expansion

6.56. While both Neopost and AMS were present in markets worldwide, there were several geographic markets, such as Germany, Switzerland, Austria, Spain and Japan, where Neopost was either not present or had only a minimal presence. The merger would allow Neopost to expand its operations into these markets.

Independent companies and dealerships

6.57. Neopost informed us that most of its UK sales were made by its direct sales forces, supplemented by some business through dealers in Northern Ireland, the Channel Islands and the Isle of Man. In 2001, dealerships represented only 1.4 per cent of Neopost's mailing systems revenue. Neopost also had a mainland dealer for its entry-level IJ25 model on an experimental basis (see paragraph 6.60).

6.58. [

Details omitted. See note on page iv.

]

6.59. Neopost said that, in the UK, Royal Mail had to authorize independent suppliers of franking machine maintenance. It had recently authorized FMCS and NFS to inspect, repair and maintain two Secap models. Neopost had also heard that FMCS had recently been authorized to provide maintenance for any franking machines supplied by any firm. The views of these companies are set out in Chapter 7.

6.60. In response to questions we put to Neopost, [

Details omitted. See note on page iv.

].

Leasing

6.61. Neopost told us that many customers preferred leasing office equipment, and had done for more than 25 years. The trend had been driven initially by generous capital allowances, which could be used by leasing companies and passed on to customers through the leasing rate, and by the opportunity to finance assets off balance sheet.

6.62. Although this situation had changed over time, especially on capital allowances, customers continued to use the lease finance method: they valued access to finance at the point of sale; the ability to preserve credit lines for working capital requirements; the ease of budgeting for periodic rentals; and the convenience and control associated with a single supplier for both equipment and finance. If dissatisfied with either product or service, the customer was able to withhold payment and so directly impact the product and service supplier.

6.63. Other benefits to customers included the convenience of upgrading to enjoy the benefit of product innovation where this occurred before expiry of the initial term of the agreement.

6.64. For Neopost, there were cash-flow benefits, in that non-lease customers took longer to pay whereas payment from a leasing company was virtually instant. Title to leased equipment was retained by Neopost, which could offset capital allowances against taxable profits. Financing could be done through its leasing subsidiary, Neopost Finance Ltd, giving Neopost a direct dialogue with its customers and a direct control over its sales force. Finally, there were benefits in terms of the additional income stream from its own leasing company rather than having this accrue to a third party.

6.65. Neopost provided us with details of its methods of supply to customers. In 2001, by number of machines, [✂] per cent were leased, [✂] per cent purchased and [✂] per cent rented. [✂] per cent of the value of invoiced orders excluding rentals was derived from leased machines and [✂] per cent was derived from purchases. This contrasted with AMS's sales where only [✂] to [✂] per cent were leases, [✂] to [✂] per cent were outright sales and [✂] per cent were rentals. The reasons for this difference are due to AMS's different approach (see paragraphs 6.105 and 6.106).

Effect on UK market

6.66. Neopost argued that, post-merger, strong competition would remain across the full range of products. Within the volume segments of the market, there was a chain of substitution. At the very low-volume end, competition with stamps would remain strong. Volumes of up to 50 letters a day could easily be substituted with stamps, and roughly 60 per cent of machines were sold to users with daily mailing volumes at this level. Within the lowest-volume range, Neopost offered an entry-level machine (IJ25) to compete against the best-selling product offered by Pitney Bowes (Personal Post). Both Frama and Francotyp had entry-level machines based on new ink-jet technology. AMS was the only supplier not to have a machine in this segment.

6.67. At the next level, the low-volume segment, all manufacturers had numerous product offerings. Machines in this segment might also be substituted by entry-level machines for customers with volume requirements at the low end of this segment. In addition, customers with higher mail volumes, or who preferred to have extra features not available on some low-volume machines, such as sophisticated accounting software or ink-jet printing, might choose to buy a medium-volume machine instead.

6.68. Similarly, in the medium-volume range, all the manufacturers had product offerings, although AMS did not have machines to compete with the new products being launched in this segment. Machines here would continue to compete with the larger low-volume machines, and higher-volume users might consider one of the machines from the upper end of the medium-volume segment, depending on the facilities offered.

6.69. At the high end of the volume range, Pitney Bowes, Neopost and AMS accounted for most of the machines installed. However, while both Neopost and AMS were established competitors in this segment, AMS had historically had greater success than Neopost, particularly with public sector clients and large institutions. This segment faced strong competition from Royal Mail's Packet Post and various bulk-buy mail services, which had certain competitive advantages (see paragraph 6.14).

6.70. There had also been new entrants to this segment. Frama had recently developed the Mailmax II, a new high-volume ink-jet machine. Francotyp, while already having two models in this segment, now offered its new Jetmail Concorde ink-jet machine to higher-volume customers. These market developments meant that this segment of the franking machine market was becoming more competitive. The process of liberalization would also encourage competition in the provision of mail services, as the bulk mail system provided Royal Mail with a valuable source of marketing information which would become increasingly important in a more competitive postal services market. Other postal providers would also develop their own bulk mail systems to compete with franked mail and with Royal Mail's bulk mail services. High-volume users, such as Government departments and large corporate customers, put out competitive tenders for a single supply contract or supply over a period of time. These customers were sophisticated purchasers of office equipment and understood well the dynamics of competition between suppliers of franking machines. So this end of the market would also remain very competitive.

Smaller companies would still be able to compete

6.71. Neopost argued that Francotyp and Frama, the two smaller companies in the market, would continue to compete vigorously across much of the franking machine product range, as well as in national and niche markets, offering a mixture of leading and non-leading edge technology focused on specific segments. Neopost would continue to pursue a policy of supplying new products to its smaller competitors to sell under their own names, thereby filling gaps in their product lines and further strengthening their presence in the market.

6.72. Francotyp's main markets were Germany (the second largest market in the world) and Austria, where it was the market leader with 52 per cent and 43 per cent respectively of machines installed. Francotyp sold largely the same models across Western Europe, where it had a larger share of the installed base than AMS, at approximately 20 per cent. In the UK, Francotyp now had its own office and marketed through a network of local dealers. It had almost doubled its share of machines installed in the past five years from 2.5 per cent of machines installed in 1995 to 4.5 per cent in 2001. Francotyp was a global supplier of franking machines with a good reputation for its technology. Since 1998, Francotyp products had been recommended in *What to Buy for Business* magazine as 'Best Buy'. In particular, Francotyp's ink-jet machines (the small/medium-volume Jetmail and the higher-volume Jetmail Concorde) had both been recommended as Best Buy. Ink-jet printing was required for the next generation of digital technology franking machines and the new IBI postmark. Francotyp had also been particularly successful in the low-volume segment with its newer T1000 model.

6.73. Similarly, Frama was also active in many markets across the world. It was the market leader in the Netherlands with 33 per cent of machines installed, had 27 per cent of machines installed in Switzerland, and its position had been improving in the UK. The company was a long-established supplier of franking machines with the expertise and resources to develop advanced technology and supply a range of small, medium and large franking machines. Frama machines had been recommended as Best Buy in *What to Buy for Business* in both 2000 and 2001, and Frama had recently started selling new ink-jet machines, supplementing its low-volume product range. Frama had also entered the high-volume segment by developing a new high-volume ink-jet machine. This was a volume range in which Frama had not previously been active, and suggested that Frama would become a more robust competitor with a broader product offering based on new ink-jet technology.

Strategy over next five years

6.74. We asked Neopost how it saw itself developing over the next five years. In response, it pointed to the evolving technological changes over the last 15 years. Its strategy over the next five years was to support the evolving requirements of postal operators worldwide whilst providing more added-value solutions to a wide variety of customers. To achieve this, Neopost had raised its investment in R&D in the last few years.

6.75. Worldwide, it aimed to increase turnover by increasing geographical coverage; [

Details omitted. See note on page iv.

].

6.76. In the UK, Neopost's strategy [

Details omitted. See note on page iv.

].

6.77. Asked about the effect of the merger on pricing, Neopost said that there would not be an immediate effect because it wanted to concentrate first on securing the synergies from the merger. In the longer term prices could be expected to fall because the merger would enable the combined group to compete more aggressively with Pitney Bowes.

Effect on folders/inserters market

6.78. Folding and inserting machines are described in more detail in Chapter 3. In 2000, according to Neopost, around 1,200 machines were sold in the UK, with a total value of about £20 million. Neopost designed and assembled machines only in the lower segment of this market—machines valued below £21,000. AMS did not make folders/inserters but obtained lower-volume machines from PFE and sold them under its own brand name.

6.79. Neopost argued that the merger would have no material effect on the sales of folders/inserters in the UK market as AMS did not produce these machines; moreover, UK sales of inserting machines sold under the Ascom brand name accounted for only around 3.5 per cent by volume of UK sales in 2001. Pitney Bowes would remain a strong seller of these products. Even without AMS, PFE had alternative routes to market through its own sales network, dealers, etc—Neopost and AMS estimated that AMS's sales of PFE machines in 2000 amounted to less than 5 per cent by volume of PFE's total UK sales and between 5 and 10 per cent of PFE's sales globally. There was no reason why PFE machines today sold under the Ascom brand should not be marketed by companies other than AMS.

6.80. Overall, the main parties argued that the merger would not have a significant effect on the distribution of PFE's products in the UK or elsewhere.

Possible remedies

6.81. We asked Neopost how it would react to there being a requirement for it to supply franking machines at wholesale prices to firms wishing to enter the market as distributors or dealers. Neopost said that it favoured the use of dealerships in some specific cases where they could offer added value, mainly at the lower end and in particular geographical areas. A general requirement to supply dealers could lead to inefficiencies, however, because of the need for Neopost to spend resources on training dealers and setting up an administration to manage dealers in order to ensure that they performed the same functions at a local level as Neopost itself. In addition, a general requirement for dealerships might change the focus away from competing against Pitney Bowes and move it more towards dealers competing with each other. [

Details omitted. See note on page iv.

]

6.82. We also asked Neopost's reaction to the idea of dealers being able to supply products from more than one company. Neopost was sceptical that this could work because much of the success of dealers depended on building a relationship with a supplier to gain customers; and the servicing element meant that dealers had to have specialized knowledge of the machines. It could be costly for them to acquire this knowledge and stock the parts needed across several ranges of products by different suppliers.

6.83. Neopost was more sympathetic to any proposal to help maintenance companies fulfil Royal Mail requirements provided always that the companies concerned were creditworthy, committed to the business and willing to put in the resources needed.

6.84. On the issue of potentially making its customer database available to others, Neopost could not envisage releasing such a valuable asset which had taken years to build up. If such a condition were to be imposed, [*Details omitted. See note on page iv.*]. In addition, there was always the possibility of the database falling into the hands of Pitney Bowes and so having an adverse effect on competition.

6.85. Although this was not a possible remedy for any adverse effects of the merger, Neopost believed that if Consignia gave discounts for the use of franking machines, as happened in France and Sweden, that could help grow the market and make it more dynamic. Potentially, 2 million businesses could be interested in buying franking machines, but currently only 200,000 were installed compared to, say, 280,000 in Germany.

6.86. Neopost confirmed that it intended to go ahead with the full acquisition of AMS if cleared to do so following our inquiry. If it were to be prohibited from acquiring AMS's UK business, it would still be interested in acquiring the rest of AMS.

6.87. On the possibility of its being required to provide to another company the rights to manufacture one or more of the products of the merged group, Neopost told us that this could be a complex issue involving Pitney Bowes as well as Neopost itself (because of the technology licensing arrangements which it had with Pitney Bowes).

The views of Ascom

6.88. Ascom told us that it agreed with the main submission which Neopost had put to us explaining the rationale for the transaction, summarized in paragraphs 6.2 to 6.7. It provided additional submissions on its own account which are summarized in the rest of this chapter.

The rationale for the transaction

6.89. Ascom told us that following a reorganization of its senior management team, including the appointment in May 2000 of a new Chairman, Ascom took a strategic decision to redefine the group's core business and divest activities that did not fit into the core business.

6.90. The decision was taken following a review in 1999 by Arthur D Little of all of Ascom's business units. A strategy proposal, under which AMS would be sold, was presented by the executive board to the board of directors on 28 August 2000 and agreed. Under the agreed strategy, AMS—representing the mailing systems business of Ascom—did not form part of the five core business areas in which Ascom had decided to concentrate. These core business areas were: telecommunications networking; enterprise communications; power supply; powerline communications; and transport revenue systems.

6.91. The decision was taken in light of the need to invest a high level of spending in R&D to develop new products for the mailing systems business. AMS did not have that capability which meant that those digital products which it had developed would be 'late to market' and would not cover all market segments. The board of directors of Ascom did not consider that the significant additional funding needed to maintain AMS's customer base and keep AMS viable in the medium to long term could be justified in the light of Ascom's new strategy and market conditions.

6.92. The board of directors considered that a merger with Neopost was the only way that the combined entity could obtain sufficient critical mass to justify the expenditure on R&D and product development necessary for it to compete with Pitney Bowes in the medium to long term. Neopost was the only bidder in the auction process that offered the opportunity to combine R&D expenditure on franking machines and spread the cost and risk of the expenditure over a larger installed customer base. None of the other bids was a realistic alternative to Neopost and, in the board's view, there were no other potential purchasers who could ensure that AMS remained a viable player. The board therefore decided that the sale to Neopost was the only way of assuring a secure future for AMS's customers and employees, both in the UK and worldwide.

6.93. Ascom's share price had fallen from CHF 126.5 per share a year ago to around CHF 19 per share at the end of January 2002. It had a heavy debt burden, and in December 2001 it had been obliged to obtain a bridging loan totalling CHF [✂] from several banks in order to repay a bond. [*Details omitted. See note on page iv.*] As a result, Ascom was not able to commit any resources to securing the future of a non-core business. Indeed it now had an urgent need to realize cash from the divestment of AMS.

6.94. The original decision to divest AMS had been for strategic rather than financial reasons, however, and stemmed from the evolution of the global franking machine industry; the dominance of Pitney Bowes; difficulties of product development; intellectual property problems; changes in the global mailing industry; meter migration; and the effect on AMS of the acquisition of Secap by Pitney Bowes. Ascom's views on these aspects are set out in paragraphs 6.95 to 6.104.

Evolution of the global franking machine industry

6.95. Ascom told us that the global franking machine industry was in a state of evolution, the pace of technological change was increasing and 'time to market' for new products was increasingly important. This was due to the decertification of franking machines using older technologies (instigated by the USPS and followed by other national postal regulators, including Royal Mail); and the competitive pressure from Pitney Bowes to innovate, in particular by the introduction of digital technology, new printing technologies (such as ink-jet printing), networking and software-based solutions and, in the near future, the introduction of franking machines with Internet connectivity. The combination of these factors was leading to shortened product life cycles and higher development costs, as well as expenditure on product replacements.

Dominance of Pitney Bowes

6.96. The market for the supply of franking machines and other mailing equipment was dominated by Pitney Bowes, both globally and in the UK. Pitney Bowes had offered a wide range of digital franking machines since early 2001 (having brought its first digital machine to market in 1997) and in 2002/03 was due to launch an entirely new range of Internet-capable digital ink-jet franking machines (AMS had not even started developing an equivalent range). It was the technology leader in the production of franking machines and had the widest-ranging patent portfolio, which it aggressively enforced. It had the largest revenue base and the lowest cost of production of all franking machine suppliers, together with financial strength unparalleled in the industry. It also had the strongest brand recognition in the industry.

Difficulties of product development

6.97. AMS's existing range of electronic postal franking machines was being overtaken technologically by the introduction of machines based on digital technology. Following a period of significant investment, AMS was only just reaching the end of the development phase for the first three of its digital franking machine products. Due to a lack of R&D capability and resources, these products were late to market and, notwithstanding the significant investment by AMS, were not differentiated from other suppliers' products and did not cover all market segments. AMS had not yet launched any of its digital products in the UK. Each product had to be adapted to meet the certification requirements of the countries in which it was to be supplied, entailing further investment in product modification. AMS also needed further funds for product development to expand its product range. The product modification and development costs were not one-off items of expenditure—they were ongoing and recurring. In addition to these costs, AMS faced increasing costs for production tools (which would have to be spread over smaller numbers of units as product life cycles shortened even further).

Intellectual property problems

6.98. AMS also risked [*Details omitted. See note on page iv.*]. Pitney Bowes had claimed ownership of the IPRs in key parts of the technology required to manufacture digital franking

machines and had a wide patent portfolio covering many other aspects of franking machine manufacture. There was considerable concern that [*Details omitted. See note on page iv.*].

Changes in the global mailing industry

6.99. The global franking machine industry was also facing increasing pressure from a number of other directions. This pressure was coming from other technological advances (for example, the use of email as a means of communication and of transferring documents and information); from existing substitutes for franking, notably through the offer of bulk-mail discounts, which were being increasingly promoted by postal operators including Royal Mail; and, in future, from Internet-based postage solutions.

6.100. The market was set to become even more dynamic in the UK and other EC member states as the liberalization of the postal services market was completed. This would result in an increasing need for incumbent postal operators to compete for customers, with the risk that they would opt for revenue collection techniques other than franking. Another area of change facing the mailing equipment industry was the rise in the volume of parcel shipping due to the increasing use of e-commerce, which had opened up a new market for supply chain execution systems which allowed senders to track delivery of parcels. AMS had not had the funds to be able to enter this market.

Meter migration

6.101. In the UK, Royal Mail's meter migration policy meant that, as at March 2002, approximately [✂] per cent of AMS's installed base of franking machines (about [✂] machines) would have to be replaced by September 2002. To achieve this timetable, AMS would need to employ and train new sales staff, as well as new service engineers to carry out installations of replacements for the decertified machines, provide customer training and ensure that the new machines were operational. Ascom did not consider that the additional capital expenditure required to increase the workforce was justifiable, and consequently AMS would have to carry out the programme using its existing workforce, which almost certainly meant that the timetable would not be met. Accordingly, AMS risked the loss of a significant proportion of its installed UK customer base when the machines were decertified.

6.102. AMS had been more severely affected than its competitors by meter migration because of its greater dependence on machines using old, electromechanical technology and the fact that a high proportion of its customers, having bought their machines outright, kept them for longer than customers that entered into lease agreements. 80 per cent of its installed base had been affected when the policy was first announced in 1997.

6.103. The sale of AMS to Neopost offered the opportunity of access to Neopost's sales and service organization to help AMS meet the challenge posed by meter migration. If the sale were not permitted, AMS considered that the majority of its customers with decertified machines would be likely to switch to Pitney Bowes machines, further strengthening the latter's dominant position.

Effect of Secap acquisition

6.104. The recent acquisition of Secap by Pitney Bowes would adversely affect AMS. This acquisition increased Pitney Bowes' dominance of the market. AMS was party to a joint development project with Secap which had now been completed. Resources and costs had been [✂] basis in the development of a low- and a mid-range digital franking machine. However, the project had failed to meet AMS's expectations and neither of the products had yet been launched commercially in the UK. Secap was not expected to continue to manufacture these products following its acquisition by Pitney Bowes. This would affect AMS's cost position because the decreased demand for components would inevitably raise prices for those components. Pitney Bowes had also gained access to any intellectual property created as part of the joint project, further reducing AMS's ability to differentiate its products from Pitney Bowes' in future. The opportunity to enter into further R&D joint ventures with Secap had passed and AMS had lost an important customer: Secap was AMS's distributor in France, with annual purchases of about CHF 4 million (£1.6 million).

AMS's distinctiveness

6.105. AMS told us that, instead of competing head-to-head with Pitney Bowes on price alone, it had put a strong emphasis on customer service. Customer care was at the heart of its organization. Its first-line customer care was handled by its call centre where staff were trained to help customers by phone if possible but could also mobilize an engineer when needed. With around 62 service engineers round the country, it offered an 8-hour response to most mainland locations. Its service team had competence in a wide range of mailroom products. AMS had built up a reputation for the reliability of its machines. It had also sought to portray itself as offering fair dealing. The franking machine industry had in the past been criticized for its sales practices, particularly in relation to leasing and rental. Ascom had sought to give customers informed choices between leasing and outright purchase, and then to develop a relationship with them based on reliability and good servicing. In practice, a much higher proportion of its machines had been bought outright, rather than leased.

6.106. These qualities would be a complementary strength for the merger with Neopost. In addition, AMS's sales force had had particular expertise over a long period in marketing in the public sector, an area where Neopost were not so strong.

6.107. We asked Ascom about two recent changes in its trading practices which, it had been suggested to us, appeared designed to bring its terms more into line with Neopost's. These concerned the practice of enforcing Ascom's contractual right to terminate a lease at the end of the initial term (see paragraph 3.90), and reducing the number of free recredits, after the first year, from twelve to six (see Appendix 3.1). Ascom said these changes had been made for ordinary commercial reasons, namely a perceived need to improve AMS's financial performance, and not in order to align its practices more closely with Neopost. It provided documentary evidence indicating that the relevant decisions were taken before Ascom entered into negotiations with Neopost for the sale of AMS in August 2001.

Other bidders as alternatives to Neopost

6.108. Ascom told us that, soon after the August 2000 board decision that AMS, as a non-core business, should be divested, AMS had approached Francotyp to discuss a possible merger of the two franking machine suppliers. [

Details omitted. See note on page iv.

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6.109. At that point Ascom decided to arrange a private auction in order to sell AMS.

6.110. Apart from Neopost, three other parties had been formally invited to make an offer to acquire AMS as part of an auction process in summer 2001. All of these were financial bidders that had in mind, in conjunction with AMS's existing management team, to undertake a management buyout of AMS, using a mixture of private equity and debt finance. Of these, one made an indicative offer but proceeded no further.

6.111. The second bidder made an offer in the form of an outline letter only. It appeared to Ascom's board that this bidder had made only a cursory review of the data room and that its offer was in a very preliminary form given the transaction timetable. Overall, the board considered that the probability of closing a deal with this bidder seemed unlikely.

6.112. The third bidder had made a higher indicative offer than Neopost, but it was not granted a period of exclusivity by Ascom. This issue is discussed in more detail in Chapter 4.

6.113. In Ascom's view there were no other viable purchasers for AMS. Pitney Bowes had expressed interest informally in acquiring AMS but Ascom believed that Pitney Bowes would not be permitted to do so. [✂] had made enquiries but when it was informed of the price which Ascom hoped to obtain for AMS the discussions ceased. Companies operating outside the franking machine industry, for example providers of office supplies, were thought unlikely to be interested because mail franking was a

niche business selling a low volume of products and was dominated by Pitney Bowes. Ascom received two expressions of interest from such companies (including [✂]) but did not believe them to be realistic options.

Possible remedies

6.114. We asked Ascom about the hypothetical remedies, particularly about what would happen if the sale fell through for any reason. Its position was that it would attempt to divest AMS to another buyer.