7 Views of third parties

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Franking machine manufacturers

Frama (UK) Ltd

7.1. Frama said that it was a private company and the wholly-owned subsidiary of Frama AG, its Swiss parent company. Frama AG had been manufacturing franking machines and postal systems for just over 30 years and now supplied to over 60 countries, mainly in Europe. It employed around 150 staff worldwide. Frama (UK) Ltd was established in 1990 to supply and distribute franking systems and related products and to service them in UK. It had about 30 employees. The UK was probably Frama AG's third largest market.

7.2. Frama reported that its share of the UK installed base of franking machines was around 4.5 per cent. After starting off with a dealer network, five or six years ago Frama started to undertake some direct sales itself in certain areas of the country. Now around 60 per cent of sales were through dealers and the other 40 per cent were sold and serviced directly.

7.3. Frama was not opposed to the proposed merger and did not think it would have a particularly detrimental effect on Frama's business or that it would make it any more difficult to compete in the market. Frama was unlikely to withdraw from the UK because the UK arm formed a large part of Frama AG's business. Frama judged Neopost to be in the same league as Pitney Bowes in terms of sales tactics, prices, sales force and marketing. Frama came across AMS less frequently.

7.4. Frama classified franking machines into three segments: small office machines capable of up to 2,500 impressions an hour; mid-range machines capable of about 3,000 to 5,000 impressions an hour; and high-volume machines. Frama supplied all three segments of the market with machines manufactured in Switzerland by Frama AG. Frama thought that customers were likely to keep their franking machines, once they had acquired them, though the market was more price sensitive for low-end machines. Royal Mail's meter migration policy caused some customers to revert to using stamps because they were not prepared to change their machine.

7.5. Frama said that it was not easy to increase production of franking machines at short notice due to lead times in production and materials planning. Frama estimated that it would take about three months to change the relative volumes of smaller and larger franking machines produced, but that the cost would not be significant.

7.6. Frama thought that it would be relatively difficult for a new entrant to the market to gain access to the technology required to begin the production of franking machines, since knowledge of high-security printing/metering systems and, possibly, knowledge of cryptography were required. However, the amount of regulatory knowledge about different countries that was required presented a more significant barrier to entry than technology.

7.7. Frama saw the market for postal scales as related to that for franking machines since scales were usually sold with the franking machine.

7.8. Frama believed that the market for folding and inserting machines was separate from that for franking machines. It said that for different mailing solutions to work together, the machines generally needed to be technically compatible, and it was therefore possible that customers would buy from the same supplier. However, most franking machines were generally compatible with most inserting machines: as far as Frama was aware, Pitney Bowes was the only manufacturer whose folders/inserters worked only with its own franking systems.

7.9. Frama said that it provided servicing for its products: 99 per cent of its customers had a contract, and the majority had a comprehensive contract, which usually consisted of one servicing agreement for all the different mailing solutions. The contracts were generally of 12 months' duration, renewed from year to year, with an annual fee starting in the second year (the first year was covered by a warranty). The list price of a standard comprehensive service contract was 8 per cent of the list price of the machine. Frama did not provide servicing for other manufacturers' machines. It said that most manufacturers tried to sell service and maintenance contracts with their machines.

7.10. Frama reported that published prices for franking machines were broadly similar between companies, but differed from the prices actually being offered to customers. It said that it did not follow the market leaders' pricing. In Frama's opinion, the larger manufacturers were probably in a position to discount prices to gain business. Frama did not cross-subsidize between machines and servicing, and was not subsidized by its Swiss parent company: its products were not the cheapest and it tended not to compete on price. Frama thought that franking machines were more expensive in the UK than in Germany and the Netherlands.

7.11. Frama said that the majority of customers paid less than the list price, certainly at the lower end of the market, but less so in the middle. The high end of the market was the least price sensitive since customers were more concerned about reliability and service, in cases where they had only one machine (not in the case of competitive tendering for multiple installations, where price was the most significant factor). Frama would not expect a major impact on the market if prices were increased by 5 to 10 per cent across the board as currently there were huge differences in offer prices to customers. Generally, Frama did not compete with its dealers, though there were some places where they overlapped. Its dealers were free to do their own discounting.

7.12. Frama said that it had no preference between leasing and selling its machines. Of its direct sales, approximately [✂] per cent were leased and [✂] per cent were purchased. Smaller machines were more likely to be purchased. Frama used two third party leasing companies for [✂] per cent of its work.

Francotyp-Postalia Ltd

7.13. Francotyp explained that it was a wholly-owned subsidiary of Francotyp AG & Co. It had grown, both in turnover and in customer base terms, probably by taking customers from either Pitney Bowes or Neopost (although there were no accurate figures on this) but very rarely from AMS, Frama or Secap. One of the key parts of Francotyp's relationship with Neopost was that it purchased folders/inserters from Neopost and sold them under its own name, although it was not a particularly big part of Francotyp's business. In 2001, Francotyp had taken part in a due diligence exercise with Neopost as part of the latter's unsuccessful attempts to acquire the Francotyp group of companies. This had been followed by negotiations between Ascom and Francotyp, which also came to nothing. One of Francotyp's reactions to the Pitney Bowes acquisition of Secap, and subsequently the Neopost/Ascom merger, was to say that Francotyp was not for sale and that it was unlikely to be an attractive target at the moment.

7.14. Francotyp said that it operated worldwide. Its home market, Germany, was easily its biggest revenue producer. But since 1998 the overseas business arising from sales revenues from equipment sales exceeded the revenues from the home market, and had gradually been increasing as a proportion of the total. UK growth had been part of that and there had also been reasonable growth in the USA. The group was also strong in Austria and Belgium. Francotyp's market share in the UK was probably just over 5 per cent of the installed base. Francotyp said that its share of annual sales was difficult to estimate but in terms of new business had probably been around 12 per cent in 2001. It had steadily increased its market share over the previous five years.

7.15. Francotyp explained that the three segments of the franking machine market were not distinct markets. It believed that, like double-glazing, franking machines were sold proactively: nobody had succeeded in selling them in shops, and customers very rarely contacted a supplier to order a franking machine. The reason that customers changed their machines was that they were sold replacements. Looking at that reality against the three segments, the customer would be in whatever segment the salesman could persuade him to be in.

7.16. Hence there was substantial sales scope for customers to move between the different segments.

7.17. Francotyp believed that the prices of franking machines were coming down: a small-end machine in 1988 had been priced at about £1,000, and it was under £1,000 today. That reflected the need to try and pull in stamp users with SoHo machines, and to maintain a low cost of usage at the top end in order to try and keep customers using franked mail as opposed to permit mail or PPI. Francotyp told us that prices were, nevertheless, lower in some other European countries: it estimated that realized prices were around 20 per cent lower in Germany, and 30 or 40 per cent lower in the Netherlands, than they were in the UK.

7.18. Francotyp saw small to medium-sized enterprises as an attractive target because such businesses would probably not want to switch back to stamps. There was a strong convenience factor that would keep them in franking machines, but the attraction was not purely volume-related: customers liked being able to print their own logo, believed that putting their own date on was a benefit, and regarded the image of a franked impression as better than a permit mail stamp.

7.19. Francotyp believed that over 95 per cent of its customer base had a maintenance contract or some type of maintenance arrangement with it. There was a basic or mandatory cover for inspection only: call-outs had to be paid for. Then there was comprehensive cover priced at just a few pounds more than mandatory, making it attractive. Francotyp said that the industry norm (which Francotyp shared) was that around 75 per cent of customers had comprehensive cover, 20 per cent had basic cover, and 5 per cent had no contract. Pitney Bowes set the prices for comprehensive maintenance, and the industry all followed its rates.

7.20. Francotyp's strategy was to talk to customers about whole-life costs and about service levels so that it did not end up competing purely on price. Pitney Bowes had, however, engaged many new sales people who, being inexperienced, were able to achieve sales only at lower prices. One of the easiest ways of competing was on price as opposed to machine benefits or customer requirements. But franking machine sales people could not sell folders/inserters because these were more complex products. Users needed to find an easy way of getting paper into envelopes, looking after the paper and getting the address position in the right place, as well as saving time and money, so the two sales did not actually fit together. A supplier of folders/inserters did not need to be in the franking machine business to be able to establish a customer relationship.

7.21. Francotyp said that the propensity of customers to lease made it difficult for them to switch between suppliers. Pitney Bowes and Neopost had always either had their own finance companies, or finance companies with which they had close relationships, so they had deliberately led with leasing. Pitney Bowes in particular was a master of customer retention by renting the meter and the base on separate agreements. Thus, the customer would find that he or she could not put one of Francotyp's meters on Pitney Bowes' base, or vice versa. The other benefit of leasing was that the lease company was able to tell customers at the end of, say, three years that a five-year lease was potentially changeable, and offer an upgraded machine. This might seem attractive to the customer. It was an excellent way to protect the customer base but made switching between manufacturers difficult. The only way Francotyp gained customers was to recruit those who were dissatisfied with Pitney Bowes or Neopost. If AMS disappeared as a separate entity, then Francotyp would have a fair chance of gaining more of those.

7.22. Francotyp had a high opinion of the quality of AMS's services, and thought that if AMS were no longer available its customers would choose Francotyp rather than Pitney Bowes or Neopost. Francotyp believed it could step into AMS's shoes. Francotyp would be vulnerable if Pitney Bowes and the enlarged Neopost were to compete fiercely on price. However, it expected competition to be 'reasonable' rather than fierce, and not purely on price.

7.23. Francotyp said that about [✄] per cent of the sales its franchisees made were of second-hand franking machines. If a franchisee upgraded a customer whose original machine was still serviceable, and Francotyp was prepared to offer a service contract on it, the franchisees did quite well from selling the machine second hand.

7.24. Francotyp thought the second-hand market would start to build again after meter migration because a new generation of second-hand machines would be coming through then, although they might not last as long as the old ones did.

7.25. Francotyp thought the barriers to entry to the franking machine industry were almost insuperable.

7.26. Francotyp said that, if the CC were to conclude that the proposed merger was against the public interest in the UK, it would be very interested in acquiring AMS's UK business and in particular a machine that AMS manufactured that would compete with Neopost's products in that sector of the market. However, it expressed doubts as to whether a merger between the AMS and Francotyp groups would have had the necessary critical mass to challenge Pitney Bowes on a global basis.

Pitney Bowes

7.27. Pitney Bowes said that it was a $4 billion US corporation which had been in the franking machine business over 80 years but whose activities extended to all aspects of physical mail. It entered the UK in the 1920s, had a manufacturing plant in the UK producing for worldwide distribution, and was engaged in 100 countries around the world. The US market had about 1.5 million postage meters in use, and the rest of the world about 1.4 million. Postage meters and related business accounted for about 50 per cent of Pitney Bowes' revenues in the USA, but less elsewhere because Pitney Bowes had folders/inserters and other businesses, like management services in which it managed mailrooms.

7.28. Pitney Bowes said that the UK franking market had been reasonably stable in terms of the population of meters for the last four or five years. It had reached maturity in the middle and higher segments, and in the last four years Pitney Bowes had targeted the lower segment of the market because lower-cost technology had become available. Hence machines could now be sold for less than £600, which had never been the case before. Over [✄] of Pitney Bowes' machine placements in the next year would be into that part of the market. They would be sold through [*Details omitted. See note on page iv.*], not through [*Details omitted. See note on page iv.*]. Moreover, the production of these machines was out-sourced to a sub-contractor. The top end of the market had been adversely affected by Royal Mail trying to retain its customers by offering bulk mail and related services, including to customers the size of whose business fell below its own criteria.

7.29. Pitney Bowes agreed that a segmentation of the UK market into three classes of machines was generally recognized. A small business operation would generate around 25 letters each day. It might be a branch office or a one-man home office, although the SoHo market was not particularly attractive because some postal regulations did not permit posting franked letters in the postbox. The middle of the market was the heartland of postage meters. Broadly, it covered customers with between 25 and 1,000 letters a day and was where the benefits of the metered mail system really came into play, because although franking machines were in use for perhaps only an hour a day, they were essential when the post had to go out. Such machines had to work fairly hard for a short space of time. At the higher end of the market (over 1,000 letters a day) the machines were designed to work eight hours a day, and so the reliability built into the machine was higher.

7.30. Customers were unlikely to switch from one segment to another. It might be expected that if a newly-established company—a small business—were successful it would move into a bigger range of equipment, but Pitney Bowes' statistics did not bear that out. Only 10 per cent of small companies grew to become big companies, so they tended to stay within their segments, and not many people would go into the production mail area unless mailing was their business. Firms did not suddenly start doing bulk mailing. But the middle ground was very differentiated. Some firms produced parcels and packets, some made considerable use of special services, such as next-day delivery, and other firms generated very mixed mailings, including international mailings, for example. The range of machines found in the middle segment was therefore designed to handle different types of mail.

7.31. Pitney Bowes said that it had acquired Secap in 2001 solely to enter the French market. Pitney Bowes had had less than 5 per cent of that market, and had been trying to get into it for many years. In the UK Secap had only about 3,500 machines in place. [*Details omitted. See note on page iv.*] Secap distributors had just started to sell a new range of digital franking machines. They were no longer selling any of the non-digital products but would continue to service them to the end of their lives with the customer. Secap's UK operation was not a consideration for Pitney Bowes in making its acquisition.

7.32. In discussion of the undertakings that were put in place after the 1986 MMC report Pitney Bowes argued that, if the merger were to proceed, Neopost should become bound by the same undertakings that bound Pitney Bowes. This was because Neopost, at that stage, would be in a virtually indistinguishable market position from Pitney Bowes.

7.33. Pitney Bowes said that competition in the industry reflected a combination of what customers were interested in. The higher end was price sensitive, because most of the work was done by tender, for example for the Government, or one of the bigger bank groups or insurance companies. In the middle ground it would be features of the product, highly specific to the customer, which determined the choice, which was why it was essential for the supplier to have a thorough understanding of the customer's requirements. Service was very important to everybody but the industry as a whole had a good reputation for service, so it was unlikely that customers would differentiate between suppliers on that basis.

7.34. Pitney Bowes said that about [✄] per cent of mid-volume placements would be to existing customers, usually at the end of a lease term. Leasing was the preferred option, either through the manufacturer's lease or a lease of the customer's own choosing. Part of the purpose of leasing was to avoid technological obsolescence, so that the customer could change equipment with an ongoing cost that would be fairly constant. The other [✄] per cent of orders in the mid-volume segment were either won from competitors or new businesses coming in.

7.35. Pitney Bowes said that until five years ago there was not very much price difference between countries in terms of franking machines. But the advent of the Euro had caused intense competition, with all suppliers wanting to make sure that they kept their market share during the course of the migration to the new currency. As a result, pricing in Germany in the last two years had fallen below pricing in the UK. This was despite the costs of converting older machines to be Euro-compatible. With digital meters, however, it was a matter of just changing the electronics in the new machine and getting the specification right, so the machines themselves did not cost more.

7.36. The French meter market had been through a wholly different type of migration: the postal authority insisted on moving to data capture, so all franking machines in France had to do itemized billing. That was technologically a very different programme in which Neopost was in the lead because the post had largely negotiated the specification through this French company.

7.37. Pitney Bowes said that the effect of a non-transitory 5 to 10 per cent rise in franking machine prices would be likely to vary by market segment, as follows:

(a) *Small business machines* (£600 to £800 purchase price). This segment was dealt with by direct marketing and telesales. About [✄] per cent of units were rented and [✄] per cent were sold. None were leased. Sales were to small businesses which were generally price sensitive so rental contracts were the usual form of payment to keep outgoings low. In sales presentations prices were normally quoted in terms of weekly fixed rental payments. Because of cost and performance differences between machines for this segment and those for the mid-size business segment there was little upward substitution. Pitney Bowes thought there might be some tolerance for price rises of up to 5 per cent but that it would appreciably decline thereafter, and that an increase of 10 per cent would reduce the new business take-up by 10 to 15 per cent.

(b) *Mid-size business machines.* About [✄] per cent of units were leased and [✄] per cent sold. None were rented. In the UK this segment was less sensitive to price, but a price increase of 10 per cent might lead customers to buy machines smaller than they really needed.

(c) *Production mailers.* About [✄] per cent of units were leased and [✄] per cent sold. None were rented. This segment was sensitive to price because users had an alternative to postage metering. In Pitney Bowes' view, a non-transitory price rise of 5 to 10 per cent would lead to the transfer of large accounts to PPI.

In all three segments prices did not differ by transaction type.

7.38. Pitney Bowes said that it had one list price, but discounts were given in response to competitive conditions. It believed its competitors did the same. The discount trends had generally varied by market segment and type of customer:

(a) Small business machines: fewer than [✄] per cent of customers received a discount.

(b) Mid-size business machines and production mailers:

(i) In standard commercial accounts, about [✂] per cent of sales were at list price; [✂] per cent were at [✂] per cent discount; [✂] per cent at [✂] per cent discount; and [✂] per cent at [✂] per cent.

(ii) In public and corporate accounts, about [✂] per cent of sales were at [✂] per cent discount; [✂] per cent at [✂] per cent discount; and [✂] per cent at [✂] per cent discount.

7.39. Pitney Bowes said that economies of scale in machine production and marketing were not competitively decisive. There were no material scale economies realized by Pitney Bowes that were not realized by Neopost and AMS. As a matter of course it might be generally advantageous to spread R&D expenditure over a larger base, but smaller companies had been able to compete successfully because a large R&D programme was not critical to success and many technologies used in franking machines (such as ink-jet printheads) might be procured from external suppliers. Through a combination of internal development efforts and external sourcing, suppliers of franking machines had the ability to compete in all phases of the business. Neopost, for example, had been among the first to offer digital postage technology, and had offered solutions based on a digital two-dimensional bar code postage mark since 1998. AMS had developed a new range of digital franking products as well as software applications for the efficient management of mailrooms. But in any event, Pitney Bowes licensed its own patented technology to competitors, including both Neopost and AMS, both of which had access not only to Pitney Bowes patents in existence at the time of their respective licence agreements but also to later patents. Pitney Bowes was sceptical of the claim that Neopost needed to merge with AMS in order to compete effectively with Pitney Bowes.

7.40. Pitney Bowes and its subsidiaries had about 1400 unique patents worldwide in all areas of its technology. About 500 were applicable to the UK, and there were a further 280 pending patent applications also applicable to the UK. These patents were the result of substantial investments in R&D by Pitney Bowes and its subsidiaries. The patents included important inventions applicable to all aspects of the franking field, but they had always been made available by licence to Pitney Bowes' competitors.

7.41. Pitney Bowes had entered into cross-licence arrangements with other manufacturers of franking machines. These were subject to confidentiality requirements. In general, these agreements *(a)* provided the licensees with access to Pitney Bowes' patented franking machine technology; *(b)* included options (yet unexercised) for access to additional and future Pitney Bowes patents; and *(c)* reflected pricing based on the value of the technology involved and the nature of the licence, taking into account the facts and circumstances of the particular situation, including the value of any technology licensed back to Pitney Bowes by the other party.

7.42. Pitney Bowes said that it had opposed the adoption of a two-dimensional bar code system by the USPS and supported the adoption of a different system, based on OCR-B technology. Pitney Bowes had patents that read on the security mechanism and information contents of the two-dimensional barcode system adopted by the USPS and, consistently with its licensing policy, was committed to licensing those patents for reasonable compensation. Pitney Bowes expected that other postal authorities would also adopt digital postage mark systems that incorporated two-dimensional bar codes. The applicability of Pitney Bowes' patents to such systems would depend on the specific security mechanisms and information contents of the systems adopted by those authorities. Should the patents apply, they would be licensable.

7.43. Pitney Bowes said the important skills that franking machine suppliers needed to be competitive were the ability to design products that addressed the requirements of customers; the capability to adapt to the regulatory requirements of various postal authorities around the world; and good service and customer support. Technological change created opportunities for competitors to address rivals' customer bases by offering a superior value proposition. Particularly as postal authorities worldwide required customers to migrate away from old technologies, new opportunities were created for all competitors to displace the incumbent suppliers. Because all postal authorities typically arranged for the migration process to take place over a period of several years, with substantial advance notice, companies with extensive R&D capabilities did not necessarily obtain a competitive advantage. In general, the adoption of newer technologies by postal authorities had tended to occur after all franking machine manufacturers had gained the technological capability to comply with the standards adopted by the authorities.

7.44. Postal authorities had not yet agreed on a common standard to facilitate the use of digital postage marks on international mail. However, the Universal Postal Union was studying the issue and was likely to adopt standards to enable the use of digital indicia on international mail. The ownership of intellectual property that might be required for this use would depend on the standard adopted. Both carriers and suppliers of franking machines had relationships with customers, and this was likely to remain the case if Internet connectivity became a general feature of franking machines. Such a development was unlikely to take place in the next few years, however, as most franking machines in use were expected to lack Internet capabilities in the next five years. Franking machine suppliers and postal carriers were likely to be interested in different types of information. Whereas carriers would chiefly be interested in information regarding mailing and shipping patterns to facilitate improvements in the logistics of deliveries, franking machine suppliers might be more interested in information that would be supplied voluntarily by customers to enable suppliers to offer products and services targeted to users' needs.

7.45. Pitney Bowes said that the barriers to entry applied across the whole market. The knowledge needed to understand the franking machine market was quite detailed because of, among other things, secure printing, encryption technology and US standards. Ink-jet printing technologies were a very difficult area, constraining high-speed printing capabilities. Postal authorities had a formidable army of technology-based staff who liked to impose their own standards, and would be working to make it difficult for other postal authorities to enter their market and use their own sorting equipment. So there were a lot of politics affecting technological developments that were far beyond Pitney Bowes' power to influence. The biggest barrier was the size of the market. Unless a company was dedicated to the mailing market there was no point in entering it, because at 200,000 units a year it had such small potential compared with other investment opportunities.

7.46. A substantial R&D budget was necessary but marketing skill was the key element because, once the technology reached a certain level, the issue was getting customers to use machines that incorporated the technology.

7.47. Because of Pitney Bowes' position in the US market, with 80 per cent of the customer base, it was treated very much at arm's length by the USPS. So Pitney Bowes, having developed products to US standards, then had to catch up with local standards developed in other countries, which severely disadvantaged it.

Other office equipment companies

Franking Machine Company Supplies Ltd

7.48. The directors of FMCS told us that they had formed the company in 1988 having previously been employed by other franking machine companies in the UK. There were essentially three parts to the business: the lease or, less often, sale of franking machines; the servicing and maintenance of the machines including arranging the recharging with postal credit; and the supply of consumables such as ink and labels. The company had begun as a dealer for Frama. Later it had become a dealer for Secap machines on slightly better terms. It also supplied Francotyp machines, obtaining these through a franchisee. The company serviced Secap machines, but was not permitted by the manufacturer to service Francotyp machines. However, it was now licensed by Consignia to service all types of postal franking machine, but only with the agreement of the manufacturer. That agreement had not been forthcoming in the case of AMS, Frama, Francotyp, Neopost and Pitney Bowes. The takeover by Pitney Bowes of Secap threatened the maintenance arrangements for the latter.

7.49. FMCS said that the Consignia conditions for a company to service a machine were quite onerous, though the incidence of postal fraud was very low. The company had had to be ISO 2000 registered (although this was no longer required), to have secure premises for the storage of stock, to keep reliable records of machines and seals, to be insured for loss of postage income through fraudulent use of machines (a requirement now replaced by a financial check of the company) and, most awkwardly, to have the approval of the manufacturer of the machine. Despite the fact that the 1986 MMC report had recommended opening the servicing market to independent firms, this had been slow to happen. FMCS had been trying to obtain approved servicing status for eight years. Having to meet Consignia's standards and other business reasons meant the prospects of a new entrant obtaining servicing business seemed remote. Furthermore, FMCS expressed concern that its core business servicing Secap machines was at risk following the takeover of Secap by Pitney Bowes in September 2001. It was not sure that Pitney Bowes would authorize it to continue servicing Secap machines.

7.50. The manufacturers of franking machines were reluctant to allow independent maintainers access to their customers. They preferred to maintain their own machines. Their prices for maintenance were very similar. FMCS believed that it could provide equivalent services at a much lower cost.

7.51. FMCS suggested that the manufacturers should be compelled to allow customers with their products the choice of Consignia-approved service providers, to give the approved providers service training and to supply spares and consumables at wholesale prices. The manufacturers should give the customer the information necessary to make an informed choice of service provider.

7.52. FMCS believed the UK market to comprise some 200,000 machines. There was presently a growth of about 1 per cent a year, largely in entry-level machines using an ink-jet printer. This was a slow machine capable of franking four items a minute. It had an ink cartridge costing £50 and was capable of printing 1,000 items of mail, ie 5p a letter. Typically, the machine would be leased at £25 a month for 15 months. Towards the end of this period the supplier's salesman would call to offer an upgrade. The machine often served as a means of acquiring a new customer who could subsequently be upgraded to a higher level of machine: a customer who was already paying 5p a letter, in addition to postage, for an in-house franking service was likely to be looking for a cheaper per-item cost of dispatch.

7.53. FMCS thought that only 20 per cent of machine sales were to new users of franking machines. Most new machines were sold to existing users to replace ones they had had for five to seven years. The cost of acquiring a new customer was high but FCMS hoped that the benefit of the servicing contract, the supply of consumables and the opportunity of a further sale in future would compensate. It was, therefore, annoying as an independent maintainer to be obliged to pass the name and location of every customer to the manufacturer in order to arrange for the top-up of the postal credit.

7.54. FCMS told us that most franking machines were leased to the customer. FCMS had its own leasing arrangements that were quite profitable and also gave it some control of the customer base. Other suppliers had to come to it for the finance settlement figure when they attempted to sell the customer a rival machine.

7.55. FMCS told us that it supplied postal scales, folders/inserters and letter openers when the customer's mail operation required these items. Folders/inserters constituted a separate market not linked to the sale of franking machines. The sale of these items, and letter openers, did not involve divulging customer details to the manufacturer. The sale of some consumables and spare parts was restricted by some manufacturers, such as Pitney Bowes, to their own customers. They would refuse to supply independent maintainers such as FMCS.

Nationwide Franking Sense Ltd

7.56. NFS explained that it was a trading company providing, among other services, third party supply and maintenance of franking machines. Royal Mail's Meter Population Report of August 2001 calculated that NFS had 0.6 per cent of the franking machine market (this was part of the 1.8 per cent attributed to Secap machines). The majority of NFS's customer base was made up of former customers of Pitney Bowes and Neopost who had chosen NFS as a more competitive option.

7.57. NFS supplied the franking machines of three companies:

(a) Secap, which had been taken over by Pitney Bowes. Secap made the majority of franking machines that NFS supplied, and NFS supplied all types of franking machine produced by Secap. Secap franking machines had generally been at the low- to mid-range of the market. NFS also sold Secap folding and inserting machines.

(b) Neopost supplied NFS with a single model of franking machine, the entry-level IJ25. Neopost supplied this product to NFS at a competitive price, which enabled its customers to benefit from lower prices and choice of supplier.

(c) Francotyp supplied NFS with a top-range franking machine.

7.58. On 1 March 2001, after seven years of negotiation, NFS believed it had become the first UK company to be approved by Royal Mail as a third party maintainer of franking machines. It had been given a restricted service bond that enabled it to service the machines it had supplied. After receiving the bond, NFS had begun to service Secap franking machines, but not Neopost or Francotyp machines. NFS believed that its annual service contracts were substantially cheaper than those offered by its competitors.

7.59. NFS said that it also supplied consumables for franking machines and for Secap folding and inserting machines. Pitney Bowes and Neopost had offered to supply NFS with folding and inserting machines, but NFS had resisted, as it did not wish to over-complicate its supply network.

7.60. NFS believed that third party supply and service companies offered competition, lower prices, alternative service and a choice of suppliers beyond direct sales. NFS expressed concern about competition in several areas of the franking machine market:

(a) Manufacturers which supplied and serviced their own machines were aware of the prices offered by their competitors and this ensured a certain degree of price levelling which third party supply and service companies had to undercut.

(b) It was common practice for the in-house leasing companies of the manufacturers to offer five-year fixed-term lease contracts to customers. At the mid-point of the contract the customer would be asked to sign and pay for a new five-year contract, often with an upgraded machine, but would continue paying the previous lease simultaneously. As a result, the price quoted at the start of the contract would increase substantially over the duration of the contract, a concept that NFS referred to as a 'carousel'. NFS used a separate leasing company and only increased the cost of its leases in line with inflation.

(c) Manufacturers had been in the practice of developing incompatible systems to restrict other companies from supplying consumables to be used in their machines. They had also invalidated maintenance contracts if a customer had been found to use the consumables provided by another supplier.

7.61. Since the takeover of Secap by Pitney Bowes, NFS had received correspondence from Pitney Bowes questioning whether NFS should continue with the supply and servicing of Secap machines. NFS said that this could be an attempt to force its customers to use Pitney Bowes again and remove competition from the marketplace. NFS reported that there was no animosity between itself and Pitney Bowes, however.

7.62. NFS was concerned that the Neopost/AMS merger would operate against the public interest. If the merger went ahead it would cause some 90 per cent of the franking machine market to be controlled by two companies: the merged company and Pitney Bowes. This would constitute a duopoly wherein Pitney Bowes and Neopost dictated pricing, freedom of supply and services to the remaining 10 per cent of the marketplace. There would be a reduction in choice for customers. If the merger went ahead without safeguards, the duopoly might refuse to supply a third party maintainer such as NFS. NFS said that it had no business relations with AMS, but that it considered AMS to offer competitive prices and was concerned that AMS might not be able to sustain the franking machine side of its business after the merger.

7.63. NFS recommended a number of safeguards:

— Distributors should be supplied at competitive rates.

— Manufacturers should be compelled to supply technical data and service training to third parties.

— Distributors should not be restricted to confined geographical areas.

— The sale of spare parts and consumables should be guaranteed at trade prices to distributors.

North Time and Data Limited

7.64. North Time and Data Limited (NTD) told us that it was a small company with 14 staff, a turnover of £1.2 million and a 25 per cent share of the mailroom equipment business in Northern Ireland. It supplied, maintained and repaired Ascom equipment in Northern Ireland. NTD had an agency agreement with AMS, which, inter alia, allowed Royal Mail to license the company to maintain and repair Ascom machines.

7.65. NTD had sought assurances from AMS that it intended to continue to supply spare parts, training, technical support and service updates on reasonable terms after the acquisition had taken place. This would enable NTD to continue in its role as an independent maintainer for AMS machines. AMS had replied that the future was uncertain and AMS's management was not in a position to make commitments which would, were the acquisition approved, be binding on Neopost. Further, AMS had said that it considered the commitments NTD was requesting to be commercially unreasonable. Yet these commitments were only those required by Consignia to allow NTD to acquire independent maintainer status in the first place: Consignia required an assurance that AMS would continue to provide the equipment and backup to NTD to enable it to meet fully Royal Mail's terms and conditions with regard to inspecting and maintaining franking machines.

7.66. NTD believed that AMS's refusal to provide a reference for Consignia in the accepted terms ran counter to the intentions of the 1986 MMC report, which had said that the availability of independent maintenance services would help the development of supply of franking machines through dealers.

PFE

7.67. PFE said that it was a privately-owned UK company whose principal activity was the manufacture and marketing of mailing systems and paper-handling equipment and, in particular, of folding and inserting equipment. PFE said it was based at Loughton, in Essex, and employed 350 people in the UK and 460 worldwide. All its machines were produced in the UK but about 80 per cent of its production was exported to over 55 countries. PFE was extremely concerned about the proposed merger of Neopost and AMS because it believed it raised substantial competition concerns in two separate but related markets. First, in the market for production and supply of franking machines, the acquisition would reduce the number of major suppliers in the UK from three to two, which would account between them for about 90 per cent of the market. Second, PFE believed that the proposed merger raised substantial competition issues in the closely related market for the supply of folding and inserting machines.

7.68. Both the merging parties and PFE were involved in the mailing systems industry. This comprised principally two product lines: franking machines, and folding and inserting machines. Neopost produced both. AMS produced franking machines and supplied folding and inserting machines on an OEM basis. PFE produced only folding and inserting machines. PFE estimated that in the UK in 2000 about 30,000 franking machines were sold for a total value in excess of £18 million and about 1,200 folders and inserters were sold for a total value of about £20 million. It believed that around 150,000 undertakings (principally companies, government bodies and institutions) had at least one franking machine and that the total number installed in the UK exceeded 200,000. The number of folding and inserting machines installed in the UK was probably over 8,000.

7.69. PFE estimated that, following the merger, the UK franking machine market would be shared evenly between Neopost and Pitney Bowes. Neopost would have, on current sales figures, about 40 per cent of the market (by combining its existing 27 per cent share with the 13 per cent share of AMS); installed base data gave the merged entity a combined market share of 39 per cent (ie the 23 per cent held by Neopost and the 16 per cent of AMS). Pitney Bowes, the largest global supplier of mailing equipment, had a UK market share of about 52 per cent, based on both current sales and on its installed base. It had recently reinforced its international position by acquiring the French company Secap.

7.70. PFE said that other competitors in the UK franking machine market were Francotyp and Frama which respectively had around 6 and 2 per cent based on current sales and around 5 and 4 per cent on installed base figures. Francotyp had an OEM arrangement with Neopost in the UK for the supply by Neopost of specific models of folding and inserting machines, and PFE believed that this arrangement had recently been extended to cover a wider selection of products. Similarly, Frama sold a Neopost franking machine in the UK.

7.71. As to whether the franking machine market was geographically limited to the UK or whether it should be considered as part of a wider geographic market, PFE thought the market was international in the sense that a franking machine manufacturer could remain competitive only if it had a presence internationally which enabled it to achieve economies of scale. However, in order to succeed in a country such as the UK, it was necessary to have a national distribution network together with the possibility to provide maintenance services locally. A customer in the UK would not consider purchasing its franking machine abroad, and in this respect the market was national. The same was true in relation to folding/ inserting machines.

7.72. PFE did not believe that stamps at the lower end of the market or bulk mail at the higher end exercised any real constraints on franking machine manufacturers. The only effective constraint on their market behaviour was the competition which currently existed between them. The loss of one of the most important players in the industry would eliminate the key competitive constraint on the two leading manufacturers. PFE did not expect the situation to change in the next two to three years. The development of Internet-based franking was in its very early days and had not proved successful so far even in the USA, where this technique was more advanced that in the UK. The impact of the Internet over the next two to three years was, therefore, in PFE's view likely to be very limited. Even if successful in the long term, the Internet could have an impact at the lower end of the market only for customers who did not mail large volumes of post. The companies that were most likely to succeed in this potential market were Pitney Bowes and Neopost, which would therefore be able to leverage their position on the Internet in the lower segment of the market on to their larger machines. PFE did not believe that the liberalization of postal services would have any major impact on the franking machine market.

7.73. In March 1986, the MMC had reported on the supply, maintenance and repair of postal franking machines in the UK. It had concluded that the general effect of Post Office testing and regulations, while no ultimate barrier to a determined new entrant, had been to confer some advantage on established suppliers by restricting the availability of methods of supply and preventing the establishment of alternative maintenance services. At that time there were two major suppliers in the UK of franking machines: Pitney Bowes and Roneo Alcatel (now Neopost). The three other suppliers accounted for about 12 per cent of the market between them. The structure of the market had changed little since then. This supported PFE's belief that barriers to entry in the industry were high. Moreover, it had taken a long time for AMS to increase its UK market share since its entry (as Hasler) in 1969. It was now a substantial force in the UK market, having drawn well ahead of Francotyp and Frama. Unlike them it was able to offer a full product range and had a substantial direct sales force in the UK, whereas they, lacking the critical mass to support a direct sales force, either had only franchised dealers (Francotyp) or were predominantly reliant on dealer distribution (Frama). The third competitive force represented by AMS would be eliminated by the proposed merger. Thus, PFE believed that if it were allowed to proceed it would bring about a major change in the structure of the UK franking machines market. It would reduce the number of major franking machine suppliers in the UK from three to two, and those two (Neopost and Pitney Bowes) would between them have over 90 per cent of the market. The effect would be to reduce competition substantially.

7.74. PFE thought, too, that the proposed merger would have a major effect on the neighbouring market for the production and supply of folding and inserting machines. There did not appear to be any generally accepted segmentation of this market but PFE divided it broadly into three sub-markets, based on the ability of machines to process certain monthly volumes of filled envelopes. These were production mail (in excess of 300,000 envelopes a month), modular office (30,000 to 300,000 envelopes a month) and desktop (2,500 to 30,000 envelopes a month). On that basis desktop machines accounted for over 80 per cent of the number of folding and inserting machines sold in the UK. PFE estimated that about 1,000 desktop machines were sold in 2000, for about £6 million, although the figures depended a little on the definition of desktop machines adopted by each manufacturer. The numbers of machines sold in the other two segments had been falling in the last few years. PFE had always competed in the modular office and desktop segments of the market but had recently entered the lower end of the production mail segment. Pitney Bowes competed in all three segments and Neopost competed in modular office and desktop machines. AMS did not produce folding and inserting machines but had an OEM arrangement with PFE in relation to desktop machines.

7.75. PFE said that the proposed merger chiefly affected the desktop segment of the folding and inserting machine market, where AMS currently operated a partnering arrangement with PFE, alongside its OEM arrangement. PFE estimated that the UK market shares of the principal UK suppliers of desktop machines in 2000 were: Neopost 40 per cent, Pitney Bowes 30 per cent, PFE 27 per cent and AMS 3 per cent, under its OEM arrangement with PFE. PFE estimated, too, that in the first six months of 2001 AMS's share had risen to 8 per cent.

7.76. PFE submitted that a large proportion of PFE's market share would be vulnerable to attack if the proposed merger went ahead. This was because the franking machine market and the folding and inserting machine market were so closely related. Nearly all purchasers of folding and inserting machines would have purchased at least one franking machine, and the latter would almost invariably be the first mailing product that potential buyers would be made aware of and the first which would meet their mailing needs. The average price of a franking machine was around £1,250 whilst that of a desktop folding and inserting machine was around £5,250. Hence the volume of mail required to justify acquiring a franking machine was far lower than that required to justify the acquisition of a folding and inserting machine. As a result, the franking machine customer base provided an excellent sales base for those manufacturers that offered a complete range of mailing products. PFE believed that about two-thirds of the orders of both Neopost and Pitney Bowes for folding and inserting machines derived from users of their franking machines.

7.77. PFE said that recent years had seen the emergence of 'mailing solution manufacturers', ie those that could offer the whole line of mailing products, from franking machines and folding and inserting machines to postroom furniture and envelopes. In parallel, customers sought more and more to deal with a manufacturer that could meet all their needs. Neopost and Pitney Bowes clearly had a strong advantage in this environment. In addition, Neopost had an OEM arrangement for folding and inserting machines with Francotyp. Specialist manufacturers such as PFE and AMS had had to adapt to these developments. Together with specialist manufacturers of other mailing products they set up a partnership group in 1995 called Mailroom Innovations (formerly known as Mailroom 2000). This group ran 10 to 12 regional exhibitions each year, thereby enabling its members between them to spread the cost (PFE could not justify such an outlay on its own).

7.78. Mailroom Innovations expected to see between 100 and 150 visitors at each exhibition and had become the principal marketing tool of PFE. Since Mailroom Innovations was started PFE's share of the UK folding and inserting market had risen from 19 per cent in 1996 to 31 per cent in 2000. PFE estimated that approaching one-half of PFE's and AMS's installed base (for folding and inserting machines and franking machines respectively) in the UK was common. The loss of access to the customer base of a substantial franking machine manufacturer was likely to affect PFE's future business and its ability to maintain its competitiveness with Neopost and Pitney Bowes. Conversely, through access to AMS's customer base, Neopost would be able to target a large proportion of PFE's existing and prospective customers with its mailing solution offering.

7.79. PFE believed that, should the merger proceed, the credibility of Mailroom Innovations and its attractiveness to potential customers would suffer significantly from the inevitable departure of AMS. A mail equipment exhibition such as Mailroom Innovations had to have as one of its participants a recognized manufacturer of franking machines, the lead product in the industry. This was illustrated by a direct mailing carried out in 2000 which focused on the Mailing Innovations theme. It was sent to about 50,000 potential customers and over 32 per cent of the responses were in respect of franking machines (17 per cent) or folding and inserting machines (15 per cent). The other participants in Mailing Innovations averaged 6 per cent of responses each.

7.80. Mailroom Innovations was created primarily to enable specialist manufacturers to propose a mailing solution package equivalent to that offered by Pitney Bowes and Neopost and this would clearly not be the case without the participation of a franking machine manufacturer. The only alternative would be to replace AMS by Francotyp or Frama. However, PFE believed that, because of their small market shares and the indirect nature of their national distribution arrangements, neither Francotyp nor Frama was equipped to provide an effective replacement to AMS. Moreover, in the case of Francotyp its OEM arrangement with Neopost was a further barrier. Similarly, the fact that Frama sold a Neopost franking machine in the UK would act as a barrier in its case. The future of Mailroom Innovations would, therefore, be in serious jeopardy if the proposed merger went ahead.

7.81. If the merger proceeded PFE was likely to lose its access to those foreign markets in which AMS dealers distributed its products. PFE said that it produced 2,000 machines annually from its Loughton factory. It estimated that the production of 800 a year (ie 40 per cent) would be at risk as a result of the loss of a substantial part of its distribution network outside the UK. A large part of the production costs were fixed and a reduction in production of this scale would have a dramatic effect on PFE's unit cost of production. This would have an immediate impact on the ability of PFE to continue to remain competitive on the UK market.

7.82. In summary, PFE believed that if the merger were allowed to proceed it would reduce from three to two the number of major franking machine suppliers. Even more critically there would be only two suppliers with equipment for the SoHo segment of the market, ie the entry point level.

7.83. There would be a softening of competition between Pitney Bowes and Neopost. They might compete hard for new customers at the entry level, but PFE expected that thereafter they would each rely on their respective installed customer bases. Their similar manner of trading, notably their policy in relation to leasing of equipment, pointed in that direction.

7.84. The loss of AMS as an independent company would mean not only the loss of a third force in the market, but the loss of a company that had been willing to differentiate itself from Pitney Bowes and Neopost, which had slowly but successfully increased its market share as a result.

7.85. The industry had a long history of trading malpractice. The two dominant players, Pitney Bowes and Neopost, had similar techniques which, in PFE's opinion, did not serve the consumer interest well. These companies sought to maximize sales opportunities through leasing products, rather than selling them outright, and then upgrading the product when the original lease had expired. AMS had always sold with integrity. It had offered products on lease or purchase. It had never sought to update the lease when the lease or hire-purchase agreement had expired. In PFE's opinion machines should be sold on merit and not because the lease had expired. Freedom of choice in the marketplace was essential. The proposed merger would reduce that choice. The industry needed a strong viable alternative to the offerings of Pitney Bowes and Neopost. AMS was that alternative, one which had consistently grown market share and which continued to bring new products to market. If it were owned by Neopost it would be tarred by the same brush and tied to the culture which had existed in that company for many years.

7.86. PFE did not believe that prohibiting the UK element of the merger would adequately address the public interest detriments flowing from it, unless it were to involve disposal of AMS's UK business along with the necessary access to products on competitive terms. The key public interest requirement of an effective remedy was the retention or creation of a third competitive force in the franking machines market. Without access to products, the disposal of AMS's UK business, or the exclusion of it from the merger, would in practice mean the disposal or exclusion of its sales force, maintenance services, customer database and leasing company. That would not be a viable entity. If Neopost were merely prevented from acquiring the business of AMS in the UK the customer base of that business would in due course simply be taken over by either Neopost or Pitney Bowes.

7.87. PFE thought that to require the merged entity to supply independent dealers with franking machines at wholesale prices, and to permit the provision of inspection and maintenance services by independent dealers and other operators, would not offer a credible long-term solution. Independent dealers would not represent a credible and competitive third force on the market. There were five reasons for this:

(a) Independent dealers would operate in a local market and not on a national basis. They would never be able to tender for large contracts, which could amount to hundreds of machines. These contracts were an important part of AMS's business.

(b) Independent dealers would not be able to afford to invest in the necessary remote recrediting system, which cost about £100,000. Moreover, such a system had to be operated centrally. This meant that recrediting would be done by the merged Neopost/AMS, which would thereby have full access to its dealers' customer database. This would enable the merged company to approach the dealers' customers at the time they needed to renew their leases or purchase upgraded machines.

(c) Independent dealers would by definition lack any central organization. The nature of local dealership arrangements would prevent a credible third force being created: the inability of Frama and Frankotyp to establish their presence in the UK and increase their market shares largely reflected the weakness of their distribution arrangements.

(d) Independent dealers could not compete effectively with Pitney Bowes and Neopost in the growing entry level SoHo segment of the market. The SoHo segment of the market could be developed only by establishing a national telesales force. Independent local dealers would not have the financial backing to support such a force in the important SoHo market, and the margins were too small to enable them to operate in it.

(e) Supplying independent dealers with franking machines would not prevent the reduction in competition in the neighbouring markets of folding/inserting machines and letter openers because independent dealers could not effectively replace AMS in the Mailroom Innovations partnership.

7.88. PFE thought that the proposal to facilitate the provision of inspection and maintenance services for franking machines by independent dealers and other operators would be of some use, but PFE said that it did not address the creation of a duopoly between Pitney Bowes and Neopost in the supply of franking machines.

7.89. PFE said that the only remedy which would address the public interest issues raised by the proposed merger would be the creation of a third force which could effectively compete with Pitney Bowes and Neopost, which required access to franking machines and an infrastructure of direct sales and support on a national basis. To be effective this third force should have a separate identity from Neopost/AMS (ie the machines should be sold under a different label from those sold by Neopost). PFE told us it had expressed interest to Ascom in the possibility of PFE's buying AMS, and would have been very keen to do so, but Ascom had not given it the opportunity.

7.90. PFE thought there was a practicable remedy that would go a long way to addressing the adverse public interest effects of the proposed merger. This remedy would require Neopost to agree to supply a third party, to be approved by the OFT, with franking machines on an OEM basis on terms that enabled the third party to compete effectively with Pitney Bowes and Neopost in the UK. The products, spare parts and consumables would have to be supplied on no less favourable terms than those on which they were supplied by Neopost to its own UK subsidiary. The third party would have to be free to control the recrediting of the machines and have the right to service them. Neopost would have to make available to the third party a full range of competitive products. These requirements should be coupled with sale to the third party of the current UK AMS business, in particular the transfer of the customer base and those of AMS's employees involved in distribution and marketing of franking machines in the UK, together with the assignment of all relevant AMS contracts.

Consignia

7.91. In general Consignia believed the proposed merger would have a positive effect in the marketplace, for the following reasons:

(a) Bringing together Neopost's 25 per cent share and AMS's 15 per cent share of the UK franking machine market would create a company whose overall 40 per cent share would create a more competitive marketplace. Merging these companies would significantly increase the competitive pressure on the market leader, Pitney Bowes, which currently had a 48 per cent market share. These competitive forces should result in the market being supplied with better products, services and value for money.

(b) Combining Neopost's and AMS's R&D budgets should lead to the development of more products, and bring them to market more quickly. This should improve customer choice, and the newest technologies should become available more rapidly.

(c) Combining Neopost's and AMS's marketing resources should create a better understanding of the marketplace and of individual customers, resulting in better products and after-sales service (ie equipment, systems and processes that added value to the customer's mailing operation). In Consignia's experience, franking machine products from Neopost tended to be innovative and customer-orientated. Consignia would therefore expect this trend to continue, and potentially strengthen, if the merger were to go ahead.

7.92. Consignia said that it had no significant concerns about Pitney Bowes' size, or about the franking machine market in terms of competition. It would be easy to think that there was some sort of competition issue in that 90 per cent of the UK franking machine market was in the hands of three firms. But customers had a genuine choice in that, irrespective of the high, medium and small segments of machine, they did not have to go to one of the big three. If a customer preferred to do business with a much smaller firm, and on a localized basis through dealerships, then they could do so. Pitney Bowes and Neopost had large R&D budgets and were pushing the technology boundaries. One reason why Consignia supported the proposed merger was that Neopost was particularly forward thinking in its use of technologies, [*Details omitted. See note on page iv.*]. [✂] AMS had fewer products. Over the last seven years Consignia had seen only one new AMS franking machine product, and even that was a joint development with Secap, whereas with Neopost there was probably at least one new product a year. The 30,000 customers of AMS could benefit greatly from the newer technologies and the increased marketing budget that Neopost had. [*Details omitted. See note on page iv.*].

7.93. It would be in Neopost's interest to expand its customer base, and it would be helpful to Neopost to get a foothold in Switzerland, which was AMS's home market. Strategically speaking there was probably more interest for Neopost in joining with AMS in Continental Europe than there was in the UK. Clearly, Neopost had aspirations to compete more effectively with Pitney Bowes than it did at the moment, and this would be one reason for the proposed merger.

7.94. Consignia described the process whereby it authorized independent firms wishing to maintain franking machines. It said that the process for authorizing the first one, NFS, had taken over a year while Consignia reviewed its terms of authorization in the light of NFS's inability to obtain a bond provider. The assessment of the second firm to apply, FCMS, had been quicker, more like six months. Now that Consignia had streamlined the process, it might take as little as six weeks.

7.95. Any company that came to Consignia asking to be authorized to maintain machines on an independent basis needed to show Consignia that it had the consent of its chosen manufacturer. The type of consent Consignia was looking for was willingness by the manufacturer to provide the independent maintainer with the training, spare parts, tools and technical documentation needed to keep the equipment in the condition in which it was originally approved. In the cases of NFS and FMCS, both had shown Consignia evidence that they had the agreement of Secap that all these things were in place. They would have to do that, too, if they wanted to act on behalf of, say, Pitney Bowes or Neopost. But that could potentially present a problem if the supplier did not want to license a competitor. FMCS and NFS had recently applied for the first time to maintain a different make of machine from those they were currently involved with. The manufacturer concerned had had several worries. These were on three levels (and this was something common across all the manufacturers) concerning respectively intellectual property, security and liability. Consignia believed that all of these could be addressed in the form of an agreement, but they raised legal issues and therefore took time to agree on. Both dealers were operating under their own name, and they had worked long and hard to create their own customer base selling and maintaining Secap machines. If Pitney Bowes, as the new owner of Secap, did not want to operate on a dealership basis, that would effectively wipe out their franchise to operate. So both companies were seeking to protect their own position in the marketplace.

7.96. Significantly, until very recently Consignia had had no company approach it with an application to handle other makes of machine, nor had it had any applications from companies outside the franking industry itself. When Consignia made arrangements for new companies to become authorized it had looked at the economics of setting up as an independent franking machine maintainer and concluded that a company would need at least 800 customers to make the service viable. Franking machine customers were difficult to identify, however. The other issue was that for the first year of operation most franking machines came with free inspections, maintenance and repairs. So it was easy for the customer simply to deal with the company that supplied the original machine. Consignia believed that a lot of customers favoured an all-in price that included inspections and maintenance. That made it quite difficult for independent companies to gain an entry point into the marketplace.

7.97. Consignia had met three office equipment companies outside the franking industry which it envisaged might have found the business of franking machine maintenance an interesting new line. They had said that it was of interest in principle and that they would think about it, but they had never come back to Consignia with an application. One reason might be that the cost of training their engineers to deal with every type of franking machine was potentially quite high. FMCS and NFS were already trained to Secap standards so no major injection of resources was needed. Another relevant point was that the number of machines that needed to be physically inspected, as distinct from a virtual, remote inspection, was decreasing, so it was not an expanding marketplace, and hence perhaps not too attractive to join.

7.98. Consignia said that it licensed potential servicing companies for a full range of services: the basic inspection, plus the higher level and optional preventative maintenance and repair service. It did not make practical sense to license companies only for annual inspection because if faults were found the customer would end up paying twice, whereas the inclusive fee customers paid for inspections, maintenance and repairs should be more economical for them if they dealt with a single company.

7.99. Consignia said that the manufacturers had not come forward in any proactive way to support and encourage third party applications to become independent authorized maintainers. Consignia believed manufacturers had been reluctant because they had concerns about patent protection, about independent companies having access to their customer databases, and about where responsibility for liability would rest if a machine of theirs being maintained by an independent company were to malfunction. Consignia's view was that it had put in place a system enabling companies to become authorized, and had shown in practice that that was possible. Consignia believed that any concerns the manufacturers had about supporting an independent maintainer could be met through a suitably worded agreement between the two parties.

7.100. On customers' pricing sensitivity between different postal options, Consignia said that until recently franking was generally not cost-effective for companies sending less than about 30 items of mail a day because of the cost of acquiring and running the franking equipment. However, since the introduction of small, quiet and portable low-volume machines such as Personal Post from Pitney Bowes and Autostamp from Neopost, franking was a realistic alternative to stamps for companies sending as few as ten letters a day. Franking machines, when leased, could be very cost-effective as companies were able to spread payment for the equipment over a relatively long period, typically five years. Customers wanting to benefit from the postage discounts available with pre-sorted bulk mail needed to invest in address management software to ensure that addresses were full and correctly postcoded, and in mailing software which ordered their mailing lists in line with Consignia's sortation requirements. This type of investment was unlikely to be cost-effective for customers not mailing high volumes on a regular basis.

7.101. On whether a change in the price of franking machines, rather than in the price of franked postage, would affect the evaluation in the previous paragraph, Consignia said that the price of franking machines and their running costs tended to be an issue more for small businesses, as a price rise had a bigger effect on their profits than it would for medium- and larger-sized businesses. By contrast, a rise in postal tariffs tended to have a greater effect on the latter group because of their higher mail volumes.

7.102. On whether the advantages of franking machines meant that customers would be reluctant to shift to stamps or bulk mail, Consignia said that the key benefits of franking over other payment identifiers or channels were:

(a) the ability to print a customized slogan or message, providing an additional advertising and communications channel for customers: it gave small companies a larger corporate image;

(b) productivity: machines were quick and efficient;

(c) availability of postage: if customers kept their accounts in credit they need never run out of postage, because of the availability of remote, rapid recrediting of their franking machines;

(d) cost control: if customers used online electronic scales they could be certain of always paying the correct postage, thus eliminating unnecessary overpayment or surcharges for underpayment; machines could allocate costs between departments and give printouts for expenditure analysis and budget planning;

(e) security: machines were lockable and password-protected, preventing unauthorized usage; and

(f) modularity: customers could often link their franking machines to other mailing equipment (for example, folders, inserters, feeders or stackers) to make their entire mailing process more efficient.

7.103. Consignia said that its bulk mail contracts were of two different types: a straightforward contract for mail priced at the same rate as stamps and franked mail, but paid retrospectively (postage credit) and a range of services under which customers could earn discount through work sharing, ie sorting the outgoing mail to ease its processing by Consignia. The threshold for the former type was £5,000: the cost to Consignia of setting up an account could not be justified below that level. The threshold for work-sharing contracts was 4,000 items of mail per batch.

7.104. The latest cost information that Consignia had suggested that franking had a small financial advantage to it over straightforward postage credit contracts. This was because of the cost of setting up an account and handling contracts, particularly at lower volumes. Both were more profitable than stamps.

7.105. At present, franking customers were asked only to sort their mail between first and second class. Consignia planned to discuss with customers and franking machine suppliers the possibilities for developing more work sharing in association with franked mail. Such an arrangement could enable customers to qualify for discounts, subject to Consignia being able to realize a sufficient margin by doing so.

7.106. On the effects that liberalization of the postal market would have on the use of franking machines, Consignia said that experience in countries where the postal market was already liberalized, of which Sweden seemed to be the best example, suggested that demand for franking machines did not increase when new postal service providers entered the market. Once the UK market was fully liberalized Consignia would expect to see franking machine suppliers work hard to retain their existing customers who sent their post through Royal Mail; this might result in lower machine and after-sale prices, and other marketing propositions.

7.107. On the other hand, the suppliers did not see themselves as mere providers of franking and related equipment, but as companies that could add value to customers' document and messaging activities. When the postal market opened up Consignia expected suppliers to seek out new opportunities to work alongside the new providers of postal services in offering technologies, systems and hardware that gave customers access to the new postal networks.

7.108. Consignia believed that in Sweden the impact of deregulation on franking and franking machines had been small. According to Posten, the main postal service provider (and previously the monopoly holder) in Sweden, there had been cases of small local competitors using their own stamps to indicate payment for their services, but not franking machines. Posten believed that this was simply because there was no need or demand for this kind of payment channel, since the newer postal providers had been targeting either the very low end of the market (for local delivery) or the high end of it (where invoicing was the normal payment method).

7.109. On the effects that moves towards harmonization of requirements for franking machines might have, Consignia said that it was in discussion with the UK's franking machine suppliers over the introduction of an international approach to the approval of franking machine security. This was intended to create a uniform approach in all countries where franking machines were used, both in Europe and North America. Consignia had told the franking industry that from 1 April 2002 all new franking machines submitted to Royal Mail for approval in the UK must comply with the technical standards contained in a Universal Postal Union document entitled International Postage Meter Approval Requirements. From that date Consignia would require the manufacturers to demonstrate their conformance with these standards by obtaining a certificate from an accredited test house using criteria recognized by national security authorities for the evaluation of IT-based security. However, Consignia, at the request of the industry, had postponed the introduction of this approach until 1 January 2003 to give it more time to prepare.

7.110. Once this common approach was adopted across the world, Consignia thought it should be possible for franking suppliers to introduce their products into various markets simultaneously, leading to increased franking machine usage. Manufacturers would still need to gain country-specific approval because of minor differences in acceptance criteria, usually to do with print readability, ink composition and the infrastructure for topping up postage credit. Overall, though, the international approach should reduce the time lapse between the conception of a new product and its market launch compared with that currently experienced by manufacturers.

7.111. On the effects that the introduction of electronic stamps might have on franking machines, Consignia said that its plans were dependent on finding a commercial model which realized a sufficient level of customer demand and an adequate return for Royal Mail within two to three years. As Consignia did not currently have a concept that provided that critical balance, it was seeking a greater understanding of the type of infrastructure needed to support this form of postage, and exploring whether it could reduce the cost base to the point where the concept became viable. Consignia had no immediate plans to introduce electronic stamps but did not expect their introduction to have a substantial effect on franking machine usage. Electronic stamps were likely to be of interest to non-franking machine users sending small amounts of mail at infrequent intervals.

7.112. Consignia said that it might decide to introduce two-dimensional franking marks into the UK within the next five years for security reasons, but would do so only if the costs of the online decryption software and investigation of irregularities were deemed affordable. Electronic stamps would have to bear a secure, verifiable postmark because of the lack of security associated with the type of printer that would produce it. If Consignia introduced electronic stamps it would consider introducing two-dimensional marks on all franked mail to exploit decryption software more fully. It was likely that broadly the same technology would be used in the UK as elsewhere for generating and decrypting the two-dimensional meter mark.

7.113. On whether Consignia would actively seek to avoid making a particular technology standard if one manufacturer had a patent for it, Consignia said that Pitney Bowes owned a family of patents associated with two-dimensional meter marks (sometimes known as 'intelligent indicia'). It was unlikely that these patents would cover every conceivable aspect of the way these marks were produced, but it could potentially be difficult for a third party to produce such a mark without infringing Pitney Bowes' intellectual property. When Consignia was first investigating the feasibility of online postage (electronic stamps) its stated aim was to produce a standard for the two-dimensional meter mark which was as patent-free as possible. However, Consignia placed the onus on manufacturers to ensure that any indicia produced by their online postage system to its standards either did not infringe others' intellectual property rights or, if they did, to gain written permission from the holder of those rights.

7.114. On segmentation of the market, Consignia said that the three segments could be considered separate markets in the sense that customers in each had different sets of needs. In terms of what they wanted from their franking machines, the priorities for low-volume customers were affordability, convenience and ease of posting; for mid-volume customers, machine efficiency and versatility; and for high-volume users, interconnectivity with other mailroom equipment, allocation of costs to multiple accounts and management information.

7.115. These segments were not necessarily defined by whether customers had a small, medium or large franking machine but by how much mail they put through it. It was not unusual for a small franking machine such as the Pitney Bowes Personal Post to be used to frank five times more mail than it was originally designed for, simply because it was cheap to acquire in the first place.

7.116. [

Details omitted. See note on page iv.

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7.117. The three segments would have different needs as far as Royal Mail was concerned (for example, range of domestic and international services, access to the postal system, operational and marketing information or account management). Royal Mail would treat these customers not merely as users of franking machines but as users of its postal services. Consignia's marketing, therefore, tended to focus on how these users could benefit by communicating with their own customers and suppliers through the mail; franking was just one way in which they could make that connection.

7.118. On fraud related to postal meter use, Consignia said that at the time when it first introduced technical changes for franking machines the evidence it had was that the maximum extent of revenue losses through fraud ran to about £10 million per annum. There were two major categories of postage meter fraud: one was where the fraudster physically attacked or interfered with the machine and somehow enabled it to frank but without the injection of any funds, and the other type of fraud—although not literally franking machine fraud—was the use of colour photocopiers or colour laser printers to produce what looked to be a meter mark. It was difficult to estimate the volume of such abuse because so much of it went through without being recognized. All the figures Consignia had on this were based on known cases of fraud in the UK and elsewhere, and estimates of the amount of postage lost before the fraud was uncovered.

7.119. Machine manipulation fraud was being addressed through Consignia's new technical standards, whereas the production of counterfeit meter marks would be addressed through the cryptographic route. This would identify each individual item of mail but, although that was a step forward in security terms, the existence of cryptographic information in the meter mark was only as good as the decryption that followed. In the USA this began with hand-held decryption equipment, and purely on a sampled basis. It might be that as more and more mail in the USA became encrypted it would be necessary to look at automated decryption systems. In the UK there would be major cost implications in building that capability within Royal Mail's reading systems. But if Consignia thought the amount of counterfeit meter mail was substantial then that might be worthwhile. Revenue loss of £10 million from franking fraud was about 1 per cent of the revenue value of franked mail.

7.120. Consignia said it received far fewer complaints about the sales tactics of franking machine suppliers than it used to, although by nature the industry could be quite aggressive in its approach to sales and marketing. If Consignia received a complaint from a customer, it referred the complaint to the manufacturer concerned immediately and had found that the companies were responsive in taking the matter up with the sales person or dealer concerned.

7.121. Consignia said that it would not normally be appropriate for it to suggest particular remedies to ameliorate the effects of the proposed merger, if it were to be found against the public interest, because it would be outside Consignia's remit to do so. But the CC had asked for its views and therefore might wish to consider one or more of the following measures:

(a) To permit Neopost and AMS to pool their R&D funds and expertise to facilitate the development of new products which made the most of each company's technologies, and which were closer to customer needs. For branding reasons, however, each company might decide to badge and package the resulting product separately. Economies of scale should lower the cost of production, leading potentially to lower prices for customers. This type of arrangement existed between Secap (before its acquisition by Pitney Bowes) and AMS, and led to the production of two mid-range digital franking machines now on sale as the Secap DP200/Ascom Intelipost 36 and the Secap DP400/Ascom Intelipost 54. The machines were identical except for the resetting method, screen, keyboard and minor cosmetic details.

(b) To scrutinize Pitney Bowes' applications for, use of and licensing of patents to ensure that its activity in this area did not unfairly impede the pace of development and innovation elsewhere in the franking equipment market.

Postcomm

7.122. Postcomm had a statutory responsibility for postal services but franking machines as equipment for the provision of those services were not its direct responsibility. It did not wish to give a view on the merits of the merger. However, Postcomm expected that its competition proposals for postal services might affect franking machine suppliers. Newly-licensed mail operators would in future be able to supply bulk mail services and collect and sort mail in competition with Consignia. Postcomm thought that if a number of new operators began to collect and sort mail and then, depending on the type of mail, either delivered it or passed it to Consignia for final delivery, and if they were able to win a significant market share, there might be an effect on the franking machine market. The new operators would deal direct with their customers and implement their own systems for paying for mail. Dependence on Consignia for approved franking machines might decline over time.

7.123. Postcomm also noted that the PPI service run by Consignia was likely to be a potential competitive restraint on the franking machine market. Essentially, mailing customers were able to use a rubber stamp for their mail. This stamp had an account number and Consignia invoiced the user subsequently.

Postwatch

7.124. Postwatch explained that it was the new consumer watchdog for postal services set up by Parliament but acting independently of both the Government and Consignia. Postwatch had a statutory duty to provide advice and information about relevant postal issues to various people including public bodies.

7.125. Postwatch believed that the proposed merger was potentially of concern as it brought together the second and third largest competitors in the market for franking machines in the UK, and reduced the number of major suppliers from three to two in an already concentrated market. Postwatch agreed with the concerns expressed by the OFT. In future the licensing of operators other than Consignia to carry certain types of large-volume mail would affect the market for franking machines. The regulator, Postcomm, would issue three types of licence.

7.126. Postcomm would grant Large Mailing Licences to operators wishing to provide mailing services where each individual mailing contained a minimum of 4,000 items (or an average of at least 4,000 items per mailing under a multiple mailing contract). The issue of these licences was designed to expose to competition nearly 30 per cent of Consignia's inland letters revenue, equivalent to about 40 per cent of mail by volume.

7.127. Postwatch further explained that Postcomm would grant Consolidation Licences to operators wishing to collect and consolidate mail from a number of users. This mail would then be passed to Consignia for delivery. The loss of business for Consignia would thus be limited to the upstream activities of collection and sortation.

7.128. Postcomm would also consider opening up further discrete parts of the market in response to interest expressed by mail operators.

7.129. Postwatch said that, from April 2004, it was proposed that the next 30 per cent of Consignia's inland letters by revenue, and 30 per cent of letters by volume, be opened to competition. A review would be conducted at this time to determine whether the final end date for full liberalization, set at March 2006, could be brought forward.

7.130. Postwatch believed that Postcomm's proposal to open the market by volume was likely to benefit in particular those users who bought or leased franking machines, rather than paid for postage in other ways. In Postwatch's view this proposal raised several issues for the inquiry:

(a) The OFT had found that there was little prospect of new entrants coming into the market. In part this was because the market presence and size of the existing suppliers gave them a significant advantage when meeting the rigorous specifications of Consignia. Arguably, in a liberalized market the competitors to Consignia would have the opportunity to be more flexible and the prospects of supply-side market entry would increase. This flexibility could serve to mitigate the negative consequences of the merger.

(b) Postwatch observed that a main argument advanced in favour of the merger was the need to create a strong competitor to the market leader, Pitney Bowes. But this was premised in part on the need for a competitor to have critical mass in order to meet Consignia's specifications. Postwatch believed that, in a more open market for postal services, this train of logic might be compromised, and the supposed positive effects of the merger would not be as claimed by the parties.

7.131. Thus, competition meant that in future there would be alternative postal service providers with different specifications for franking, including some which were potentially less rigorous than Consignia's. Developments of this kind should allow greater competition in the market for franking machines. However, Postwatch believed there was a risk that the duopolists would be mainly concerned about maintaining their existing relationships with Consignia, the dominant operator for the foreseeable future for letters weighing less than 350g and costing less than £1. Therefore, in the absence of competitors to the duopoly, new entrants to the postal services market might struggle to obtain fair deals from the franking machine manufacturers. This in turn would affect competition in the postal services sector, to the detriment of firms wishing to employ someone other than Consignia.

7.132. Postwatch agreed with the OFT view that further investigation was required to determine whether the limited alternatives available for high- and low-volume postings acted as a competitive constraint on franked mail.

7.133. Postwatch discussed the situation of businesses that did not meet the criteria for bulk mail or PPI, as defined by Consignia. They had to choose between using postage stamps or a franking machine.

Though the cost of postage was the same for each service, use of a franking machine was more efficient. But in a duopoly market businesses might find it even more difficult to negotiate a fair deal with franking machine manufacturers. Postwatch said that it would be unfortunate to have a merger creating a de facto duopoly in the franking machine market at exactly the same time as postal services were being opened up to competition.

Customers

Chartered Institute of Purchasing and Supply

7.134. The CIPS said that it was an international education and qualification body representing purchasing and supply chain professionals. It worked to promote and represent the profession of purchasing and supply management, to improve professional standards, to develop purchasing and supply methods, and to educate individuals in the profession. The CIPS said that it had over 31,000 members worldwide, of which 27,000 were in the UK.

7.135. The CIPS said that it published a fortnightly magazine, *Supply Management*, for members which gave information on all aspects of purchasing and supply. The CIPS offered guidance on lease-or-buy decisions, but tried not to mention company names, so as not to endorse specific companies. It reported that it tried to make its members aware of the small print in lease documentation, for example regarding the practice of rolling-on leases if three months' notice of termination had not been given. The CIPS communicated advice to its members in a variety of ways: advice received through its bookshop was paid for, but advice through the magazine, on the web site, in its topic reference files or in branch events was usually free. It also conducted conferences, seminars and training days.

7.136. The CIPS reported that in general its members had not raised franking machines as an important issue; neither had the product emerged as an issue on which there would be an 'alert' requiring an article to be written or the press to be contacted.

7.137. The CIPS had conducted a brief email survey of the 200 practitioners in its policy advisory network, to which it obtained 20 responses. Some of the respondents thought that the merger would cause competition problems, but some commented that it would not have a major impact on their business. Preferences between rental and purchase of franking machines were fairly evenly divided, as were views on whether consumables were expected to be included when a machine was purchased. About two-thirds of respondents had been unaware of the proposed merger.

HSBC Bank plc

7.138. HSBC Bank plc said that it was a major user of postal services. However, the group's usage of postal franking machines had declined in recent years as a result of its move towards using prepaid envelopes licensed by Consignia. As a result, in the UK it now owned only 50 franking machines, whereas previously it had used over 1,000, with machines in all main branches of the bank. HSBC Bank plc therefore did not see any adverse consequences for itself arising as a result of the proposed merger.

HM Land Registry

7.139. HM Land Registry told us that as a user of postal franking machines it had no issue with the proposed merger. Although the merger might be seen as narrowing the marketplace, there were no specific concerns at this time.

Society of Procurement Officers

7.140. A member of the Society of Procurement Officers in local government said that merging two of the three main players in the franking machine market would give the new company a large market share. Competition would then be between the merged entity and Pitney Bowes. This seemed to indicate that competition for franking machines would be restricted.

Other parties

Business Post Limited

7.141. Business Post Limited (Business Post) said that it was a leading UK parcel delivery company with 63 depots and 18,000 business accounts. Its associate company UK Mail had obtained a licence from Postcomm giving access to the Royal Mail delivery network in certain areas of the UK from 1 April 2002. Negotiations with Royal Mail were ongoing.

7.142. In developing its business mail services, it had announced in March that UK Mail, the Business Post subsidiary, was working with Pitney Bowes on the automation of mail management and payment solutions for its new service. Pitney Bowes would supply technology permitting UK businesses the chance to pay for their mail in a familiar and convenient way. (We took this to be a reference to franking machines.)

7.143. Business Post said that it had no formal comment to make on the merger.

[*Details omitted. See note on page iv.*]

7.144. [✄], which explored the possibility of arranging a management buyout of AMS, told us that, while it did not carry out a full due diligence assessment, it did enough to conclude that the risks of infringing Pitney Bowes' intellectual property were potentially too great for a stand-alone entity. It also believed that these risks would severely impair its ability to raise debt financing, and therefore to pay a price for AMS that would be acceptable to Ascom.

7.145. [✄] believed that Pitney Bowes had created what it described as a 'complex patent minefield', to which it did not wish to expose itself unless it believed it was in a strong position. It understood that AMS's existing settlement agreement with Pitney Bowes could not be assigned to the new owners in the event of a buyout: while the agreement would still afford some protection, its effect would be significantly reduced. [✄] primary concern related to machine developments occurring after the settlement agreement in 1994, that is the new generation of machines launched from 2001. [

Details omitted. See note on page iv.

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G F OWEN *(Chairman)*

B MILLS

D M G NEWBERY

R A RAWLINSON

A STEELE

R FOSTER *(Secretary)*

24 April 2002