

2 Conclusions

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The reference

2.1. On 10 January 2002 the Secretary of State for Trade and Industry (the Secretary of State) referred to the CC for investigation the proposed acquisition by Neopost of AMS (see Appendix 1.1 for our terms of reference). The Department of Trade and Industry (DTI) press notice said the Director General of Fair Trading (DGFT) had advised that the acquisition might raise competition concerns in the market for postal franking machines in the UK since it would bring together the second and third largest suppliers in a sector which was considered to have high barriers to entry and modest buyer power.

The companies involved

Neopost

2.2. Neopost, which is incorporated in France, was created by a management buyout from Alcatel SA (Alcatel) in 1992 and was listed on the French stock exchange in 1999. The company operates in three segments: mailing systems, in which franking machines are the principal product; document management, which is mainly concerned with machines that fold documents and insert them into envelopes (folders/inserters); and logistics, which concerns systems for parcel delivery. The mailing systems division accounts for some two-thirds of total turnover. Neopost employs 3,700 people worldwide, of which 450 are in the UK.

2.3. In its financial year to 31 January 2002, Neopost reported a consolidated turnover of €575 million (£357 million) and net income of €38 million (£24 million). Its net debt at 31 January 2002 was €294 million (£179.5 million). The stock market valuation of the company's equity capital on 15 April 2002 was €1,248 million or £763 million.

2.4. Neopost imports franking machines and related products into the UK from production facilities in France (for most franking machines) and the Netherlands (for folders/inserters), and from a sub-contractor in China (for small franking machines). It distributes products and provides services through a direct (that is, in-house) sales and service network which employs some [] sales representatives and 80 engineers based at six branch offices. In Northern Ireland it uses an independent company as exclusive distributor.

AMS

2.5. AMS is a business unit of Ascom, a company incorporated in Switzerland. Ascom was founded in 1963 under the name Hasler Holding AG and was renamed Ascom Holding AG in 1987 following the merger of several Swiss telecommunications companies. Ascom's principal activities are in telecommunications networks, transport ticketing and power supply systems. The group employs some 10,000 people worldwide. Of these AMS employs around 1,000, 140 of whom are based in the UK.

2.6. For the year to 31 December 2001, Ascom reported consolidated turnover of CHF 3,143 million (£1,293 million) and a net loss after exceptionals of CHF 396 million (£163 million). Its net debt at 31 December 2001 was CHF 631 million (£260 million). The stock market valuation of its equity capital on 15 April 2002 was CHF 428 million (£179 million). In 2000, AMS generated turnover of CHF 282 million (£110 million), of which 12 per cent was accounted for by its operations in the UK. (Full year figures for AMS in 2001 were not available.)

2.7. AMS manufactures franking machines and related products at facilities in Switzerland and the USA. It also sells other mailing products sourced from other companies but sold under its own name, notably folders/inserters and letter openers. In the UK, AMS is involved in the import, sales and servicing of mailroom equipment and the supply of associated consumables. It distributes products and provides services to customers in Great Britain through a direct sales and service network comprising some [] sales representatives and 65 engineers based at six branches. Like Neopost it uses an independent distributor in Northern Ireland.

The merger

2.8. At a board meeting on 28 August 2000, Ascom decided that its mailing equipment operation, AMS, was not a core activity for the group and should be divested. AMS opened discussions with Francotyp, a German mailing equipment company, about a possible merger between them. [

Details omitted. See note on page iv.

2.9. In January 2001, Ascom appointed HSBC Investment Bank plc (HSBC Investment Bank) to review possible ways of exiting the mailing equipment business. [

Details omitted. See note on page iv.

] but eventually decided that it did not wish to pursue this possibility (see paragraph 2.73). Ascom then decided to sell AMS by private auction, and in July 2001 HSBC Investment Bank contacted potential bidders. Those interested were sent an information memorandum, dated 9 July 2001, and given access to a data room.

2.10. In addition to Neopost, three parties were invited to make an offer by early August 2001, all of them being financial bidders which were interested in financing a management buyout, with AMS's existing management team, using a mixture of private equity and debt finance. One made an indicative offer but proceeded no further, and one made an offer in the form of an outline letter only. The third, [*Details omitted. See note on page iv.*], made the highest indicative offer, with Neopost second highest.

2.11. Ascom considered, however, that Neopost's bid should be preferred, for the following reasons:

(a) [] bid relied largely on debt financing from banks. Ascom felt that banks would have concerns about [

Details omitted. See note on page iv.

].

(b) AMS's management team was unwilling to bear the risk of the fixed-cost repayment obligations flowing from a high proportion of debt finance.

(c) [] did not have an in-depth understanding of the mailing equipment industry. Ascom thought that, if [] were offered a period of exclusivity to carry out further due diligence work, it would be likely to reduce its offer significantly.

(d) [] did not offer the synergies that Neopost did, hence AMS's future position in the market would be weakened.

2.12. Ascom therefore decided to enter into negotiations with Neopost. Neopost agreed to raise its offer by about [] per cent and on 17 August 2001 was granted a period of exclusivity. The outcome was the signing of a purchase and sale agreement on 2 October 2001 by which

Neopost agreed to acquire AMS for €240 million (£149 million), subject to final adjustments at closing. The agreement was conditional on, among other things, government authorizations.

2.13. The acquisition price of €240 million represented 1.4 times AMS's revenues in 2000, and 6.8 times its 2000 earnings before interest, tax, depreciation and amortization (EBITDA). The parties have subsequently agreed a final figure of €[§] million (£[§] million) as a result of further negotiations and the application of a formula in the agreement concerning variations in the value of net assets and financial indebtedness.

2.14. In announcing the agreement Neopost said that the acquisition represented a strategic step in its international expansion, reinforcing its position in key markets—the USA, Canada and the UK—and bringing direct distribution in Germany. It would add one-third to Neopost's revenues and increase its share of the world mailing systems market from 15 to 25 per cent.

2.15. AMS told us that Ascom's original decision in August 2000 to divest its mailing systems division had been taken for strategic, not financial, reasons. During 2001, however, Ascom's financial position deteriorated sharply. In December 2001 it obtained a bridging loan of CHF [§] million (£[§] million) from a syndicate of banks to repay bonds and meet short-term financial needs. This loan was secured on the expected proceeds of the sale of AMS and was due to be repaid on 31 March 2002. [

Details omitted. See note on page iv.]

2.16. Neopost told us in March 2002 that the merger had received the necessary authorizations in all the countries concerned except the UK. On 28 February 2002 Ascom sold to Neopost the distribution businesses of AMS in North America for €132 million (£80.5 million), [§] per cent of the total consideration which Ascom now expects for the AMS business as a whole. Because regulatory clearance had been granted in the USA and was not required in Canada, the parties were permitted to proceed with this sale. Neopost told us that the sale would not affect the AMS business in the UK or elsewhere in Europe: the parties would not transfer the AMS businesses outside North America, including their manufacturing and central research and development (R&D) functions, until the conclusion of the CC's investigation. By proceeding with the sale of the North American distribution businesses, Neopost hoped to realize some of the expected synergies without further delay, while Ascom needed the proceeds to alleviate pressing short-term cash needs. However, the principal objectives of the overall transaction—achieving global R&D and distribution synergies, and competing more effectively against Pitney Bowes—could not be realized until the overall transaction was completed.

Jurisdiction

2.17. Our terms of reference (see Appendix 1.1) require us to report on whether arrangements are in progress or in contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation, as defined in the Fair Trading Act 1973 (FTA), in that:

- (a) enterprises carried on by or under the control of Neopost will cease to be distinct from enterprises carried on by or under the control of Ascom; and
- (b) either the worldwide gross value of the assets which will be taken over exceeds £70 million (the assets test) or the merger will create or enhance a share of at least one-quarter in the supply of goods or services of any description in the UK, or a substantial part of the UK (the share of supply test).

If so, we have to report on whether the creation of that situation may be expected to operate against the public interest. Section 63(2) of the FTA provides that 'enterprise' means the

activities, or part of the activities, of a business. Section 65 specifies the circumstances in which two enterprises are to be regarded as ceasing to be distinct. One of the circumstances is where they are brought under common ownership or control.

2.18. As described in paragraph 2.12, Neopost entered into an agreement to acquire AMS in October 2001. AMS is an enterprise carried on under the control of Ascom. Neopost told us that, if granted approval following our inquiry, it intended to complete the acquisition of AMS. In that event, it is clear that enterprises carried on by Neopost and enterprises carried on by Ascom would come under common control and hence cease to be distinct within the meaning of the FTA.

2.19. Table 5.1 shows that in 2001 Neopost supplied 22.9 per cent of all franking machines supplied to end-users and dealers in the UK, and AMS supplied 9.1 per cent. The merger would, therefore, create a share of at least one-quarter in the supply of franking machines in the UK, and we conclude that the share of supply test is satisfied. In accordance with our terms of reference (see Appendix 1.1) we therefore exclude the assets test from consideration.

2.20. For the reasons set out in paragraphs 2.18 and 2.19, we conclude that arrangements are in progress or contemplation which, if carried into effect, will result in the creation of a merger situation qualifying for investigation as postulated in our terms of reference. Accordingly, we have to consider whether the creation of that situation may be expected to operate against the public interest. We describe first the markets which would be affected by the merger, before analysing what its effects would be.

The markets affected

Market definition

2.21. The operations of Neopost and AMS overlap in the supply of certain categories of mailroom equipment: franking machines, folders/inserters, letter openers, scales and mailroom furniture (though the last of these is not a significant element). They also overlap in the provision of maintenance, repair and other after-sales services for the equipment items; in the supply of consumables for franking machines; and in the provision of lease finance for mailroom equipment. We now consider how the principal markets affected by the bringing together of Neopost and AMS should be defined. The relevant economic market comprises the market for a group of products or services that currently provide competitive constraints (be they active or potential) on the merging firms, and the geographic area in which this occurs. One tool that helps us identify this group of products or services is the SSNIP (small but significant non-transitory increase in prices) or hypothetical monopolist test. This seeks to identify the smallest set of related products/services for which a hypothetical monopoly supplier could profitably increase prices by a small but significant amount, over a significant period, ie the market is defined as the smallest that could be profitably monopolized. Such an increase in price would be unprofitable if enough customers switched to other products or services in order to avoid the effect of the price rise (demand-side substitution); or if there were an increase in the supply of the product/service from other sources, except by new entry (supply-side substitution).

Franking machines

2.22. The function of a postal franking machine (referred to in this report simply as a ‘franking machine’) is to print a franked impression—that is, a mark recording the payment of postage—on an envelope or label, and to record the amount of postage paid. A franking machine consists of a meter and a base. The meter, which has to be pre-credited with an amount

of postage payable, securely records the amount of postage used, the credit left on the machine, the price of each item and the date sent. The base handles the passage of envelopes or labels through the meter.

2.23. Because franking machines are used to pay postage, in effect printing money, their production and use are tightly regulated by postal authorities (posts) in order to protect their revenues. In the UK, all models of franking machine must be tested and approved by Royal Mail, part of Consignia plc (Consignia), before they can be used. Manufacturers, and any independent firms wishing to service franking machines, must also be approved by Royal Mail, which seeks to satisfy itself that they are financially sound, properly managed and have secure systems and premises. Users have to be licensed by Royal Mail for each machine, and every machine in use must be inspected by an approved firm at least once a year. Manufacturers, distributors and service operators must all indemnify Royal Mail against loss of revenue from fraud that is attributable to their negligence. These regulations have major effects on the franking machine market.

2.24. Franking machines range from small machines processing perhaps no more than ten letters a day and priced at under £400, to machines handling 5,000 or more items of mail a day and priced at £18,000 or more. Machines designed to frank at the higher speeds, and handling the greater volumes of mail, typically offer a wider range of additional features, such as the ability to interface with other equipment. High-volume machines may be integrated into entire mailing systems, including folders/inserters, automatic feeders and stackers.

2.25. Machines can be classified into segments, broadly according to the volume of mail they are capable of handling:

- (a) low-volume machines, which are sometimes subdivided between so-called SoHo (small office/home office) machines processing around ten letters a day, and machines processing up to 100 letters a day;
- (b) mid-range machines typically processing between 100 and 500 letters a day; and
- (c) high-volume machines dealing with volumes over 500 a day.

However, there appears to be no consensus in the industry as to the precise dividing lines between these segments. Moreover, some models span two segments.

2.26. Most parties giving evidence to us said that, while broad distinctions could be made between the different categories, and between the types of use to which each category would be put, the dividing lines were blurred. A customer's choice of machine would depend not only on the volume of mail the machine could process in a day, but on other factors such as the pattern of the customer's mailing activities. Moreover, a customer could choose between using, say, two small-volume machines and one medium-volume, or two medium-volume machines and one high-volume. For these reasons the demand for different sizes of machine does not fall into separate sub-markets.

2.27. As regards the supply side, Neopost told us that the production techniques, skills and infrastructure required for the manufacture of all types of franking machine were similar: a production line could easily be redeployed to make different models and capacities of machine. On the other hand, there is some evidence that, while production of mid-range and high-volume machines is carried out in the same way, assembly of the simpler, low-volume machines uses different, mass-production methods. Both Neopost and Pitney Bowes outsource the manufacture of their smallest (SoHo) models to sub-contractors. However, this is not true of the other suppliers, each of which makes its full range of models in one facility. All five significant global manufacturers of franking machines supply machines in all three main segments.

2.28. For the reasons given in paragraphs 2.25 to 2.27, we consider that the supply of franking machines cannot be broken down into separate markets differentiated by category of machine.

2.29. The next logical step is to consider whether franking machines are part of a wider market which encompasses other forms of postage payment, namely:

- stamps and prepaid envelopes;
- various forms of bulk mail services provided by Royal Mail under contract (also referred to as ‘permit mail’);
- services provided by other licensed postal service providers;
- the outsourcing of mailing functions to specialist mailing houses; and
- electronic mail (email) and other communications technologies.

2.30. The parties emphasized the extent of the competition which franking machines faced from stamps and bulk mail, in particular. They said that customers using low-volume machines were quick to turn back to the use of stamps in the event of a price increase affecting franking machines. Furthermore, the proportion of Royal Mail revenue coming from bulk mail services had risen sharply, from 33 per cent in 1997/98 to 57.5 per cent in 2000/01, as Royal Mail had vigorously promoted these services and lowered the threshold of mail volume at which users became eligible for them (see Table 5.5).

2.31. In considering whether a rise in the price of franking machines would lead to a significant shift in demand to these other methods, we need to consider the particular advantages which franking machines offer. Compared with stamps, which are the main alternative at the low-volume end, the use of franking machines:

- (a) is much faster, and therefore allows savings in labour costs;
- (b) is more cost effective in that it allows the correct value of postage to be applied to each item;
- (c) facilitates cost control, in that many models allow a form of cost-centre accounting;
- (d) allows undeliverable mail to be tracked, since the sender’s Royal Mail identification number is printed on every frank;
- (e) allows the printing of a logo or promotional message alongside the frank; and
- (f) is seen by many users as creating a more professional image.

2.32. Evidently, franking machines provide a wider range of services than just postage payment. Some of these advantages, particularly (c), (d) and (e), are also relevant in comparing medium- and high-volume machines with bulk mail. Royal Mail told us that franking was also better suited than bulk mail options for the handling of mixed runs of mail.

2.33. Users have to weigh these benefits against the cost of acquiring the franking machine and the cost of ownership (in the form of servicing and consumables costs), as well as the need to train staff in the operation of the machines. We calculate that a 10 per cent increase in the price of franking machines and in the associated maintenance and consumables would increase users’ postage costs by about 2 per cent for low-volume machines and as little as 0.1 per cent for high-volume machines (see paragraph 5.15). Considering the advantages of franking machines, and the differences compared with the other forms of postage payment listed in

paragraph 2.29, it is implausible that such an increase in costs would lead to a significant reduction in demand for franking machines in favour of other methods. Suppliers told us that the proportion of total mail revenue attributed to franking machines was higher in countries, such as France, Germany, the Netherlands and Sweden, where the post gave a discount for franking machine use compared with stamps. This suggests that customers are sensitive to changes in the cost of postage, and that this sensitivity feeds through into the demand for franking machines. We note, however, that the discounts are often large in relation to the element of customers' postage costs which is due to the costs of acquiring and using franking machines (see paragraphs 3.40 and 5.16). We believe that other methods of postage payment are not in the same market as franking machines, although they may provide some competitive constraint on franking machine suppliers.

2.34. We have considered whether other mailroom products are in the same market as franking machines. This might be the case, for example, if the other products were always sold with franking machines because they were used to provide integrated mailroom functions.

2.35. In relation to folders/inserters, the evidence indicates that, while these are sometimes sold with franking machines in order to provide a seamless mailing operation, this is true for only a minority of sales. Folders/inserters sold in this way are not materially differentiated from other folders/inserters, and can be acquired and used separately from franking machines. Most franking machine users do not use folders/inserters, which are most suitable for processing the large volumes of similar or identical mail that are associated with bulk mail. We therefore believe that folders/inserters are not in the same market as franking machines.

2.36. Most franking machines are used with scales which weigh the mail before it is franked in order to determine the correct rate of postage. Larger and more modern franking machines incorporate scales as an integral part of the machine. In other cases, scales are supplied as a separate item but are required to interface electronically with a franking machine:¹ in such cases the electronic protocols which allow communication between the two pieces of equipment are proprietary products, and the scales have to be acquired from the same supplier as the machine. Scales are, however, acquired for other purposes too, for example by customers who use stamps. We consider that scales required to interface with franking machines, but not other scales, are in the same market as the franking machines themselves.

Services and consumables for franking machines

2.37. The provision of after-sales services and consumables forms a major element in the business model of franking machine suppliers. In the case of Neopost and AMS, service accounts for around [§] and [§] per cent respectively of their annual UK revenues (see Tables 4.2 and 4.9).

2.38. The services required by users of franking machines are as follows:

- (a) maintenance and repair;
- (b) inspection of meters to check that the meters' registers of postage used and credit remaining tally with Royal Mail's own records, and to look for any evidence of tampering (see paragraph 2.23);
- (c) recrediting: the amount of credit recorded in a franking machine meter needs to be topped up from time to time; and

¹In the past scales did not interface electronically with franking machines. There is therefore an installed base of stand-alone scales used with franking machines.

- (d) rate changes: whenever Royal Mail changes the rate of postage payable, the scales which interface with franking machines have to be reset to the new level.

2.39. Only two companies which are not franking machine suppliers have been approved by Royal Mail to carry out maintenance and repair work on franking machines. These approvals were granted in March and September 2001, and apply to only a few of the many models currently used in the UK. The two companies obtained about 1 to 2 per cent of the total revenues arising from this activity in the UK in 2001. The vast majority of users enter into a service contract with their supplier of franking machines at the same time as they buy a machine, or obtain service from the supplier on a non-contractual, call-out basis. Furthermore, only the franking machine suppliers or their authorized dealers are able to provide recrediting services¹ and make rate changes. For these reasons we consider that after-sales services for franking machines are part of the same market as the machines themselves.

2.40. The main consumable items needed by users of franking machines are envelopes, labels and ink or ink cartridges. The envelopes and labels required are not specific to franking machines and can be obtained from sources other than the machine suppliers. Special ink meeting Royal Mail specifications has to be used but may be obtainable from sources other than machine suppliers. The more modern models of machine, introduced from 1998 onwards, use ink-jet technology with the effect that ink has to be obtained in cartridges. Cartridges are specific to a particular model of machine and at present are obtainable only from the machine supplier. Thus, we consider that ink-jet cartridges, but no other consumables, are in the same market as franking machines.

Geographical extent of the franking machine market

2.41. As noted in paragraph 2.23, every model of franking machine used in the UK has to be approved by Royal Mail as meeting its specifications. These are different from the specifications used in other countries. (The UK is not unusual in this respect.) The parties told us that, while the machines they supplied to different countries were fundamentally the same, they had to be tailored to the requirements of each national post. These modifications accounted on average for about [] per cent of the development cost of a machine. It follows that, as far as users are concerned, markets are national in extent: a user in the UK is not able to buy a machine outside the UK for import and use in this country because it will not be approved by Royal Mail. On the other hand, we saw no evidence to suggest that market conditions varied significantly between different parts of the UK.

2.42. As far as the supply side is concerned, all the significant manufacturers operate internationally, supplying machines to a substantial number of countries. It appears that, with the possible exception of the USA, no national market is big enough to sustain a full-range franking machine manufacturing business (though we understand that there are two small manufacturers in Germany which supply low-volume machines only). Manufacturers carry out R&D and product design, and set up manufacturing facilities, with an eye to supplying machines to many countries.

2.43. Because of the differences between countries on the demand side, we consider that the market for franking machines in the UK is a national one. On the supply side, however, it is important for our analysis of the merger's effects to recognize that major aspects of competition between franking machine manufacturers are global in nature.

¹Some recrediting methods currently involve Consignia in providing the service but these methods will cease to be available after 2004: see paragraph 5.27.

Other products

2.44. The parties identified two broad categories of folding and inserting machines: those valued at below £21,000, which could insert 1,000 to 150,000 items of mail a month; and those valued at £21,000 and above which could insert larger quantities of mail. Neopost argued that these segments were distinct and said that both itself and AMS supplied machines only in the lower segment.

2.45. PFE, which specializes in these products, identified three segments and described the various differences which it saw between them on both the demand and supply side (see paragraphs 5.20, 5.21 and 5.32). In our view these differences provide a justification for distinguishing between large, production-mail machines and all smaller machines taken together, and we consider that the value threshold of £21,000 suggested by Neopost provides an appropriate cut-off between the two segments, which are sufficiently distinct to form separate markets.

2.46. The alternatives to the use of folders/inserters are manual operations and the use of non-postal methods of communication, such as email. Folders/inserters are used in the preparation of large batches of similar mail, such as bills, statements and marketing literature. It seems implausible that the alternatives are close substitutes for this kind of operation, and we consider that folders/inserters are not part of a wider product market on the demand side. Moreover, they are relatively large and complex items, and we were told that labour and equipment used in the manufacture of other types of equipment could not readily be switched to manufacture folders/inserters.

2.47. Since folders/inserters are specialized products, it is not surprising that their maintenance and repair is mainly carried out by the suppliers of the machines, although PFE told us that a small amount of maintenance work for large machines was done by independent providers. Thus, after-sales service for the smaller machines is in the same market as the machines themselves.

2.48. Unlike franking machines, folders/inserters are not subject to any product-specific regulation. There are common standards and paper sizes within the EC, and products imported from other EC countries can, therefore, be used freely in the UK. This is not the case with North America, where paper sizes are different, but this is not a significant factor in differentiating the North American and EC markets because of easy substitutability on the supply side. The same few suppliers appear to be active in most geographical markets. We consider that the market for folders/inserters is a global one.

2.49. Letter openers are machines which automatically slice off the top of an envelope in order to speed up the processing of incoming mail. Some machines also extract the contents from the envelope. The only alternative to the use of these machines is manual operation, which is clearly unattractive if high volumes of mail are involved. We found no evidence of segmentation of letter openers, for example according to processing speed. There are no national characteristics to the products.

Conclusions on market definition

2.50. In summary, we find that the markets directly affected by the merger may be defined as follows:

- a single UK market for franking machines, which also includes scales that are required to interface with franking machines; all aspects of after-sales service; and ink-jet cartridges for those models which require them (see paragraphs 2.22 to 2.43);

- a worldwide market for folders/inserters up to £21,000, including maintenance and repair services (see paragraphs 2.44 to 2.48); and
- a worldwide market for letter openers of all sizes, again including maintenance and repair services (see paragraph 2.49).

The franking machine market

2.51. Apart from Neopost and AMS the suppliers of franking machines in the UK are as follows:

- (a) Pitney Bowes is easily the largest supplier of franking machines with an estimated share of 62 per cent of the installed base of machines worldwide, and 80 per cent in the USA, by far the largest market. It has operated in the UK since 1922. Franking machines account for about half of its revenues in the USA but rather less elsewhere, and it also supplies all other types of mailing equipment. Its worldwide turnover in 2001 was £2,860 million and it employed 28,500 people at the beginning of that year. In 2001 it acquired Secap, a French supplier of franking machines, which had 3 per cent of the worldwide installed base of machines. Pitney Bowes invests heavily in R&D. It has a portfolio of some 1,400 distinct patents in all areas of mailing equipment technology. It has 500 patents applicable to the UK and 280 pending, a combined total of some 780: Neopost has some 300 granted or pending UK patents and AMS 75. In the UK Pitney Bowes sells primarily through a direct sales force some [§] strong: it has no dealers, although it outsources the telephone marketing of its SoHo machines to a specialist telesales operator.
- (b) Francotyp is a subsidiary of a diversified German company, Röchling. It produces a variety of mailroom equipment and is estimated, like AMS, to account for around 10 per cent of installed franking machines worldwide. Its worldwide turnover in 2000 was around £90 million. It entered the UK market in 1983 and supplies franking machines only through dealers.
- (c) Frama is a privately-owned Swiss company which produces franking machines and other postal equipment. It is estimated to have 3 per cent of installed franking machines worldwide. It entered the UK market in 1983, initially through a distributor, and now sells both via a direct sales force and a number of regionally-based dealers.

2.52. Total revenues from UK sales in 2001 of franking machines, after-sales services and the other products and services covered by our market definition were just over £[§] million (see Table 5.2).

2.53. A wide variety of organizations use franking machines, ranging from small businesses to the largest companies and public sector organizations. Demand is highly fragmented: information from the parties showed that no single customer accounted for as much as [§] per cent of their respective sales of franking machines in 2001. It is estimated that some 10 per cent of UK businesses use franking machines, and that revenue from franking machines accounts for 24 per cent of Royal Mail's total revenue.

2.54. Franking machines are differentiated products, hence suppliers compete on product features and ease of use as well as price (both for the machines themselves and for after-sales services) and quality of service. Suppliers told us that the dynamics of the market took the form of 'supply push' rather than 'demand pull': their sales forces devoted much effort to finding and retaining customers, such that a supplier's customer database was a highly valued asset. The market is characterized by a high level of leasing as well as outright sale, while Pitney Bowes also uses a high proportion of rental contracts in the supply of its entry-level machines.

Besides the attraction of the leasing business for its own sake, the supply of products via in-house leasing companies helps maintain contact with the customer and provides opportunities for persuading it to take a new and possibly upgraded machine at, or indeed before, the end of the lease term (typically five or six years). Public sector customers are more likely to buy machines outright than are private sector customers.

2.55. Entry barriers appear high. A company wishing to enter the market would have to design and produce machines capable of meeting the requirements of posts which, as noted earlier, differ significantly between countries. Much of the technology involved is subject to patent protection, particularly by Pitney Bowes. These and other factors are unlikely to be insuperable barriers but the size of the global market appears to be insufficient to attract newcomers willing to overcome the hurdles (see also paragraph 2.129). It is instructive that Pitney Bowes has been the market leader since franking machines were first produced, around 1920, and that Neopost is the successor to companies which have been the second highest supplier in the UK for much if not all of that period. There have been no entrants into the UK market since the 1980s.

Meter migration

2.56. In October 1997, Royal Mail launched a programme, referred to as meter migration, aimed at improving the security of franking machine meters by phasing out mechanical machines in favour of electronic models by October 2002, and by requiring that all machines be recredited remotely by the end of 2004. Royal Mail estimated in 1997 that 72,000 mechanical machines, about 35 per cent of the then installed base, would need replacing by the 2002 deadline (see paragraphs 3.34 to 3.36 for further details).

2.57. AMS told us that some 10 per cent (10%) of its 1997 UK installed base of some 32,500 machines was affected by these changes. This was a higher proportion than for other manufacturers because of AMS's greater reliance on machines with old, electromechanical technology. As at December 2001 it still had over 10% non-compliant machines registered, of which it believed over 10% were still in use and would need to be replaced by the October 2002 deadline, out of an installed base of 33,000.

Other developments affecting the franking machine market

2.58. There are reasons for believing that the rate of change in the industry is increasing.

2.59. First, there have been significant changes in the technology and functionality of franking machines in the last few years, and further radical change is in prospect. Digital technology has recently been introduced, enabling franking machines to behave as intelligent devices processing software for a variety of different applications. This offers the potential to integrate franking machines with other equipment.

2.60. Digital machines use software-based ink-jet printing technology, which is cleaner and quieter—although at present significantly more expensive—than traditional mechanical printing. Moreover, ink-jet printing allows much greater flexibility to vary the printed impression. The US Postal Service (USPS), which we were told tends to lead innovation in the franking machine industry, is taking advantage of this development to switch to the use of two-dimensional bar-code postmarks known as information-based indicia (IBI). These marks are capable of containing a range of information, including unique digital 'signatures' that make counterfeiting virtually impossible. Besides improving security, IBI offer the prospect of new services being provided, such as the tracking of mail items, and will allow the collection of data on customer usage patterns, valuable marketing information for posts (see paragraph 2.65).

2.61. Other posts are considering the introduction of such two-dimensional bar coding. Global harmonization of standards, which is under discussion, would be required if IBI were to be used for cross-border mail. Consignia has said that it might introduce the system in the UK within the next five years.

2.62. The next generation of franking machines, which Pitney Bowes has announced it will launch later in 2002 and in 2003, is expected to use networked digital technology for Internet applications. The information capture and exchange made possible by this technology will enable franking machines to communicate with postal and carrier systems. This will enable the provision of value-added services such as track and trace, delivery confirmation, rate information, remote diagnostics and the gathering of customer intelligence. The development of such services will, however, depend on the extent to which a compatible wider infrastructure is in place or can be developed. A key element is the capabilities of the postal carrier's systems. To accommodate the differing requirements of posts around the world, and the liberalization of postal services (see paragraph 2.64), franking machine software applications need to be as flexible as possible.

2.63. It is difficult to predict what the consequences of this evolution will be for the franking machine industry. On the one hand, given the move towards online interaction, and the resulting need for franking machines to interface with other established systems, the differences in the specifications of franking machines for use in different countries may increase rather than reduce. On the other hand, it may be that, given suitably flexible software, machine hardware could become more standardized. In the long term such convergence could make it more difficult for smaller manufacturers to survive by preserving strong positions in particular geographical markets.

2.64. The second factor making for more rapid change in the franking machine market is the liberalization of postal services. In the UK, Postcomm, the regulatory body for postal services, has proposed that the market should be opened to further competition in three phases, beginning in 2002 and concluding in 2006 with the full liberalization of the market. There is also an EC programme under which moves towards the liberalization of postal services are taking place in all member states.

2.65. The effects of liberalization on the franking machine market are also unpredictable. Neopost told us that in two countries, New Zealand and Sweden, where liberalization was further advanced than in the UK, new entrants to the postal services market did not offer franking-machine-based services, and demand for franking machines had fallen. Neopost said that it expected this experience to be repeated in the UK, with newly-licensed postal operators concentrating on bulk-mail-type services. But at least one of these entrants has recently reached an agreement with Pitney Bowes which would apparently allow customers to pay for its services via Pitney Bowes franking machines. Moreover, liberalization is likely to push Consignia into behaving more commercially. Consignia recognizes that it derives a financial benefit from the use of franking machines, compared with stamps, because of the lower costs involved (see paragraph 7.104). It may also see the developments in franking machine technology outlined above as presenting it with market opportunities. One possibility, therefore, is that Consignia might start to offer discounts on postage rates for users of franking machines (which currently pay the same rates as users of stamps) in recognition of these reduced costs and additional service possibilities, and as a way of keeping market share that it might otherwise lose to new entrants. Such a development could increase the growth of the franking machine market, and this could lead to a period of more intense competition for new customers.

2.66. One possible threat to the franking machine industry is the introduction of franking based on personal computers (PCs), a service which is already available in the USA, Germany and the Netherlands. Users purchase credit via the Internet, store it on a PC and print franks using a conventional computer printer. However, Neopost, which is one of four companies

authorized by the USPS to provide Internet-based postage services (Pitney Bowes is another), has substantially cut back its R&D spending on this activity, and told us that it now expected the growth of this form of franking to be much slower than it had earlier projected. Consignia told us that it had no immediate plans to introduce a similar service since it could not see an adequate financial return from it.

Implications for franking machine suppliers

2.67. The developments outlined above are obliging franking machine suppliers to acquire new skills, to enter into new partnerships, and to increase their R&D spending in order to keep pace with technological change and introduce innovative products. Neopost has raised its R&D spending as a proportion of revenue from 3.1 per cent in the year to 31 January 1997 to 5.5 per cent in the year to 31 January 2002. Since its revenues have grown quite strongly, this has enabled it to treble its R&D expenditure over the period (see Table 4.1 and Appendix 4.2). AMS's ratio of R&D expenditure to revenue rose from [§] to [§] per cent between 1998 and 2000 before falling back to [§] per cent in 2001. (In absolute terms, however, the two companies spent a combined total of only £[§] million in 2000, far less than Pitney Bowes' £80 million: see paragraph 2.111.)

2.68. In order to share the burden of rising R&D spending, AMS entered into a joint programme with Secap in 1997. The programme led to the development of two digital machines, the intellectual property in which is jointly owned by the two partners. However, AMS told us that the experience had not met its expectations in terms of speed of development, cost or quality of product, and the products were not yet fully operational in several countries, including the UK. Moreover, Pitney Bowes, following its acquisition of Secap in 2001, now has access to the jointly-owned technology.

Intellectual property rights

2.69. As noted in paragraph 2.51(a), Pitney Bowes has an extensive portfolio of patents—much larger than the other suppliers—covering aspects of technology for mailing equipment, notably franking machines. It has registered patents that relate, inter alia, to the two-dimensional bar codes introduced by the USPS (see paragraph 2.60). The parties told us that a proportion of Pitney Bowes' patents covered broad concepts in product design as well as narrower, technical features. They said that Pitney Bowes was willing to license its technology but was vigorous in protecting it. Other manufacturers had to find ways of developing products which avoided infringing Pitney Bowes' patents or face having costs imposed on them through licensing agreements.

2.70. Francotyp told us that the whole industry had to work around Pitney Bowes' patent portfolio when developing new products. Frama said that the technology was not groundbreaking but that it was a costly process to develop new products to avoid existing patents; Pitney Bowes' patent portfolio was a particular concern. Consignia told us that it would be difficult for other suppliers to produce two-dimensional indicia without infringing Pitney Bowes' intellectual property (see paragraph 5.77).

2.71. Pitney Bowes told us that its patents were the result of substantial investments in R&D. They included important inventions applicable to all aspects of the franking field, but they had always been made available by licence to Pitney Bowes' competitors. It had entered into cross-licensing agreements with other manufacturers of franking machines which in broad terms:

- provided the other party with access to Pitney Bowes' patented technology;

- included options for access to additional and future Pitney Bowes patents; and
- reflected pricing based on the value of the technology involved and the nature of the licence, taking into account the value of any technology licensed to Pitney Bowes by the other party.

Pitney Bowes said that the applicability of its patents concerning aspects of the USPS's two-dimensional bar-code system to any such systems adopted by other postal authorities would depend on their specific features: should the patents apply, they would be licensable.

2.72. Both Neopost and Ascom have cross-licensing agreements with Pitney Bowes which they entered into as part of the settlements of actions brought by Pitney Bowes alleging infringement of its IPRs (see paragraphs 5.71 to 5.72). The agreements are unlikely, however, to cover the newer technology which Pitney Bowes will be using in its next generation of machines. Both Neopost and AMS said that the issue of patent infringement was likely to be raised with them again in future by Pitney Bowes in relation to this technology.

2.73. [§], which explored the possibility of arranging a management buyout of AMS (see paragraph 2.9), 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 believed that Pitney Bowes had created what it described as a 'complex patent minefield', which it did not wish to expose itself to unless it believed it was in a strong legal 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. (AMS confirmed that its rights under the cross-licensing agreement with Pitney Bowes were not assignable to Neopost under the merger agreement.) [§] 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.

]

The folders/inserters market

2.74. In paragraph 2.50 we concluded that there was a worldwide market for folders/inserters valued at up to £21,000. There appear to be only three significant manufacturers of these machines globally, namely Neopost, Pitney Bowes and PFE. AMS sells machines sourced from PFE under the Ascom name but does not manufacture them. In the market for large folders/inserters there are several manufacturers, including Pitney Bowes and PFE, but neither Neopost nor AMS is present.

2.75. PFE is a British-based company. All of its output of folders/inserters is produced in the UK and 80 per cent of its production is exported.

2.76. In 2001, worldwide sales of small folders/inserters were worth around £[§] million. Of this total Neopost had 56 per cent and Pitney Bowes 35 per cent. PFE's direct sales accounted for 6 per cent of the total, and AMS's sales of rebadged PFE machines for a further 2 per cent (see Table 5.4). In the UK, total sales of these machines in 2001 were worth £[§] million, of which Neopost had 48 per cent, compared with 26 per cent for Pitney Bowes, 16 per cent for PFE, and 3 per cent for AMS (again through its sales of rebadged PFE machines).

2.77. The customers for these products are either specialist mailing houses, or organizations such as banks and insurance companies, manufacturing companies, local authorities and government departments, which generate large batches of similar outgoing mail, for example bills, statements and marketing literature.

The letter-openers market

2.78. Although we have defined the market for the supply of letter openers as worldwide, the industry is relatively fragmented, and there is no data on worldwide sales and market shares. In the UK, Neopost estimated that the merged company would have under 30 per cent of the market, of which AMS accounted for less than 5 per cent. As with folders/inserters, however, AMS's share arises from sales under its own name of machines sourced from other manufacturers (indeed some of Neopost's sales are also rebadged machines). Other leading suppliers of letter openers are Opex, Stielow and Pitney Bowes. Neopost's sales of letter openers in the UK in its financial year to 31 January 2002 were worth some £[redacted], while AMS's sales in 2001 were £[redacted] (see Tables 4.2 and 4.9).

2.79. We received no representations about adverse effects from the merger on the supply of letter openers. In view of the small increment to Neopost's share, the fact that AMS's share arises entirely from machines bought in and rebadged, and the fact that this is a worldwide market with a number of suppliers, we are not concerned about the merger's effect on this market and we do not consider this aspect further.

The counter-factual

2.80. In order to establish the merger's effects, we have to compare the prospects under the merger with the prospects under the most likely alternative scenario(s). Thus, we need to consider what would have been likely to happen if Neopost had not agreed to acquire AMS. This is a hypothetical exercise, and for this purpose it is irrelevant whether or not the merger has already gone ahead, in whole or in part. The question of practical alternatives to the merger, given the situation now reached, will only become relevant if we conclude that the merger is against the public interest and have to consider remedies for the adverse effects. In this connection it is pertinent to note that our terms of reference (see Appendix 1.1) require us to report on the merger as a whole, not merely the UK element of it, although our concern is with the merger's effect on the UK public interest.

2.81. As described in paragraph 2.8, Ascom decided in August 2000 that its mailing systems division, AMS, was not a core activity for the group, and set about the process of divesting the business. Subsequently, Ascom has run into financial difficulty and now has an urgent need to raise money to repay loans. Ascom told us that, whether or not the sale to Neopost went ahead, it would certainly divest AMS. It is clear to us that a continuation of the status quo, in which AMS formed part of the Ascom group, was unlikely.

2.82. AMS appears to be a viable business in its own right at present. According to the 'carve-out' accounts prepared for the purposes of the divestment by Ascom, its revenues have been growing moderately. Its EBITDA as a proportion of revenues fell from [redacted] per cent in 1998 to [redacted] per cent in 2000 but rose to [redacted] per cent in the first nine months of 2001 (see Appendix 4.6). Its product range is ageing, however—it has not yet succeeded in launching any digital machines—and it appears to have had difficulty in sustaining an R&D programme of adequate quantity and quality.

2.83. Nevertheless, it was clear from the evidence we received that AMS enjoys a high reputation in the franking machine industry and that its products, though not at the leading edge

of recent developments, are good. Given the importance of after-sales revenue and the prospects for retaining customers, its customer database is a valuable asset.

2.84. In view of the factors outlined in paragraphs 2.82 and 2.83, we consider it reasonable to assume that Ascom would probably have been able to find a buyer other than Neopost, albeit at a lower price. A relevant question for our inquiry is whether the buyer might have been another supplier of franking machines.

2.85. We assume that competition regulators would prevent AMS being sold to Pitney Bowes, which already has a dominant position in the franking machines industry worldwide. (We note that Ascom also took this view: see paragraph 6.113.) There are only two other significant suppliers of franking machines besides Neopost, namely Francotyp and Frama (see paragraph 2.51 for a brief description of these companies).

2.86. As noted in paragraphs 2.8 and 2.9, efforts were made over an extended period in 2000/01 to merge AMS with Francotyp, but although different permutations were considered, the efforts failed. Nevertheless, it is clear that those involved saw commercial logic in putting the two companies together. Despite the failures of the earlier efforts, we do not dismiss the possibility that, given the right financial conditions (for example, if Ascom had been obliged, in the absence of Neopost as a bidder, to accept a lower price), such a merger would have been possible.

2.87. Since Frama is a private Swiss company, no consolidated accounts for the group are available. It is, therefore, difficult to form a soundly-based judgement as to whether it might have been able to buy AMS. The fact that its share of the worldwide installed base of franking machines, at 3 per cent, is only one-third of AMS's suggests that it might not have the capability to finance and manage an acquisition of AMS. Unlike the other four franking machine manufacturers, it has no experience of operating in the key US market. [

Details omitted. See note on page iv.

] Nevertheless, we cannot rule out the possibility that, at a lower price, Frama might have been a buyer for AMS.

2.88. Turning to the possibility of whether someone from outside the franking machine industry might have acquired AMS if Neopost had not, we note that, although three financial bidders expressed interest in acquiring AMS, only one made a serious offer. Moreover, we cannot be sure that that company ([§]), which actually made the highest indicative offer, would have proceeded if it had been granted exclusive negotiating rights. Taking account of the view which [§] took of the intellectual property infringement risk when it was able to study the matter in some detail (see paragraph 2.73), we believe that some doubt must be attached to the possibility that a buyout for AMS would have gone ahead.

2.89. There remains the possibility that an industrial company, probably one operating in a related field, might have bought AMS. Ascom dismissed this possibility, but was no doubt influenced by its view that Neopost would be in a position to offer the best price. [§], which made enquiries but was effectively rebuffed by Ascom, told us that it would have been very keen to acquire AMS. Given [§]'s lack of detailed knowledge about some aspects of AMS's situation, we cannot assume that it would in fact have acquired AMS if it had been given the opportunity. Nevertheless, the possibility that an industrial company from outside the franking machine industry might have acquired AMS, if Neopost had not, cannot be ruled out.

2.90. We note, however, that an acquisition of AMS by any party other than Neopost might have been problematic. This is for three reasons:

- (a) At the present juncture the franking machine business calls for significant investment in R&D and product development because of technological change (see paragraphs 2.59 to 2.63).

- (b) There is considerable uncertainty about the future evolution of the industry and the level of demand.
- (c) There is further uncertainty over the issue of intellectual property infringement arising from Pitney Bowes' extensive patent portfolio and vigour in protecting its IPR (see paragraph 2.73).

2.91. Taking account of the factors set out in paragraphs 2.81 to 2.89, we think there were two possible alternatives to the merger:

- (a) that AMS would have merged with Francotyp or (less likely) Frama; and
- (b) that AMS would have been acquired by someone from outside the franking machine industry, possibly a financial buyer, possibly an industrial company operating in a related market.

We shall assess the effects of the Neopost/AMS merger against both these alternatives.

2.92. A merger between AMS and Francotyp would have created a company with a combined share of the worldwide installed base of franking machines of around 20 per cent, ahead of Neopost's 15 per cent. In broad terms the structure of the industry would then have included one dominant firm, Pitney Bowes, two modest-sized players and one small player, Frama. A combined AMS/Francotyp could have devoted significant resources to investment in R&D but Francotyp expressed doubt that such a combination would have had sufficient critical mass to challenge Pitney Bowes. A combined AMS/Frama would have been a considerably smaller player in the franking machine market. In assessing the effects of the Neopost/AMS merger, it is sufficient for analytical purposes to compare it with the alternative of an AMS/Francotyp combination since it is reasonable to expect that an AMS/Frama combination, besides being the less likely of the two, would also have been a weaker competitive force.

2.93. If AMS had been owned by someone from outside the franking machine industry, it is likely that it would have had relatively low R&D spend and chosen to compete in particular niches rather than across the board, perhaps selling some rebadged products sourced from the original equipment manufacturer (OEM). Given its likely weakness in product development, it would have had to compete for business on other aspects, notably price, quality of service and financing terms. This is broadly similar to the present situation with AMS in Ascom's ownership. If AMS had been owned by a financial buyer, it might have been weaker financially than it is now because of the high level of debt typically associated with such ownership. Although AMS would probably have continued as a competitive force in the short term in those circumstances, the company would have had limited resources for tackling the patent problem. It could have started to lose customers quite soon due to its weakness in digital machines. It seems quite likely that it would, after a short time, have looked to merge with another franking machine company to achieve economies in these areas. This would have been equivalent to the other possible scenario that we have described in paragraph 2.92.

2.94. The other element in the counter-factual is that Neopost would have continued as a separate supplier, not merging with another manufacturer of franking machines.

The merger's effect on the UK franking machine market

2.95. Table 5.2 shows suppliers' UK revenues in 2001 from sales of franking machines, interfaced scales, after-sales service and ink-jet cartridges, in line with our definition of the market. Pitney Bowes' revenues accounted for 52.3 per cent of the total (by value), Neopost 25.6 per cent and Ascom 9.8 per cent. Thus, the effect of the merger would be to increase

Neopost's share to 35.4 per cent, still well behind Pitney Bowes but far ahead of Francotyp with 6.3 per cent and Frama with 4.5 per cent.

2.96. Shares of the installed base are another useful indicator of suppliers' positions in the market. Figure 3.3 shows that, in 2001, Neopost had some 24 per cent of the installed base and Ascom 16 per cent. Thus, the merged company would have a combined share of 40 per cent, compared with Pitney Bowes' 49 per cent.

2.97. Based on our definition of the franking machine market, the Herfindahl Hirschman Index (HHI), a measure of industry concentration, would increase from around 3,640 to 4,140. In the guidelines of the US anti-trust authorities, an HHI of over 1,800 is seen as denoting high concentration. An increment of over 100—and in this case it would be 500—in a market which is already highly concentrated indicates that a merger may raise significant competition concerns which warrant close scrutiny. Nevertheless, the HHI can be no more than an indicator: our view of the merger's effects needs to be based on a detailed scrutiny of the particular circumstance in this market.

Changes in the market since the mid-1980s

2.98. In the mid-1980s our predecessor body, the Monopolies and Mergers Commission (MMC), carried out an inquiry under the monopoly provisions of the FTA into the supply, maintenance and repair of franking machines in the UK. The report was completed in January 1986, and the latest full year for which market information was available to the inquiry was 1984 (see Appendix 3.3). Since this is an industry in which change has hitherto generally been gradual, it is useful to compare the situation as we have found it (albeit in the context of a merger inquiry) with that described by our predecessors.

2.99. The 1986 report found that, in 1984, Pitney Bowes had 56.5 per cent of the installed base of franking machines in the UK, and Roneo Alcatel (the predecessor of Neopost) 37.2 per cent. AMS (then called Hasler) was the only other supplier of any consequence, with 5.8 per cent.

2.100. The inquiry concluded that the dominant position of Pitney Bowes had enabled that company to assume a degree of price leadership which other suppliers had not been in a position to challenge. There was selective discounting to the bigger and more valued customers but the price level of franking machines had stayed well ahead of that for other office equipment and the general price index, and was higher than it need be or would be in conditions of more effective competition. Other factors which restricted competition arose from Post Office regulations which effectively prevented distribution through dealers. Those regulations also prevented the development of independent maintenance services, which would have introduced competition into the maintenance market and, in the MMC's view, helped bring about the sale of second-hand equipment.¹

2.101. The inquiry rejected any form of price control, or an obligation on Pitney Bowes and Roneo Alcatel to supply dealers, but it recommended that the Post Office should amend its arrangements to allow for:

- (a) the distribution of franking machines by independent dealers approved by the Post Office;
- (b) the maintenance of franking machines by independent engineers approved by the Post Office; and

¹See paragraphs 9.44 to 9.46 of the report.

- (c) the refurbishment and supply of second-hand machines by approved dealers or maintenance engineers.

The report also recommended that the Post Office should reduce the requirement for regular maintenance and inspection visits to two visits a year and to consider within two years a further reduction to annual inspection for all established machines with a low fault rate.

2.102. If the Post Office adopted these recommendations, the report continued, Pitney Bowes and Roneo Alcatel should require only that maintenance of franking machine meters be carried out by persons approved by the Post Office. Other recommendations were that Pitney Bowes and Roneo Alcatel should not make the return of franking machines to the original supplier a condition of their arrangements with leasing companies, and should provide customers with price lists for franking machines showing the purchase prices, the terms of other methods of supply, and maintenance charges. Pitney Bowes should inform customers that they were free to obtain leases from companies other than its in-house lease supplier.

2.103. The Government accepted the conclusions and recommendations. As a result, Pitney Bowes and Roneo Alcatel gave undertakings to comply with the recommendations which affected them, and the Post Office agreed to amend some of its arrangements concerning franking machines.

Subsequent developments

2.104. The principal changes in market shares, expressed as shares of the installed base, since the mid-1980s have been as follows:

- (a) Pitney Bowes' share fell from 56 to 50 per cent by 1990 but has continued at broadly the same level since then;
- (b) Roneo Alcatel's (now Neopost's) share fell steadily from 37 per cent to 23.4 per cent in 2000 before recovering a little to 24.4 per cent in 2001 (this was the first year in the period in which Neopost's share rose);
- (c) AMS's share rose steadily from 5 per cent in 1984 to 17.4 per cent in 1998 but has since declined to 15.8 per cent;
- (d) Frama and Francotyp have each slowly grown their share from under 1 per cent in 1984, and each had 4.4 per cent in 2001; and
- (e) Secap entered the market in 1988, selling through a distributor named Addressing Systems International (ASI), and had achieved a share of 1.9 per cent by 2001 when it was acquired by Pitney Bowes.

Apart from the advent of Frama and Francotyp, the only significant developments in the identity of the suppliers have been the change in ownership of Neopost from being a division of a diversified group, Alcatel, into a focused mailing equipment supplier, and the absorption of Secap by Pitney Bowes.

2.105. The recommendations of the 1986 report that were designed to reduce restrictions on competition and open up the market seem to have had very limited effect. As noted in paragraph 2.39, only two companies other than the franking machine suppliers themselves have been approved by Royal Mail to carry out maintenance work, and both of these approvals were granted as recently as 2001 and limited to certain models of the then smallest supplier, Secap, for which they also act as dealers (see below). Both of these companies told us that the process of securing Royal Mail approval had taken about seven years. (Royal Mail told us that, now the

approval process had been developed in detail, future applications could expect to be processed much more quickly.) Independent maintenance operators require approval and cooperation from franking machine suppliers as well as Royal Mail, however. Until 2001, Secap was an independent manufacturer seeking to grow a UK business from a low base. It is not surprising that a company in this position, lacking the economies of scale to carry a sizeable in-house service function, would make use of independent maintenance operators. Now that Pitney Bowes has acquired Secap the position is different, although Pitney Bowes has for the present continued the arrangement with the independent maintenance operators (we note that it continues to be subject to the undertakings that it gave following the 1986 MMC report: see Appendix 3.3).

2.106. There is now some use of dealers to distribute franking machines, which was prevented by Post Office regulations until the 1986 report. Francotyp supplies entirely through dealers and Frama partly so. It may be that the development of their UK sales, slow as it has been, would have been hindered if they had not been permitted to supply through dealers. Both Neopost and AMS supply through dealers in Northern Ireland, the Channel Islands and the Isle of Man. They presumably find that arrangement more efficient than direct supply. In all these cases the dealers are exclusive to their respective suppliers and operate on the basis of allocated territories: there appears to be little competition, in the sale of a given supplier's products, either between different dealers or between dealers and the suppliers' direct sales forces.

2.107. [

Details omitted. See note on page iv.

] Neopost told us that this was an experiment, but that it was considering extending the arrangement to cover other products.

2.108. Neopost claimed that the franking machine market was significantly more competitive now than in the mid-1980s, and that prices had fallen. However, it is difficult to track price changes for differentiated products such as these when old models are replaced by new ones with different characteristics, and when the mix of products sold varies over time. There has been a sharp fall in Neopost's average realized sale price per unit in the past two years, but that appears to be largely due to growing sales of its new entry-level machine, which sells at a lower price point than previous models. We heard other evidence, for example from AMS, that list prices were raised each year broadly in line with inflation. We were not persuaded that there was sound evidence of a declining trend in prices for franking machines.

2.109. Moreover, what matters to the customer is the lifetime costs of acquiring and using a franking machine. The list prices of Neopost's service contract options have generally increased significantly in real terms in the last two years. Neopost told us that the incidence and level of discounts on service contract prices had also grown, but its estimate of the proportion of its service contracts which carried a discount was only [] per cent. AMS's prices for service contracts have also risen somewhat ahead of general inflation in the last few years (see Appendix 3.6).

2.110. Where Neopost was on stronger ground in claiming that the industry had changed was in pointing to the much more rapid pace of technological change in the industry compared with the mid-1980s: see paragraphs 2.58 to 2.66.

The parties' case that the merger will strengthen competition

2.111. The parties submitted that the merger would enhance competition in the UK franking machine market. The merger should be seen in the global context, they argued. The industry was dominated by Pitney Bowes, whose strength stemmed from its large patent portfolio, heavy R&D spending, high brand recognition, full range of products, large distribution network and scale efficiencies. Pitney Bowes' share of installed franking machines worldwide,

at 62 per cent, was four times as great as Neopost's. It had an unassailable 80 per cent share in the USA, by far the world's largest market for franking machines. The parties said that in 2000 Neopost had spent £[redacted] million on R&D and AMS £[redacted] million: by contrast Pitney Bowes had spent £80 million, yet this represented a much smaller proportion of its revenues than did Neopost's and AMS's spend.

2.112. The parties submitted that the merger would allow the enlarged Neopost to challenge Pitney Bowes more effectively. It would permit the combined group to offer a broader range of products, gain enhanced brand recognition, reduce manufacturing costs, avoid duplication in research efforts, strengthen product development, and become more efficient in marketing and distribution. In particular, the enlarged group would be able to compete in developing machines incorporating leading-edge technology.

2.113. Pitney Bowes and the enlarged Neopost would continue to face competitive constraints from Frama and Francotyp in the franking machine market itself; from existing alternative forms of postage such as stamps and bulk mail; and from new forms of postage such as Internet-based franking. Moreover, postal liberalization would increase the options open to customers.

2.114. The parties recognized that the merger would restore a duopolistic structure in the UK franking machine market but argued that tacit coordination (or joint dominance) would not arise because none of the market characteristics typically associated with situations of tacit coordination was present (see paragraph 2.147).

The views of third parties

2.115. We received few representations arguing that the merger would have adverse effects. There was little evident interest from customers (see paragraphs 7.134 to 7.140). The Chartered Institute of Purchasing and Supply (CIPS) reported that its members had not raised franking machines as an important issue in recent years. When it asked members for views on the merger it received relatively few replies: some respondents felt that the merger would cause competition problems but some commented that it would not have a major impact on their business. The general lack of interest from customers reflects the fragmented nature of the demand side of the market.

2.116. Among other franking machine suppliers, Pitney Bowes was sceptical of the claim that Neopost needed to acquire AMS in order to be able to compete effectively with Pitney Bowes. If the merger were to proceed, Neopost's market position in the UK would be indistinguishable from Pitney Bowes' and it should, therefore, be subject to the same undertakings as Pitney Bowes was as a result of the 1986 MMC report. (See Appendix 3.3: the undertakings applying to Neopost were lifted some years ago, although the company told us that it continued to observe them.)

2.117. Frama and Francotyp were not opposed to the merger. Frama did not think the merger would have a detrimental affect on its own position. Francotyp had a high opinion of AMS's products and service, and thought that, if AMS ceased to exist as a separate entity, its customers would choose to switch to Francotyp rather than Pitney Bowes or Neopost. (See also paragraph 2.143 for our assessment of the views of these two companies.)

2.118. Consignia told us that it believed the merger would have a positive effect on the UK franking machine market. It would increase the competitive pressure on Pitney Bowes, with beneficial effects on customers. Combining the R&D budgets of Neopost and AMS should lead to the development of more products and their more rapid introduction to the market. In Consignia's experience, Neopost's franking products tended to be innovative and customer-orientated: it would expect this trend to continue, and potentially strengthen, if the merger went ahead.

2.119. The main source of opposition to the merger was PFE, which submitted that the merger raised substantial competition concerns in the related markets of franking machines and folders/insetters. The concerns which it raised in respect of the franking machine market are among those that we considered in our assessment, which follows below. PFE's own interests arise in the folders/insetters market, and we record its representations in respect of that aspect of the merger in paragraphs 2.174 to 2.177.

Our assessment

2.120. The merger has the following principal effects on the structure of the UK franking machine market:

- (a) it reduces the number of suppliers from five to four and, in particular, removes AMS as an independent source of competition and choice;
- (b) it creates a market structure in which the top two suppliers will have over 85 per cent of the market between them; and
- (c) it strengthens the position of the number two supplier in relation to the market leader.

We examine the likely implications of each of these consequences in turn, recalling where relevant the counter-factuals to the merger which we identified earlier (see paragraphs 2.80 to 2.94). We begin our assessment, however, with some remarks on the present state of competition in the market.

The present state of competition

2.121. The main focus of competitive activity in the last few years has been in the introduction of low-priced entry level machines using digital technology and ink-jet printing. Pitney Bowes was the first to introduce such a machine, and, as a result, achieved substantial growth in its sales and market share measured by volume, particularly in 1999. Neopost made up some of the lost ground in 2000 and 2001—and not only at the low end of the market—when its share of sales rose very sharply both in volume and value terms. As a result, the long decline in its share of the installed base (a volume measure) was arrested in 2001 when its share rose by a full percentage point—a significant rise given the slowness with which this indicator changes in response to movements in annual sales.

2.122. AMS increased its share of sales a little between 2000 and 2001 (see Tables 5.1 and 5.2). This success appears, however, to be at least partly due to the fact that its installed base users were more affected by meter migration than those of its competitors (see paragraph 2.57), creating more selling opportunities for AMS. Its current share of sales is well below its share of the installed base, with the result that the latter has started to fall steadily from 1998 to 2001 (see Figure 3.3). Unlike the other four suppliers, AMS has not so far been able to launch commercially any digital machines in the UK market.

2.123. Over the same period, Francotyp's share of the installed base has risen from 3.8 to 4.4 per cent, while Frama's has fallen slightly, from 4.6 to 4.4 per cent. Both have good, though incomplete, product ranges (they have featured among the 'best buys' recommended in business magazines). Both are strong in particular geographical markets in Europe: Francotyp in Germany and Austria; Frama in Switzerland and the Netherlands.

2.124. We have noted earlier that buyer power is weak because there are no large buyers of franking machines and purchases tend to be occasional and/or of modest size. We formed the impression that price competition was patchy. Neopost carried out a survey of recent contracts

showing that, in [84] of the cases covered, it achieved sales where no other supplier was involved (see Appendix 5.2). The survey also showed that, not surprisingly, the discounts which Neopost offered in such cases were low. Even across the whole range of cases, however, the average discount for Neopost's bids was [84] per cent. Other information from Neopost showed that it was prepared to offer considerably higher discounts for national accounts, where orders were put out to tender (see Table 3.5).

2.125. Assessing the strength of price competition, however, is a complex matter. Because of discounts and the high incidence of leasing, prices for machines are not transparent. Moreover, a high proportion of suppliers' revenues derives from after-sales service and consumables. Accounting information from the parties showed that, as is characteristic of such industries, the suppliers made much higher margins on service and the supply of consumables than on their sales of machines. Partly thanks to Royal Mail regulations—but partly also because franking machines are a relatively small and specialized market—the suppliers have so far been able to retain a very high proportion of the after-sales revenue from the machines they sell. They are also able to use their ongoing relationships with customers—through leasing and maintenance contracts and the recrediting of meters—to retain follow-on business.

2.126. Some of these characteristics are likely to be common to the franking machine markets in most countries, although differences in postal regulations can have a material effect on competitive conditions. Some parties, however, including Francotyp and Frama, told us that machine prices in the UK were generally higher than in some other Western European countries. Soundly-based international price comparisons are hard to make. Information from the parties did not indicate that their intra-group suppliers in France (for Neopost) and Switzerland (for AMS) made higher margins on their sales of machines to the UK compared with the margins on sales to distribution subsidiaries in other countries. However, Neopost's UK distribution company appears to earn margins which are rather higher than its counterparts. Thus there is some, albeit not very powerful, evidence that prices in the UK may be higher than those elsewhere in Europe, which could suggest that the market here is somewhat less competitive. (Another possible explanation is that distribution costs in the UK are higher for reasons which are not to do with the competitiveness of the market).

2.127. Pitney Bowes told us that, until five years ago, there had not been much difference in franking machine prices between countries. The advent of the Euro had caused intense price competition in the countries affected, however, with all suppliers seeking to preserve their market shares during the migration to the new currency. As a result, prices in Germany, for example, had fallen below those in the UK in the last two years.

2.128. We have given some attention to the IPR situation arising from Pitney Bowes' extensive portfolio of patents. The 1986 MMC report commented that cross-licensing agreements of the kind that exist between Pitney Bowes and both Neopost and AMS could be anti-competitive in that they might remove the incentive on companies to carry out R&D. On the other hand, Neopost and AMS appear still to have ample incentive to invest in R&D in order to avoid the cost implications of having to license Pitney Bowes technology for forthcoming generations of machine: as noted in paragraph 2.67, both companies have increased their R&D investment in recent years (although AMS had to cut back in the latest year because of financial constraints).

2.129. Neopost and AMS have significant patent portfolios of their own, albeit much smaller than Pitney Bowes'. For any entrant, however, the possibilities for launching machines without having to license technology from an incumbent, most probably Pitney Bowes, appear slight. This appears to constitute a substantial barrier to entry; moreover, the likelihood that entrants would have to pay IPR royalties may serve to raise the prices which incumbents can charge for machines while still being competitive with entrants.

2.130. We commented earlier that the liberalization of postal services is a source of uncertainty (see paragraph 2.65). Given, however, that at present there are no discounts for franking machine users compared with the price of stamps, we believe that Consignia may start to offer such discounts as part of a strategy to protect its existing business. Thus, on balance we consider that liberalization is likely to be a positive factor for the franking machine market.

The reduction in the number of suppliers and the removal of AMS as a separate player

2.131. One of the possible counter-factuals to the merger (see paragraph 2.91) would have involved the combination of AMS and Francotyp, which like the merger itself would have reduced the number of suppliers from five to four and removed AMS as a separate player. For the purposes of analysis, we concentrate in this section primarily on comparing the merger with the other alternative, which is broadly equivalent to the status quo.

2.132. The effect of the reduction in the number of suppliers depends on how the competitive process works. We have seen that, in this market, it is the suppliers that normally take the initiative. A supplier's impact on competition, therefore depends heavily on the size and effectiveness of its sales force. AMS has some [redacted] salespersons in the UK, compared with around [redacted] for Pitney Bowes and [redacted] for Neopost. Neopost's survey (see paragraph 2.124) found that Neopost faced AMS as a rival bidder in only [redacted] per cent of the 165 cases studied, and that in [redacted] case was AMS the only other bidder. (Of the [redacted] cases where Neopost and one other supplier made bids, Pitney Bowes was the other bidder in [redacted] of them.) The survey was relatively small and concerned bids made over a period of only a few weeks. Its results are, however, consistent with the picture which emerges from recent sales data, and from the relative sizes of sales force, that active competition takes place primarily between Pitney Bowes and Neopost.

2.133. It appears that some purchasers—though Neopost's survey suggests they are a minority—seek to obtain at least three bids when they wish to acquire new machines. Following the merger it would be open to such purchasers to invite bids from Frama and/or Francotyp, both of which have good products, some of them more modern than AMS's. In particular, Frama offers an entry-level ink-jet machine (albeit sourced from Neopost on an OEM basis), and Francotyp is expected to launch one very shortly. These machines are (or will be) priced well below £1,000, whereas AMS's small machine has a list price of over £1,300. The loss of AMS would be felt more at the very top end, where only Pitney Bowes, Neopost and AMS compete. (We note, however, that at this end of the market permit mail offers a growing competitive constraint: see paragraph 2.30.)

2.134. AMS told us that it had sought to differentiate itself from Pitney Bowes and Neopost in the UK market by an emphasis on giving the customer a better deal. It could not hope to compete head-on with Pitney Bowes with the price of machines, so it had emphasized the reliability of its products, and the quality and value of its after-sales service. It had also sought to portray itself as offering fair dealing. The franking machine industry had in the past been criticized for some of its sales practices, particularly in relation to leasing. AMS had sought to give customers an informed choice between leasing and outright purchase, and in practice a much higher proportion of the installed base of its machines had been bought outright (though this was partly because a relatively high proportion of its sales had gone to the public sector).

2.135. We heard evidence from other sources which broadly corroborated this account. It is fair to say, however, that no recent cases of sales malpractice were brought to our attention. Consignia told us that standards had improved in recent years. CIPS told us that its members had not raised concerns with it in respect of franking machines. Moreover, although it may have been the case in the past that AMS made no attempt to persuade customers to opt for leasing rather than outright purchase, for the last few years its salesmen have been able to earn

additional commission for taking leased orders (provided the lease is arranged through AMS's in-house leasing company). Nevertheless, even now a much smaller proportion of AMS's sales by value are made through leasing (around [§] per cent) than is the case for Neopost ([§] per cent).

2.136. Both parties said that Neopost had something to learn from AMS about customer satisfaction, and argued that the particular qualities of AMS's offering would not be lost as a result of the merger. On the other hand, Neopost indicated that it continued to see attractions in leasing products, through its in-house leasing company, rather than selling them outright. It seems to us reasonable to expect that the corporate culture of Neopost, as the larger and the acquiring company, will broadly prevail following the merger.

2.137. There is no clear evidence on the recent trend in AMS's prices. List prices have risen for some products but fallen for others. For the reasons alluded to earlier (see paragraph 2.108) it is difficult to discern the underlying trend, although in broad terms AMS's product prices appear to have risen in line with general inflation.

2.138. The average operating margin on the full range of AMS's UK activities, including service as well as machines, [

Details omitted. See note on page iv.

]. However, some third parties suggested that AMS had increasingly had to compete on price in selling its ageing range of products.

2.139. We sought to compare AMS's list prices for franking machines with Neopost's. There were difficulties in doing so because of differences in the features of the two companies' machines, including processing speeds, even within product segments. To the extent that it was possible to compare pairs of models, there was no consistent pattern of one supplier's prices being higher than the other's.

2.140. Some other aspects of AMS's trading practices have been more beneficial to customers than those of its bigger rivals. AMS has offered leasing customers the option to extend their leases at the end of the initial term if they were content to keep their existing machine(s). It also used to allow customers 12 free recredits a year (after an initial year in which the number of free recredits was not limited). However, it told us that it had changed policy on both points in 2001: it now no longer offered to extend leases—although it would do so if the customer asked—and had cut the number of free recredits after the first year from 12 to 6. It told us that both decisions had been taken for ordinary commercial reasons, namely a perceived need to improve its financial performance, and not in order to align its practices more closely with Neopost's in anticipation of the merger going ahead. At our request, it provided documentary evidence indicating that the relevant decisions were taken before Ascom entered into negotiations with Neopost for the sale of AMS in August 2001.

2.141. In assessing the impact of the loss of AMS as a separate competitive force it is important that we take into account the prospective weakening of AMS's position in the absence of the merger. Because of the high proportion of its UK customers whose machines require replacement under Royal Mail's meter migration programme, its lack of proven digital products and the smallness of its sales force, AMS would in these circumstances be at risk of losing a sizeable part of its UK installed base within the next few months. Nor are there grounds to expect its fortunes to be improved by a new generation of products: because of the comparative failure of its joint development programme with Secap (see paragraph 2.68), its digital machines are, at best, late in reaching the market and will not offer innovative features compared with products already available from other suppliers. In relation to Pitney Bowes' forthcoming range of Internet-enabled products, AMS is even further behind.

2.142. Both Frama and Francotyp are likely, in our judgement, to stay in the UK market if the merger proceeds. The UK is a relatively important market for both companies. Their impact on competition is likely to be limited in that they appear to lack resources to spend heavily on research and product development. However, Francotyp is winning a greater share of sales than its share of the installed base. Both companies have sufficient presence to exercise a downward pressure on prices by competing actively for business, even in cases where they lose.

2.143. Neither company appears concerned about the merger. Francotyp told us that it expected to benefit by being invited more frequently to compete as third bidder for orders, replacing AMS. It also hoped to step into AMS's shoes by picking up dissatisfied customers of the 'big two'. We are mindful, however, that both Frama and Francotyp may welcome the merger because they expect prices to rise as a result. Indeed Francotyp indicated that, while it would be vulnerable if Pitney Bowes and the merged Neopost/AMS were to compete fiercely on price, it expected competition to be 'reasonable' rather than fierce, and not purely on price.

2.144. Having weighed the various factors discussed in paragraphs 2.132 to 2.143, we take the view that, while AMS has been and, to some extent, remains a beneficial force for competition in the UK franking machine market, it would be a declining force in the future if it did not merge with another franking machine supplier. This view applies to AMS both under Ascom's ownership and if it were acquired by someone from outside the franking machine industry.

2.145. Turning to a comparison with the other alternative to the merger, a combination of AMS and Francotyp at global level, such a combination might be capable, in due course, of competing more strongly in product development—although to a lesser extent than a Neopost/AMS combination—as well as continuing to compete with both Pitney Bowes and Neopost in price and service quality. But whereas there would be a better balance between the second and third players in the market, the pre-eminence of Pitney Bowes would be scarcely affected.

The restoration of a duopolistic market structure

2.146. We have considered whether this market is vulnerable to tacit coordination in pricing, that is, parallel pricing by rival firms, without any overt agreement between them, in ways which serve their mutual commercial interest. The number of rival firms in an industry is one factor, and a duopolistic market structure may be particularly vulnerable to the development of tacit coordination because of the relative ease with which two major suppliers can monitor each other's activities. Both Pitney Bowes and Neopost would have high shares of sales in the UK franking machine market. Each group would be pursuing a strategy of developing a broad, technology-driven product range; both use similar sales methods in the UK (direct selling, with a high proportion of leases). Thus they might, for example, have a shared incentive not to compete on price but to confine competition to product development, with the benefit that customers could be persuaded to upgrade to new machines more frequently than hitherto.

2.147. The parties pointed to several factors which, they argued, would make tacit coordination unlikely (see paragraphs 6.43 to 6.48). We consider each of these in turn:

- (a) *Asymmetries between Pitney Bowes and Neopost.* The parties argued that Pitney Bowes would still be much larger than the merged Neopost/AMS. It would, therefore, enjoy greater economies of scale in both R&D and production, and might benefit from undercutting Neopost on price. We note that there is, indeed, a substantial disparity in size at the global level and in the USA. The asymmetry in the UK market, where in broad terms Pitney Bowes has 50 per cent and Neopost/AMS 40 per cent of the installed base, is much less marked.

- (b) *Franking machines are differentiated products.* The parties said suppliers competed in several ways—price, service, product development, sales effort—and a lack of competition in one dimension could be offset by competition in another. But it appears to us that it would be possible for Neopost and Pitney Bowes to agree (tacitly) not to compete in certain ways.
- (c) *Lack of price transparency.* The parties argued that discounting was widespread, making it difficult for one supplier to detect when another was undercutting. Feedback from customers would be an unreliable source of information on the rival's discounted prices. At the same time, the higher the proportion of a market held by the two leading firms, the better would be their intelligence on each other's pricing behaviour. We note that the presence of the smaller suppliers, Frama and Francotyp, would be important in this respect: the greater the extent to which they actively bid for, and sometimes win, contracts, the more the two large suppliers' intelligence about each other's pricing will be clouded.
- (d) *Technological innovation.* The parties said that at a time of rapid technological innovation, which was likely to be the situation for the next few years, it would be more difficult for Neopost and Pitney Bowes to sustain tacit coordination than if products changed slowly.
- (e) *Heterogeneity of customers.* The parties argued that there was no obvious division of customers by category which could be the basis of tacit market-sharing. We note that a public sector/private sector division might be an exception. More generally, we consider that tacit coordination might lead Pitney Bowes and Neopost not to compete vigorously for each other's customers, once acquired.
- (f) *External pressures.* The parties submitted that the existence and variability of external pressures on the two main suppliers would restrict their ability to coordinate their behaviour. Such pressures could come not only from the two smaller suppliers but also from the alternatives to franking and the impact of liberalization of postal services. We note, on the other hand, that barriers to entry into the franking machine industry are high, and that the two small suppliers might be content to live comfortably under an 'umbrella' set up by the pricing practices of the duopolists.
- (g) *Stability of demand.* The parties argued that the price elasticity of demand for franking machines was high because of the competitive constraints represented by stamps and permit mail. Overall demand has, however, been relatively stable. This could lead Neopost and Pitney Bowes to the view that keen competition for sales would not be very fruitful in sales growth and would damage margins, or it could lead them to the view that the only route to growth lay through increasing market share. Technological change and postal service liberalization may, in any event, make future sales growth unpredictable. If we are right in believing that liberalization could benefit sales of franking machines, the existence of new opportunities to grow sales might reduce the risks of tacit coordination developing.

2.148. Our impression is that Neopost's expressed desire to compete more effectively with Pitney Bowes is genuine. Neopost has been increasing its R&D spend both absolutely and as a proportion of sales, even though this has been at the expense of its profitability (see Table 4.1). In the UK it has sharply increased the size of its sales force and has begun to increase its market share after a long period of decline. The bid for AMS is clear evidence of Neopost's decision to commit itself to the franking machine business and to compete more strongly in it.

2.149. Pitney Bowes, for its part, appears to be keenly competitive, spending heavily on R&D in order to increase its lead over its rivals and actively protecting its IPRs. There does not appear to be any cultural affinity between it and Neopost.

2.150. It appears to us, therefore, that at the global level the prospects are that the duopoly will be a competitive one. It does not follow, however, that this would necessarily be translated into behaviour in the UK market, where the two companies' positions are more symmetrical than in most other countries. In particular we see some risk that the two companies would refrain from competing vigorously on price in the UK, both in relation to machines and after-sales services. It is clear from Neopost's survey (see paragraph 2.124) that there are many cases at present where customers do not invite other bidders but are content to deal with a single supplier. Although the merger offers Neopost the opportunity to deploy a larger sales force and hence to compete for a higher proportion of orders, it might at some stage decide to avoid competing in some parts of the market and to save costs by reducing its sales force again.

2.151. Neopost told us that the merger would enable it to compete more strongly on price but that this effect would take perhaps two years to come through while Neopost concentrated on realizing the synergies from the acquisition. We are inclined to see matters the other way round: in the short run, Neopost will have to compete on price because it lags behind Pitney Bowes in product development, but in the longer term, perhaps after establishing an increased share of the market, it might settle for greater stability and comfortable margins. Nevertheless, this risk will be reduced if, as we expect, Frama and Francotyp continue to have a significant presence, actively looking to win customers from the big two.

The creation of a stronger competitor to Pitney Bowes

2.152. The parties' argument that the merger would create a stronger competitor to Pitney Bowes is closely related to the rate of technological change affecting the franking machine industry and the IPR issue. The prospects of two-dimensional bar coding and Internet connectivity, in particular, to which the industry is being driven by the USPS and Pitney Bowes, will impose new requirements on suppliers (see paragraphs 2.59 to 2.63). As indicated in paragraph 2.62, these developments will open up the possibility for a range of value-added services to be offered through franking machines, with attractions both to customers and postal carriers. Product life cycles are shortening at a time when the demands of R&D are growing, a combination which puts a higher premium on scale of operation.

2.153. These developments are not imminent in the UK but competition in product development is global in nature. Developments in other industries have shown how rapidly the introduction of digital technology can transform a market. Pitney Bowes can be expected to derive the maximum marketing benefits from its new generation of machines, even though it will be some years before (for example) two-dimensional bar coding is mandated by posts in Europe.

2.154. Neopost is competing effectively at present but its position is threatened by the new generation of Internet-linked products which Pitney Bowes plans to launch over the coming year. Although it remains to be seen how successful these products will be, Neopost's apprehension that its current success could be short-lived appears well founded. At its present size, the resources it can devote to R&D are far below the level of Pitney Bowes'. While the merger seems unlikely to raise the combined spend of Neopost and AMS in the short run, its deployment on a single, coordinated programme can be expected to lead to more effective results. In this regard we attach some importance to Consignia's view that the merger should be welcomed because of its potential effect on product development (see paragraph 2.118).

2.155. Furthermore, a pooling of the respective patent portfolios of Neopost and AMS would improve the merged group's prospects of reducing its dependence on Pitney Bowes technology. In this way Neopost would become less vulnerable to having costs imposed on it by having to license Pitney Bowes patents.

2.156. A further consideration is that, if Neopost were able to develop a more substantial patent portfolio, it would have an incentive to increase its revenue by licensing its technology to other suppliers. Those suppliers—and potential entrants—would then be able to choose whether to license technology from Pitney Bowes or Neopost. This would drive down the cost of technology licensing and reduce the barrier to entry which this represents.

2.157. Because product development is a global element of competition in the franking machine industry, we expect that the UK, in common with other national markets, would benefit from an intensification in such competition. Benefits could take the form of improved security for Royal Mail's revenues as well as new services for customers. If, on the other hand Pitney Bowes were able to establish an unassailable lead in product development, it would have considerable freedom in pricing, which it could be expected to use to the disadvantage of customers.

2.158. Comparing the merger with the counter-factual alternative of a merged AMS/Francotyp, the latter would have been unlikely to offer as effective a challenge in product development, because it would have been a somewhat smaller and, probably, financially weaker force than the merged Neopost/AMS. In this respect Francotyp's view recorded in paragraph 2.92 is again relevant. We note that, in turnover terms, Francotyp is less than a third the size of Neopost: not only is it significantly smaller than Neopost in the franking machine market, it also manufactures a narrower range of mail equipment products. On the other hand, in the short term a merged AMS/Francotyp might have competed more strongly on price, quality and service with both Pitney Bowes and Neopost.

Conclusion on the merger's effect on the UK franking machine market

2.159. Pulling together the strands of our analysis of the merger's effect on the franking machine market, we distinguish between short-term effects—those which would arise within a year or so of the merger—and effects over the medium- and longer-term. The short-term effects concern customer choice, price and service. Medium- to long-term effects concern these factors, but also R&D and product development.

2.160. In the short term the loss of AMS as an independent supplier would result in some detriment for customers in terms of choice. There would be a reduction in choice of machine, since Neopost would rationalize to a single range of products. While Neopost can be expected to retain the most popular products from each of the two existing ranges, it is possible that some products that would be discarded are the most suitable for some customers.

2.161. Other aspects of AMS's distinctive offer would also be affected. AMS has been less active than Neopost in promoting leasing. Although it changed policy a few years ago and began to incentivize its sales force to favour lease deals (see paragraph 2.135), the proportion of its sales made by that route is still well below Neopost's. While Neopost offers the alternative of outright purchase, its best standard terms for servicing are confined to customers who lease. Some other aspects of AMS's terms and conditions have been more favourable to customers than Neopost's, although these had begun to change before the merger (see paragraph 2.140).

2.162. Customers would still be able to look to Pitney Bowes, Frama and Francotyp as alternative suppliers but a reduction from five to four in their number is significant. There would, of course, have been a similar reduction in the case of the counter-factual involving a merger between AMS and Francotyp (or Frama).

2.163. As regards price, direct comparisons between the offers of the various suppliers are problematic because their products are differentiated. While AMS's prices for service contracts, expressed as a proportion of the relevant machine price, are somewhat lower than Neopost's (even allowing for the fact that Neopost, unlike AMS, gives discounts on a proportion of its

contracts), what matters to customers is the overall cost of acquiring and using a machine in relation to the value they get from it. We have not found sufficient evidence to determine that AMS's prices are lower than Neopost's in this sense, and we therefore have no basis to expect price increases simply as a result of a levelling up of AMS prices to a higher Neopost level.

2.164. Whether Neopost feels able to increase prices post-merger will, we believe, depend upon the extent to which it competes with Pitney Bowes and (to a lesser extent) the amount of competition from Frama and Francotyp. As regards Pitney Bowes, in the short term we believe that tacit coordination is unlikely and that Neopost will compete on price to try to build its market share. The forthcoming launch of Pitney Bowes' new range of products will put additional pressure on Neopost to compete on price, since it will at that stage lag behind Pitney Bowes in product development. Moreover, Neopost's ability, post-merger, to deploy an enlarged sales force will enable it to challenge Pitney Bowes for a greater number of contracts.

2.165. Frama and Francotyp may be invited to bid more often as the 'third bidder' to replace AMS for those customers who go out to tender. However, for the majority of customers, who do not go out to tender, Frama and Francotyp may seek (as at present) to compete mainly on customer choice and service rather than on price—the merger may thus make little if any difference to their role in price competition. We do not consider that the merger will lead Frama or Francotyp to exit the UK market in the short term as it is an important market for both.

2.166. Looking at the counter-factuals, it is arguable that AMS under the ownership of someone from outside the franking machine industry would have had to compete more intensively on price than would the merged Neopost/AMS because of its ageing product range. Moreover, price competition might have been more intense with five suppliers than with four. On the other hand, it is also possible that the continued, and perhaps enhanced, dominance of Pitney Bowes would have led the other suppliers to be content to follow Pitney Bowes' prices.

2.167. A merged AMS/Francotyp would have a reasonably strong product range in the short term. Like a Neopost/AMS combination, it would take time to realize the synergies from the merger of the two groups. We see no reason to think that an AMS/Francotyp combination would compete more strongly on price in the short term than Neopost/AMS.

2.168. Turning to the medium and longer term, the merger would enable the enlarged group to strengthen its combined R&D operations and would give it a bigger portfolio of patents. This would enable it to be more effective in competition with Pitney Bowes: the enhanced product development which could be expected to result should benefit customers in terms of choice and quality, while also increasing the pressure on Pitney Bowes to compete on price. There might also be benefits through increased competition in the licensing of IPRs, which could enable the smaller suppliers to compete better on price and could reduce entry barriers.

2.169. If the asymmetry between Pitney Bowes and Neopost in the UK market were to lessen, however, the likelihood of tacit coordination developing between them could increase, with an adverse effect on price competition. The roles of Frama and Francotyp would be important in that event: if they gain market share, as Francotyp is continuing to do, they could significantly mitigate the impact of any weakening of price competition between the big two. On the other hand, if they were to lose ground—perhaps as a result of being unable to match the big two in product innovation—they might be reduced to competing in niche areas. Another possibility is that they might merge with each other. Clearly the effects on competition of these alternative scenarios would be very different, and we cannot predict which is the most likely.

2.170. Looking again at the counter-factuals, a merged AMS/Francotyp would have been smaller than a Neopost/AMS combination, and would have started from an inferior position in terms of product range. A market with one large and two modest-sized suppliers might in

principle make for stronger day-to-day competition than one with two large suppliers, and would not be vulnerable to tacit coordination in the form of joint dominance. But we believe the more important point is that neither Neopost nor AMS/Francotyp would then have been in a position to challenge Pitney Bowes in R&D, innovation and product development. As a result, there would be a risk of their opting for a comfortable existence under the ‘umbrella’ provided by relatively high Pitney Bowes prices.

2.171. If AMS were owned by someone from outside the franking machine industry, it would be likely quite rapidly to fall behind in R&D and shrink to the level of a niche player.

2.172. In summary, we can see the potential for a range of different effects of the merger on competition: neutral, positive and harmful. However, while the potential for harmful effects is clear, the probability of their arising is too low for us to reach an expectation that the merger would lead to a significant reduction in competition in the supply of franking machines. On the other hand, there is a clear prospect of the merger creating a stronger rival to Pitney Bowes, with potentially beneficial effects on the market in the medium to long term.

The merger’s effect on the market for folding and inserting machines

2.173. As noted in paragraphs 2.74 to 2.76, the merger affects only the market for smaller folding/inserting machines valued below £21,000. In that market Neopost had 47.9 per cent of UK sales by value in 2001 and AMS 2.8 per cent (see Table 5.3). However, AMS’s share was due solely to machines which it sourced from PFE and sold under its own name. PFE had a market share of 15.5 per cent as a result of its direct sales. If the merger went ahead PFE would lose its sales through AMS as a route to market, but it cannot be assumed that Neopost would take over those sales. In any event, the share of the market directly affected by the merger is small.

2.174. PFE, however, expressed strong concern about the merger’s likely consequences for its position in the folders/inserters market, both in the UK and elsewhere. It argued that this market was closely related to the franking machine market. Nearly all purchasers of folders/inserters would have previously purchased a franking machine, it said. The average price of even a desk-top folder/insertion was about four times as high as the average price of a franking machine, hence the volume of mail required to justify acquiring a franking machine was far lower than for a folder/insertion. As a result, a customer base of franking machine users provided an excellent sales platform for those manufacturers—Neopost and Pitney Bowes, PFE’s only competitors in the supply of small folders/inserters—which offered a complete range of mailing products.

2.175. Specialist manufacturers such as PFE and AMS had had to adapt to these developments. Together with other specialist manufacturers they had set up in 1995 a marketing group called Mailroom Innovations. The group organized 10 to 12 exhibitions each year. It had become PFE’s principal marketing tool: since it was established, PFE’s share of the UK folders/inserters 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.

2.176. PFE believed that, should the merger proceed, the credibility of Mailroom Innovations and its attractiveness to potential customers would suffer from the inevitable

departure of AMS. A mail equipment exhibition had to have as one of its participants a recognized manufacturer of franking machines, the lead product in the industry. However, the philosophy of the grouping was that its members should not be in competition with each other. While Neopost and AMS suggested that the merged group would be happy to be the franking machine representative in Mailroom Innovations, PFE told us that the merged group would not be welcome to the other members. The only alternatives 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 for AMS. Moreover, in the case of Francotyp its OEM arrangement, under which it sold certain Neopost models of folder/inserters under its own name, 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.

2.177. Furthermore, AMS dealers distributed PFE products in certain overseas markets, notably the USA. PFE estimated that 40 per cent of its total annual sales would be at risk as a result of the loss of a substantial part of its distribution network outside the UK. A reduction in production of this scale would severely impact PFE's unit production costs and damage its competitiveness in the UK market.

2.178. We believe, however, that PFE has exaggerated the extent to which the merger might harm its position. As stated in paragraph 2.35, customers for folders/inserters are more likely to be organizations that use bulk mail services than franking machines. No other party giving evidence to us agreed with PFE's portrayal of the two markets as being closely linked, although there is clearly some affinity between them. If they were as interconnected as PFE argued, shares of the folders/inserters market would be similar to shares of the franking machine market, yet Neopost has a considerably higher share of the supply of smaller folders/inserters than it does of franking machines. The share of the market represented by AMS's sales of rebadged PFE machines, which represents about 15 per cent of PFE's total sales in the UK, cannot be of major importance to PFE's position. (PFE suggested to us that AMS's share had risen to 8 per cent in the first half of 2001, but the data we collected showed that AMS's share in 2001 as a whole, at 2.8 per cent, was not materially higher than in 2000.)

2.179. As regards Mailroom Innovations, the disappearance of AMS as an independent player, and the resulting perceived need for its removal from the group, would doubtless be a blow. It would be open to the participants, however, to seek to recruit one of the two other franking machine manufacturers, Frama and Francotyp, to replace AMS. We do not see that the OEM arrangements which both companies have with Neopost need be an obstacle to this, any more than they prevent Frama and Francotyp from competing with Neopost in the franking machine market generally. Nor is it clear that their distribution of franking machines primarily through dealers is an overriding obstacle to their prospects of winning national contracts. Both may have weaknesses as potential partners in Mailroom Innovations, but, as discussed earlier, AMS's own position can be expected to worsen if the merger with Neopost does not proceed.

2.180. Similarly, we believe that PFE would be able, if perhaps with some difficulty in the short term, to adjust its distribution arrangements in overseas markets. In the USA it has its own direct sales force, as well as supplying through AMS's dealer network. It would not, therefore, be starting from scratch in seeking to develop new routes to market.

2.181. For these reasons we are not persuaded by PFE's arguments, and we do not believe that the merger would bring about a significant lessening of competition in the UK market for folders/inserters.

Conclusion on the public interest

2.182. We have found that the merger may not be expected to lead to a significant reduction in competition in the UK markets for the supply of franking machines and folders/inserters. There are no other factors which would cause the merger to have a significant impact on the public interest. We therefore conclude that the merger may not be expected to operate against the public interest.

Concluding remarks

2.183. The supply of franking machines is a relatively small, niche market in which the supply side is highly concentrated. The demand side, by contrast, is highly fragmented and there is little buyer power; moreover, for most customers the acquisition of a franking machine is an occasional purchase, and transactions are not of a size to warrant much management attention. Prices are not transparent, and suppliers control most of the revenue from the use of machines, as well as their sale. There is a risk that competition among suppliers will be muted and that prices will be high in relation to costs, and/or that there will not be effective downward pressure on costs. These concerns stem from the inherent characteristics of the market, not from the merger which we were required to investigate.

2.184. The MMC report of 1986 found that there were factors—with regard, among other things, to selling practices, the dominant position of Pitney Bowes and the implementation of Post Office regulations and practice—which restricted competition in the market for franking machines. We were not persuaded by Neopost's arguments that conditions had changed radically since then: there appear to have been some improvements in suppliers' conduct and in Royal Mail's regulations, but Neopost's survey suggested that a significant proportion of sales today involve only one 'bidder' and are made at list price. Moreover, the introduction of more sophisticated machines is giving suppliers the ability to lock in an even higher proportion of after-sales revenues through the sale of proprietary ink-jet cartridges. The actions taken following the 1986 report, with a view to opening up the market, have had relatively little impact.

2.185. We have found no basis to conclude that Neopost's acquisition of AMS may be expected to operate against the public interest. Indeed it may strengthen competition by creating a stronger competitor to Pitney Bowes. Without it we see a distinct risk that Pitney Bowes will be able to take advantage of the current situation to increase its dominance.

2.186. This risk arises because of the large and discontinuous change that is represented by the switch to digital technology, at the same time as several geographical markets are being affected by the upheaval of postal liberalization.

2.187. The powers available to the competition authorities to deal with anti-competitive practices have been greatly strengthened by the Competition Act 1998—which gives protection to customers both from the abuse of dominant positions and from the effects of restrictive agreements and concerted practices—and the powers are likely to be strengthened further by the Enterprise Bill (now before Parliament) which seeks to provide the OFT with appropriate powers of investigation in respect of the newly-created cartel offences. In view of the current period of change, we propose that the DGFT should review the operation of the franking machine market within three to five years in order to consider whether any use of the powers available to him is appropriate.