



# Securing the Universal Postal Service

Proposals for the future framework for economic regulation

Consultation

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## Section 1

# Summary

## The postal sector is essential to the UK economy

- 1.1 The postal sector is essential to the UK economy and society. In 2010, 16bn letters were delivered to 28.2m addresses. Royal Mail was responsible for delivering over 99% of these. The postal sector supports a diverse range of economic activity. Nearly all businesses in the UK use post in one form or another, for delivering and receiving goods, invoicing or paying bills, marketing and communicating with customers and suppliers, publications, bills, statements, etc. While residential consumers receive more mail than they send, it is clear that they still place a high value on the postal service.
- 1.2 Total spending on postal services in the UK in 2010 exceeded £6bn, but direct consumer spending on post is very low. Average weekly household direct spending in 2009 was only 40p – around 0.1% of household income. By comparison, weekly expenditure on other utilities such as telephone services, electricity and gas, at £10.80p, £10.20p and £9.70p respectively, were each over 20 times the level of spend on post.
- 1.3 Underpinning the postal service we are all used to is a universal service obligation (USO), which requires Royal Mail to provide for the delivery and collection of letters six days a week (and other postal packets five days a week), and that prices must be affordable and uniform throughout the UK. Royal Mail is also required to ensure that 93% of First Class arrives next day, and 98.5% of Second Class within three days of posting. Royal Mail has largely met these service standards in recent years.
- 1.4 The obligations that apply to Royal Mail in respect of the universal service exceed those that apply in most other countries in Europe. For example, Royal Mail is required to deliver post 6 days a week, whereas the EU requirement is only 5 days a week. This has inevitably had an impact on the costs of providing the universal service. Despite this, prices for postal services – in particular first and second class mail delivery – have until recently been amongst the lowest in Europe.
- 1.5 The UK postal sector is the largest in Europe, but it has also seen the steepest decline in volumes. The volume of mail in the UK has fallen by 25% since 2006, as consumers have moved away from traditional mail and towards digital means of communication.
- 1.6 Furthermore, in the same period there have been substantial changes in product mix, with customers tending to move away from higher value traditional products (first and second class mail) and towards lower value services such as bulk mail (post sent in high volume typically by major business customers).

## There is a very real risk to the universal service

- 1.7 These forces have placed great strains on the industry and on viability of the universal service. Threats to the viability of the universal service are present today and are likely to remain for some years to come.

- 1.8 In the near term, the provision of the universal service is threatened by Royal Mail's immediate financial position. The part of Royal Mail responsible for delivering the universal service made a loss of £120m<sup>1</sup> in 2010-2011 on a cost base of £7bn. Royal Mail's negative operating cash gap has widened, and it reported an outflow on its mail activities of over £600m in 2010-11, in part due to its contribution towards the £300m annual costs of servicing its pension deficit and the cash cost of its modernisation programme. Since Royal Mail's current price control was imposed in 2006, its cumulative cash performance has been around £3bn worse than was expected by the regulator at that time.
- 1.9 Beyond the immediate challenge, it is likely that the market will continue to face uncertainty and challenge. Mail volumes, in particular, are expected to continue to decline worldwide, with letter volumes possibly declining by between 25% and 40% over the next five years<sup>2</sup>.
- 1.10 The risks to the universal service are therefore considerable. As volumes have dropped, Royal Mail's average unit costs have increased. Unless Royal Mail can deliver efficiency gains that exceed the effect of volume decline, it will have to rely on increasing prices, which in turn is likely to suppress demand, further increasing unit costs, and putting further upward pressure on prices.
- 1.11 To date, although Royal Mail reduced employee numbers by around 20,000 to 155,000 between 2007 and 2011<sup>3</sup>, it has not been able to cut costs to keep pace with falling volumes. Royal Mail has spent about £2bn on a combination of redundancy and capital expenditure (i.e. new technology, sortation equipment) as part of its modernisation programme, and further investment is required. Royal Mail must convert capital expenditure and cost savings into real efficiency improvements.
- 1.12 The risks of efficiency savings not being achieved, or not being achieved sufficiently quickly, are significant. With no improvement in efficiency, declining volumes will translate into higher prices, which would only serve to lock the postal sector and the universal service into an inexorable spiral of decline.

## The regulatory context

- 1.13 The challenges facing the universal service were recognised in the 2008 Hooper report: *Modernise or Decline*<sup>4</sup>. This concluded that, given the context, the status quo was untenable. In 2010 Hooper produced an updated report: *Saving the Royal Mail's*

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<sup>1</sup> UK Letters, Parcels and International (UKLPI), previously Letters, Parcelforce, Corporate and Group Property

<sup>2</sup> Figure cited in R.Hooper (2010) : *Saving the Royal Mail's Universal Service in a Digital Age*, <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/s/10-1143-saving-royal-mail-universal-postal-service>

<sup>3</sup> Based on data from Royal Mail's Statutory Accounts

<sup>4</sup> <http://www.bis.gov.uk/files/file49389.pdf>

*Universal Service in a Digital Age*<sup>5</sup>, which recognised the worsening of Royal Mail's financial position in the interim, and reaffirmed the following policy recommendations:

- That the Royal Mail needed to be opened up to private investment;
- Addressing the pension deficit by moving it to the Treasury;
- That responsibility for regulating post should be transferred to Ofcom.

1.14 The new Postal Services Act 2011 (“the Act”) has set out the basis for these changes to be effected. The Act transfers regulatory responsibility from Postcomm to Ofcom, and also provides the legal framework for the government’s intention to remove Royal Mail’s historic pension deficit and to privatise Royal Mail.

### Ofcom’s duties under the Act

1.15 The Act gives us a primary duty to carry out our functions in relation to post in a way that we consider will secure the provision of a universal postal service. In discharging our duties in relation to the universal service, the Act also requires us to have regard to the need for the provision of a universal postal service:

- to be financially sustainable, including the need for a reasonable commercial rate of return for any universal service provider; and
- to become efficient within a reasonable time, and then to remain so.

1.16 The Act requires Ofcom to designate an operator as universal service provider. Ofcom provisionally designated Royal Mail as universal service provider on 1 October 2011, and it is expected to remain so for the foreseeable future.

1.17 Ofcom’s principal duty under the Communications Act 2003 (the 2003 Act) is to further the interests of citizens and consumers, where appropriate by promoting competition. This duty, together with our general duties under the 2003 Act, also applies when we carry out our functions in relation to post. The 2011 Act also provides that in the case of a conflict between our duty to secure the provision of a universal postal service, and our general duties under the 2003 Act, our duty to the universal postal service takes precedence.

### The regulatory challenge

1.18 In this context, fulfilling the primary duty of safeguarding the universal service implies:

- *providing Royal Mail with the opportunity to return the universal service to sustainability* – Royal Mail is the only company at present capable of delivering the universal service in the UK: unless it can be made financially viable, the universal service is at risk in the near term; and
- *providing strong incentives to improve efficiency and innovation to counteract the longer-term threat to the universal service* – unless it is able to improve efficiency,

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<sup>5</sup> <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/s/10-1143-saving-royal-mail-universal-postal-service>

to cover costs Royal Mail would be forced to rely solely on price increases, which could lead to a spiral of decline.

- 1.19 In addressing this challenge, it needs to be recognised that the circumstances facing the sector at present are exceptional in a number of respects. Most fundamentally, Royal Mail, despite its market position, is currently unable to cover its costs. This forced it last year to return to the regulator to apply for further price increases over and above those agreed in the last price control, and it has recently contemplated a further application for price increases next year.
- 1.20 Not only is the market in a state of long-term decline, it is also characterised by great uncertainty. When the last price control was set in 2006, the extent of volume decline was foreseen neither by the regulator nor by Royal Mail. Moreover, the longer-term role of post in the overall communications market, and, in particular, the extent to which post will continue to be relied upon as a means of communication competing with electronic substitutes has yet to become clear.

### **Traditional approach to regulation has failed**

- 1.21 There is widespread recognition that the approach to regulation adopted in the past, has failed in the face of the particular circumstances affecting this sector.
- 1.22 To date, the approach adopted has been based on price controls - similar to those used in most other utility sectors. In normal circumstances this approach is an effective means of preventing private operators from earning excessive profits, thereby providing incentives for firms to reduce costs, while at the same time protecting consumers from excessive prices. It is an approach that is widely used by regulators, including Ofcom, to regulate private operators with significant market power.
- 1.23 The recent experience of postal regulation, however, has demonstrated all the weaknesses of price controls with none of the benefits. In a highly uncertain market, price controls have removed the flexibility that would allow Royal Mail to adjust to changes in demand, while at the same time Royal Mail has been unable to improve efficiency, either at the rate expected by the regulator when the price control was set, or at the rate set by its own internal targets at the time.
- 1.24 Furthermore, price controls on Royal Mail have served less and less to protect customers from price rises. Since 2006 Royal Mail's financial position has led it to apply to the regulator for price rises over and above those consistent with the regulatory formula. In November 2010 Royal Mail applied to Postcomm for additional flexibility to increase prices, resulting in price rises averaging 12% for 2011-12. In the light of its primary duty towards the universal service, Postcomm granted these applications.
- 1.25 We therefore consider that price controls in this sector have failed in recent years. The reasons for this are clear. First, in a highly uncertain market environment, where the level and pattern of demand is so unclear, it is not feasible to expect to predict accurately whether a given price trajectory is sufficient to allow the universal service to be financed. If the price control that is set turns out to be too tight, it will not allow for the universal service to be financed. If, on the other hand, it is set too loosely, it will provide little protection and inadequate efficiency incentives.

- 1.26 Moreover, an RPI-X approach to constraining prices and incentivising efficiency carries with it a major issue of credibility, given Royal Mail's current financial circumstances and our primary duty in relation to the universal service. If, in the near term, Royal Mail found itself unable to become profitable under the terms of a price control, it would have to return to the regulator to request further price rises. In assessing this, although we would press Royal Mail to increase efficiency rather than raise prices, we would also need to carry out our functions in a way that we consider will secure the provision of a universal service. This means that there are serious weaknesses associated with a price control formula in providing credible incentives to Royal Mail to become efficient in the near term.
- 1.27 A price control also reduces the flexibility of Royal Mail to adapt to unexpected changes in the market and its operating environment. We have examined the possibility of designing a price control which would allow for potential changes in the market, e.g. using adjustment mechanisms and re-openers. However, such approaches are unlikely to be able to predict or to resolve all potential circumstances and are also likely to reduce the incentive properties of any price control. Indeed, the more sophisticated we attempt to make a price control, the more potential there is for unintended consequences.
- 1.28 Universal service and access products make up about 60% of Royal Mail's total letter revenues. Therefore any difference between the assumptions made at the time of setting a price control and actual outturns in the market would inevitably have a very significant effect on Royal Mail's financial profitability and the viability of the universal service.
- 1.29 In summary, if Ofcom were to set a price control in relation to Royal Mail in the current circumstances:
- Prices would still need to rise in order to restore the universal service to viability in the near term.
  - The risk of regulatory error is very high given the exceptional nature of the circumstances of the postal market. In determining the appropriate level of price rises, we would need to take a view now, not just of the current pattern of demand, but the pattern of demand throughout the life of the price control period. Ofcom would, in setting the level of control, in effect need to second-guess the market and the future commercial judgement of the company now and in the longer term, during a period of considerable change and uncertainty.
  - It is highly likely that Royal Mail would apply for further price rises before the end of the price control, and quite possibly on more than one occasion.
  - The efficiency incentives on Royal Mail would be weak. If, under a price control, Royal Mail finds itself in financial difficulties, it will, as recently demonstrated, approach the regulator to reopen the control. Awareness of this possibility substantially weakens the efficiency properties of a price control approach.

## Ofcom's proposals

- 1.30 Overall, in light of Ofcom's duty to secure the provision of a universal service and in the current circumstances with the market facing such uncertainty and Royal Mail in its present financial situation, we believe that there are considerable risks in pursuing a traditional price control-based approach. We therefore propose to provide Royal

Mail with more freedom in relation to the pricing of most products and services, and do not propose to impose a traditional price control on Royal Mail.

- 1.31 Providing more commercial freedom to Royal Mail in the current context may provide a more effective means of addressing the regulatory challenge. First, it allows Royal Mail the freedom to choose the most appropriate way to raise revenues to address the financial situation facing the universal service. In this uncertain time, when the position of post in relation to electronic substitutes is unclear, Royal Mail is in a better position to determine the impact of price rises of different products on overall demand and, hence, revenues.
- 1.32 Greater freedom also provides a more effective route to incentivising efficiency gains. The government's policy is to privatise Royal Mail, and it is necessary, therefore, to establish a regulatory regime that recognises the incentives facing a private operator.
- 1.33 To undertake the considerable challenge of improving Royal Mail's efficiency and committing expenditure to modernisation, an investor would need to be confident that it could recoup the benefits of doing so. For this to be the case there needs to be confidence that there will be a sufficient period of regulatory stability in which to both deliver and benefit from greater efficiency.
- 1.34 We consequently need a regulatory settlement that lasts for a sufficient period of time to provide a stable environment within which to address the efficiency challenge. The very real benefits to consumers reside in the short term with a sustainable universal service, and in the longer term with the prospect of not only a sustainable universal service, but also in sharing the efficiency benefits delivered by more effective incentives.
- 1.35 There are, however, also significant risks with giving Royal Mail commercial freedom. Most obvious is the risk that Royal Mail uses this as a means of shying away from the efficiency challenge in favour of simply increasing prices.
- 1.36 If the new regulatory framework did not lead to increased efficiency, it would have failed one of its fundamental goals. A reliance on price rises alone would reduce demand further, exacerbating the risk of the sector falling into an inescapable spiral of decline. There is also the related risk that Royal Mail raises prices to such a degree as to begin to raise affordability issues for vulnerable consumers.
- 1.37 These risks are significant and imply that commercial freedom cannot be provided without appropriate safeguards. With the right safeguards in place, however, we believe the risks are manageable – and taken together present a package that is the most suitable for the current circumstances.
- 1.38 Therefore we propose to grant Royal Mail commercial freedom for a period of seven years by not imposing a traditional price control, subject to safeguards in the following areas:
  - effective monitoring of performance, including scope for re-regulation if the incentives to deliver greater efficiency are demonstrably failing;
  - ensuring that a basic universal service is available to all and affordable by all;
  - the discipline of competition and innovation.

## **Safeguard 1: Monitoring and the potential for reregulation**

- 1.39 Although we propose to give Royal Mail commercial freedom, we will, at the same time, carefully monitor its performance to ensure that this is used in a way which accords with our regulatory objectives in respect of the universal service.
- 1.40 For the reasons set out above, under the proposed regulatory framework, we fully expect Royal Mail to be in a position to address the sustainability of the universal service. We expect the universal service to be restored to a sustainable position as a product of price rises, but also efficiency improvements.
- 1.41 In monitoring performance we will focus in particular on the following areas:
- quality of service targets - to ensure that the universal service continues to be provided at the level required and that the service that users receive is maintained to the required standard;
  - Royal Mail's pricing and profitability – while Royal Mail needs to return to being profitable for the universal service to be sustained, if it is earning excess profits as a result of price rises, as opposed to efficiency gains, we will consider the case for re-intervention, to secure a financially sustainable, efficient and affordable universal service in the interests of consumers.
- 1.42 The Act enables us to require Royal Mail to provide us with information, and we propose to use these powers to monitor Royal Mail's performance. In this document we make specific proposals relating to the extent of financial reporting that we propose we should require of Royal Mail, and also in relation to the need for Royal Mail to provide separate accounts for different areas of its business.

## **Safeguard 2: Ensuring that a basic universal service product is available to all and affordable to all**

- 1.43 In a period of such market uncertainty, and where there is upward pressure on prices, it is vital that there remains a basic universal service product that is accessible to all, especially the vulnerable.
- 1.44 While for the reasons set out above, we believe that sustaining the universal service requires substantial commercial freedom for Royal Mail, within this it is essential that the role of the universal service in society is preserved and that the price of a basic universal service is not allowed to rise above an affordable level.
- 1.45 Therefore we propose to set a safeguard cap for Second Class stamps.
- 1.46 We believe that the ceiling should be targeted at Second Class stamps as they are the most likely to be used by vulnerable customers; at the same time this would provide a safeguard to all users in the sense that it would act as a 'backstop' service to First Class stamp customers.
- 1.47 Our analysis also indicates that setting a ceiling on Second Class stamps at an appropriate level will not unduly constrain Royal Mail's pricing flexibility in relation to other products. In this sense, this approach will not cut across the wider benefits to be gained from pricing freedom.

- 1.48 In proposing this safeguard, we note, first, that UK stamp prices are currently within the range of EU prices, despite the fact that elements of the UK's universal service are more onerous than those in other countries. We also note that average household expenditure on post is generally very low, at 40p a week. Nonetheless, this figure is an average, not just across households, but also across the whole year, and is likely to vary significantly between different consumers and at different times of year.
- 1.49 We therefore propose a straightforward price ceiling on Second Class stamps set at an initial level, and then allowed to rise in line with the retail prices index.
- 1.50 The appropriate initial level for the ceiling is essentially a matter of judgement. Given its purpose, which relates to affordability of the service to vulnerable consumers, we do not propose to set the level directly in relation to the costs of the service. Rather, our concern is to ensure that the resultant service is affordable in particular to vulnerable consumers. We are proposing, for consultation, that the cap lies in the range of 45p-55p for a standard letter, and would value stakeholders' input and views on the impact of different levels within this range on different categories of consumers and whether there is still sufficient flexibility available to Royal Mail to ensure the universal service is sustainable.
- 1.51 In line with the need for a significant period of certainty, we propose that the safeguard provisions apply for a period of seven years. However we propose to leave open the possibility of reassessment in two years exclusively in relation to the safeguard cap. Such an assessment, if necessary, would consider relevant market conditions and/or affordability.

### **Safeguard 3: Competition within the mail market**

- 1.52 Postal services inevitably face some degree of competition from other modes of communication. This has the potential to provide a real constraint on Royal Mail's ability to raise prices, although at present it is not possible to be certain about its strength.
- 1.53 The final safeguard we are proposing is consequently in relation to the overall competitive framework within the post market. Competition in principle brings substantial benefits, especially in terms of increasing pressure on Royal Mail to improve efficiency. The potential for Royal Mail to lose business as a result of competition is, however, also a potential risk to the universal service if it results in a position where Royal Mail, as the only operator capable at present of offering the universal service, cannot remain viable. Given our primary duty, the assessment of competition needs to balance these factors.
- 1.54 There are two main models of competition in post:
- Access competition – where a post operator receives mail from customers, and then accesses Royal Mail's network for the letter to be delivered to the final recipient.
  - End-to-end competition - where a post operator not only receives the letter from the customer but then delivers it to the recipient, by-passing Royal Mail's network entirely.

- 1.55 Access competition is the predominant form of competition in the UK. Around 40% of mail volumes are currently carried by access providers (but delivered by Royal Mail). Access has brought benefits to the universal service in terms of;
- improved efficiency incentives to Royal Mail;
  - reduced prices to customers;
  - improving customer focus of services; and
  - innovation in new products and services.
- 1.56 Furthermore, access appears to be critical as a platform for end-to-end competition, firstly in terms of allowing a rival operator to establish a customer base from which to begin to offer an end-to-end service and secondly, in order to maintain a national service to customers with a limited delivery network.
- 1.57 We therefore believe that it is important for access competition to remain in the future.
- 1.58 In terms of setting prices for access, however, it is clearly necessary that these allow Royal Mail to cover the costs of the network adequately. If they do not, then the universal service will be further undermined.
- 1.59 We therefore propose:
- imposing an access condition on Royal Mail to oblige it to grant access at inward mail centres;
  - not to regulate the price of access, to enable Royal Mail to set prices in a way that covers the costs of the network; and
  - ensuring, by means of a ‘margin squeeze test’, that the difference between the access price and retail price is kept at a level that allows efficient access competitors to compete effectively.
- 1.60 We note that under the Act, imposing an access condition also enables operators to bring disputes to Ofcom, relating to the terms of access.
- 1.61 End-to-end competition does not currently have a significant presence in the UK, although it is the predominant form of competition in other European countries, such as Germany and the Netherlands. We recognise that the potential benefits in terms of increased efficiency pressures are greater than those for associated with access. In particular, by providing a competing service to Royal Mail’s delivery operations, it potentially provides powerful incentives on Royal Mail to reduce cost across the full length of the value chain.
- 1.62 On the other hand, however, end-to-end competition poses a potentially greater threat to the sustainability of the universal service by removing greater amounts of revenue from Royal Mail. While end-to-end competition is the main model of competition in other countries, and appears to coexist with a healthy universal service and an efficient incumbent operator, in the current circumstances, and in terms of Royal Mail’s current financial position, we need to recognise the associated risk to the provision of the universal service.

- 1.63 Under the Act, the Secretary of State can direct us to impose a notification condition under section 41 of the Act to assess entry or expansion by rival postal operators offering a competing delivery service, and to assess this in terms of its overall impact on the provision of the universal service. On 3 October 2011 the Secretary of State issued such a direction to us, giving us six months to set this condition in place.
- 1.64 We propose to assess any actual or planned end-to-end competition notified to us on a case-by-case basis. We will do so in the light of the potential impact on the provision of the universal service, in order to decide whether it would be appropriate to impose further conditions on operators in order to secure provision of the universal service, in accordance with our primary duty under the Act. We plan to consult on the notification condition before the end of the year.
- 1.65 Lastly, in a competitive market it is important that there is also sufficient flexibility to allow Royal Mail, as well as its competitors, to innovate; to improve existing services or introduce new services that are beneficial to its customers and users. The previous licence-based regime<sup>6</sup> set constraints on Royal Mail, in terms of having to publicly notify the market of its intentions and to obtain regulatory agreement to changes in its regulated products.
- 1.66 While such a regime provides stability and clarity for customers, users and the market, it can represent a significant reduction in commercial freedom for Royal Mail in responding to a challenging market environment. We intend to consider this issue further and will be presenting proposals later in the year as part of a wider review of regulatory conditions, but our intention will be to simplify the obligations and wherever appropriate to consider the benefits of permitting greater commercial freedom for Royal Mail.
- 1.67 Ofcom invites responses to this consultation, to reach us by 5 January 2012. We anticipate issuing a final statement in February 2012.

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<sup>6</sup> Which applied under the Postal Services Act 2000

## Section 2

# Introduction

## Scope of this consultation

- 2.1 This consultation considers the regulatory safeguards for postal services from April 2012 and sets out Ofcom's proposals for the regulation of the universal service provider, Royal Mail, in relation to universal and access services.
- 2.2 In reaching the proposals in this document we have considered:
- the views and evidence provided following Postcomm's consultations: The building blocks for a sustainable postal service, Access Review 2012 - Initial Proposals, published in March 2011, and The building blocks for a sustainable postal service – Initial proposals for regulatory safeguards, published in April 2011; and
  - our analysis of the information and evidence received and gathered.
- 2.3 The regulatory conditions (the draft legal instruments) that will give effect to these final proposals will be published separately for consultation in November 2011.
- 2.4 The purpose of this consultation is to seek input from stakeholders and any other interested parties. In particular, whilst this consultation document contains a number of specific questions, we are not seeking to limit the issues on which respondents may wish to comment, and respondents are invited to include representations on any issues which they consider to be relevant.

## Legislative context

- 2.5 Under the Postal Services Act 2000 (the old Act), Postcomm, the previous regulator of postal services, had, among other things overseen:
- the opening up of the letters business to competition,
  - the introduction of an access regime under which large volumes of mail are now handled by Royal Mail's competitors, and
  - the implementation of three price controls on Royal Mail.
- 2.6 The last full price control implemented by Postcomm was put in place in 2006. This control was intended to operate for a four year term ending March 2010. However, work consulting on a new price control was delayed following the recommendation by the Independent Review Panel, led by Richard Hooper CBE published in 2008: *Modernise or Decline*. The first Postal Services Bill was introduced in parliament in 2009.
- 2.7 However, later in 2009, the government decided to defer the passage of this first Postal Services Bill through parliament. Given this deferral and Royal Mail's weakening financial position, Postcomm decided to roll forward the 2006 price control with some amendments following requests from Royal Mail.

- 2.8 In 2010, under the new coalition government, the Independent Review Panel was asked to update its review and it published its updated report: *Saving the Royal Mail's Universal Service in a Digital Age*, recognised the worsening of Royal Mail's financial position in the interim, and reaffirmed the policy recommendations:
- That the Royal Mail needed to be opened up to private investment;
  - That the pension deficit should be addressed by moving it to the Treasury; and
  - That responsibility for regulating post should be transferred to Ofcom.
- 2.9 In light of this further report, Postcomm again decided to roll forward the 2006 control with amendments following requests from Royal Mail. The most material amendment was to allow Royal Mail additional price rises of around 7% for business mail customers, resulting in total price rises in 2011-12 of 12%, and increases of 15%-20% for the largest customers.
- 2.10 The Postal Services Act 2011 (the Act) received Royal Assent in June 2011. The Act set out the basis for the recommendations by the Independent Review Panel to be effected. It transfers regulatory responsibility from Postcomm to Ofcom, and also provides the legal framework for the government's intention to remove Royal Mail's historic pension deficit and to privatise Royal Mail. It replaces the previous licensing regime with a general authorisation, subject to regulatory conditions imposed by Ofcom.
- 2.11 On 1 October 2011, Ofcom officially took over regulation of the UK's postal services from Postcomm.

## Other work outside this consultation

### Initial conditions

- 2.12 The Act required Ofcom to transpose the previous licence conditions into Initial Conditions under the Act. Ofcom consulted on the Initial Conditions on 8 August 2011 and set out the final Initial Conditions in a statement on 29 September 2011. That document also contained the following decisions:
- provisionally to designate Royal Mail as a universal service provider;
  - to re-approve the postal redress service (POSTRS) and the consumer redress scheme criteria;
  - setting interim charging principles for Ofcom to recover the administrative costs incurred by it in carrying out its regulatory function in respect of post; and
  - to apply Ofcom's current information gathering policy also to post.

### Consultation on quality of service and other related matters

- 2.13 We intend to address issues related to quality of service and the need for up to date information on universal service products, in a further consultation later in 2011. This consultation – the review of regulatory conditions – will set out how we propose to regulate Royal Mail's quality of service targets and what notification and publication

obligations we propose should apply to Royal Mail. The consultation will need to cover:

- the text of any conditions necessary for implementing the proposals within this consultation document;
- proposals on notification and publication, and on Quality of Service; and
- a review of the Initial Conditions more generally, with the intention of simplifying the regulatory framework and removing unnecessary restrictions on postal operators.

2.14 Our intention is to make decisions in respect of all these proposals alongside our decision on the proposals within this document to take effect from April 2012.

### **Consultation on users' needs and the revised scope of the universal service**

2.15 Under the Act Ofcom is required, within 18 months of vesting of the Act, to assess users' needs and to consider the implications if any for the universal service. Work on these issues is currently ongoing, and is not therefore part of this consultation, but will be consulted upon by Ofcom in due course. In the meantime the scope of the universal service will remain unchanged from the present scope.

2.16 Ofcom is required under the Act to make a universal service order, from which point certain of the initial conditions will cease to have effect. Ofcom intends to consult on the first universal service order later this year, with a view to it coming into force from 31 March 2012.

### **Outline of the rest of this document**

2.17 The remainder of this document is structured as follows:

- **Section 3 – Legal framework** - this section summarises the key features of the legal framework relevant to the proposals set out in this consultation.
- **Section 4 – Background and market context** – this section looks at the market context within which Royal Mail operates.
- **Section 5 – Financially sustainable universal service** – this section summarises our approach to the financeability of the universal service.
- **Section 6 – Securing the provision of the universal service and protecting customers** – this section sets out the challenges faced in designing the regulatory framework and our views of the best approach to meeting our statutory duties. It also considers the potential impact of our proposals on customers and competitors.
- **Section 7 – Competition** – this section focuses on the role of competition, and sets out our policy proposals in this regard. It starts by setting out the potential benefits of competition, and then the costs in terms of sustaining the financeability of the universal service. It describes the two main models of competition: end-to-end and access, and sets out our proposed policy position.

- **Section 8 – Regulatory financial reporting** – this section sets out our proposals for a new regulatory financial reporting framework for Royal Mail. Specifically, it considers the appropriate objectives to be addressed by regulatory financial reporting, the financial reporting requirements necessary to meet those objectives and the implementation of those requirements.
- **Section 9 – Proposals for a package of measures** – in this section we bring together the package of measures that we currently consider is likely best to meet our statutory duties and regulatory objectives, and assess them against the various requirements set out in the Act relating to the imposition of regulatory conditions.

2.18 The annexes to this document set out in further detail our analysis in support of the proposals we have set out in this document or other relevant information. The annexes are structured:

- **Annex 1: Responding to this consultation** – this annex includes details on how to respond to this consultation.
- **Annex 2: Ofcom’s consultation principles** – this annex sets out Ofcom’s consultation principles, under which this consultation is being conducted.
- **Annex 3: Consultation response cover sheet** – this annex contains a template coversheet for responses to this consultation.
- **Annex 4: Consultation questions** – this annex lists the consultation questions.
- **Annex 5: Glossary**
- **Annex 6: Regulatory reporting** - this provides further detail about our approach to regulatory reporting. This annex builds upon the views that we set out in section 8 of our consultation document.
- **Annex 7: Access** –this annex sets out our proposals regarding the need for the regulation of access and the appropriate form of any such regulation.

## How to respond

2.19 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm 5 January 2012**. Further detail on how to respond are set out in Annex 1 to this document.

## Section 3

# Legal framework

## Introduction

- 3.1 The framework for our assessment of any regulatory safeguards in relation to Royal Mail's pricing of postal services is set out in the Act, which received Royal Assent on 13 June 2011. One of the Act's main purposes is to make provision for a new regulatory framework for the postal services sector, including transferring regulatory responsibility from Postcomm to Ofcom.
- 3.2 This framework is set out in Part 3 of the Act, which came into force on 1 October 2011. Its provisions also give effect to Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008, which amends Directive 97/67/EC with regard to the full accomplishment of the internal market of Community postal services.
- 3.3 This section summarises the key features of the regulatory framework relevant to the proposals set out in this consultation.

## Duty to secure provision of a universal postal service

- 3.4 Section 29(1) of the Act provides that Ofcom must carry out its functions in relation to postal services<sup>7</sup> in a way that it considers will secure the provision of a universal postal service. Section 29(2) of the Act provides that Ofcom's power to impose access or other regulatory conditions is subject to the duty imposed by section 29(1) of the Act.
- 3.5 The universal postal service must, as a minimum, include each of the services set out in section 31 of the Act. Those services are known as the 'minimum requirements' and comprise (in summary):
- at least one delivery of letters every Monday to Saturday, and at least one delivery of other postal packets every Monday to Friday;
  - at least one collection of letters every Monday to Saturday, and at least one collection of other postal packets every Monday to Friday;
  - a service of conveying postal packets from one place to another by post at affordable, geographically uniform prices through the UK;
  - a registered items service at affordable, geographically uniform prices through the UK;

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<sup>7</sup> The expression 'postal services' is defined in section 27(1) as meaning the service of conveying postal packets from one place to another by post, the incidental services of receiving, collecting, sorting and delivering postal packets, and any other service which relates to, and is provided in conjunction with, any of those services.

- an insured items service at affordable, geographically uniform prices through the UK;
- the provision of certain free services to the blind/partially sighted; and
- the free conveyance of certain legislative petitions and addresses.

### **Financially sustainable and efficient provision of the universal service**

- 3.6 Section 29(3) of the Act provides that, in performing our duty under section 29(1), we must have regard to the need for the provision of a universal postal service to be:
- financially sustainable; and
  - efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 3.7 The concept of 'financially sustainable' is not exhaustively defined. However, section 29(4) of the Act states that it includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service.
- 3.8 We note in this regard that in a letter dated 15 April 2011 to Ofcom and Postcomm<sup>8</sup>, the Secretary of State set out the government's view that the words 'reasonable' and 'commercial' in section 29(4) seek simply to ensure clarity that, where Ofcom deems it appropriate, it should take into account private sector international operators in the postal market, their respective levels of efficiency and the different markets they are operating in, as well as regulated commercial companies in other regulated sectors.

### **The duty to secure the provision of sufficient access points**

- 3.9 Section 29(6) of the Act provides that Ofcom's duty under section 29(1) includes a duty to carry out its functions in relation to postal services in a way that Ofcom considers will secure the provision of sufficient access points to meet the reasonable needs of users of the universal postal service. This duty is subject to any direction by the Secretary of State for Ofcom to take, or refrain from taking, specified action. No such direction has to date been given to Ofcom.
- 3.10 The term 'access point' is defined at section 29(11) of the Act as meaning any box, receptacle or other facility provided for the purpose of receiving postal packets, or any class of postal packets, for onwards transmission by post.

## **General duties**

- 3.11 Section 3 of the Communications Act 2003 (the "2003 Act") provides that it shall be our principal duty, in carrying out our functions, to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

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<sup>8</sup> The letter is published on BIS' website at: <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/p/11-874-postal-regulatory-framework-letter-to-ofcom-postcomm> .

- 3.12 This principal duty applies also to functions carried out by us in relation to postal services.<sup>9</sup> Section 3(6A) of the 2003 Act provides that the duty in section 29(1) of the Act takes priority over our general duties in the 2003 Act in the case of conflict between the two where we are carrying out our functions in relation to postal services.
- 3.13 In performing our general duties, we are also required under section 3(4) of the 2003 Act to have regard to a range of other considerations, which appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations appear potentially relevant, including:
- the desirability of promoting competition in relevant markets;
  - the desirability of encouraging investment and innovation in relevant markets;
  - the vulnerability of children and of others whose circumstances appear to Ofcom to put them in need of special protection;
  - the needs of persons with disabilities, of the elderly and of those on low incomes;
  - the opinions of consumers in relevant markets and of members of the public generally;
  - the different interests of persons in the different parts of the United Kingdom, of the different ethnic communities within the United Kingdom and of persons living in rural and in urban areas;
  - the extent to which, in the circumstances of the case, the furthering or securing of the matters mentioned in section 3(1) is reasonably practicable.
- 3.14 Section 3(5) of the 2003 Act provides that in performing our duty to further the interests of consumers<sup>10</sup>, we must have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money.
- 3.15 Pursuant to section 3(3) of the 2003 Act, in performing our general duties, we must have regard, in all cases, to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles appearing to us to represent the best regulatory practice.
- 3.16 In this regard, we note Ofcom's general regulatory principles<sup>11</sup> including in particular the following in the present context:

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<sup>9</sup> Section 1(1) refers to such functions as may be conferred on Ofcom by or under any enactment. The reference to 'communications matters' in section 3(1) also refers generally to matters in relation to which we have functions, and similarly the reference to 'relevant markets' means markets for any of the services, facilities, apparatus or directories in relation to which we have functions: section 3(14) of the 2003 Act.

<sup>10</sup> Under section 405 of the 2003 Act as amended, references to consumers in a market for a service include, where the service is a postal service, addressees.

<sup>11</sup> <http://www.ofcom.org.uk/about/sdrp/>

- ensuring that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;
- seeking the least intrusive regulatory mechanisms to achieve our policy objectives;
- consulting widely with all relevant stakeholders and assessing the impact of regulatory action before imposing regulation upon a market.

3.17 We also note the Secretary of State's letter referred to above, in which he stresses the need for the universal service provider to have commercial flexibility, where appropriate, to react to market dynamics in pricing and product innovation, and urges Ofcom to reflect that its regulatory decisions retain sufficient flexibility and adjustment mechanisms to allow for rapid change helping to secure the future of the universal postal service, while providing appropriate incentives for Royal Mail to improve its efficiency over time.

## Legal tests

### General test for imposing regulatory conditions

3.18 Schedule 6 to the Act provides that we may impose a regulatory condition<sup>12</sup> only if we are satisfied that the condition:

- is objectively justifiable;
- does not discriminate unduly against particular persons or a particular description of persons;
- is proportionate to what it is intended to achieve; and
- is transparent in relation to what it is intended to achieve.

3.19 Individual regulatory conditions provided for in the Act go on to set out specific tests which we must be satisfied are met before they can be imposed. We consider each of these, where relevant, in Section 9 where we set out for consultation our provisional conclusions on the package of measures which in our view best meets our statutory duties.

## General impact assessment

3.20 The analysis presented in the whole of this document represents an impact assessment, as defined in section 7 of the 2003 Act.

3.21 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the 2003 Act, which means that generally Ofcom has to carry out impact assessments where its proposals would

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<sup>12</sup> The expression 'regulatory condition' is defined in section 28(2) of the Act as including a designated USP condition and a USP access condition; that definition applies to Schedule 6 by virtue of sections 53 and 63 of the Act, when read together.

be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see our guidelines, '*Better policy-making: Ofcom's approach to impact assessment*'.<sup>13</sup>

- 3.22 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

### **Equality impact assessment**

- 3.23 In carrying out our functions, we are also under a general duty under the Equality Act 2010 to have due regard to the need to:

- eliminate unlawful discrimination, harassment and victimisation;
- advance equality of opportunity between different groups; and
- foster good relations between different groups,

in relation to the following protected characteristics: age; disability; gender re-assignment; pregnancy and maternity; race; religion or belief; sex and sexual orientation.

- 3.24 Such equality impact assessments ("EIAs") also assist us in making sure that we are meeting our principal duty under section 3 of the 2003 Act discussed above.

- 3.25 We have therefore considered what (if any) impact the proposal in this consultation may have on equality. We do not consider the impact of the proposal in this consultation to be to the detriment of any group within society. In particular we have addressed in Section 6 the specific issue of whether additional safeguards are required for vulnerable customers.

- 3.26 We have therefore not carried out separate EIAs in relation to race or gender equality, or equality schemes under the Northern Ireland and Disability Equality Schemes.

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<sup>13</sup> [http://www.ofcom.org.uk/consult/policy\\_making/guidelines.pdf](http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf)

## Section 4

# Background and market context

## Introduction

4.1 This section looks at the market context within which Royal Mail operates. The past five years have seen a period of substantial change in the market. Letter volumes have declined greatly and users have moved towards lower-priced alternatives. Although prices have increased over the period, they have still not managed to offset a major decline in Royal Mail's volumes. Over the same period Royal Mail has invested in improving efficiency and has modernised many of its operations. It has reduced its costs, and headcount has fallen by 20,000 (over 10% of the workforce) in four years<sup>14</sup>. However it has not been able to reduce costs at the rate which would be necessary to offset the fall in revenues. This has led to a position where Royal Mail is struggling financially, and as such there is a risk to the financial sustainability of the universal service in the near term.

## Background

4.2 The total mail market<sup>15</sup> comprises around 16bn items and £6bn to £7bn per annum of revenue. Royal Mail has a market share by revenue of over 90%<sup>16</sup>. As shown by Figure 1 below, the majority of this revenue is from business communicating with residential customers. However, the proportion of the different types of mail being sent is changing as more businesses move communications online, particularly with respect to transactional volumes (such as invoices and statements etc).

4.3 A significant proportion of business mail is sent by a small number of large customers. For example, the top 50 senders of mail send up to 40% of Royal Mail's total volumes<sup>17</sup>. However, within a segment individual customers can have very different mailing profiles and this is changing over time. Many financial institutions currently send significant volumes of mail including statements and legal documents, while other financial institutions have dramatically reduced their mailings over recent years and now largely communicate with their customers through other communication channels.

4.4 Residential customers send only about 13% of Royal Mail's volumes the majority of which is personal correspondence such as greetings cards. This therefore significantly increases at peak times such as Christmas.

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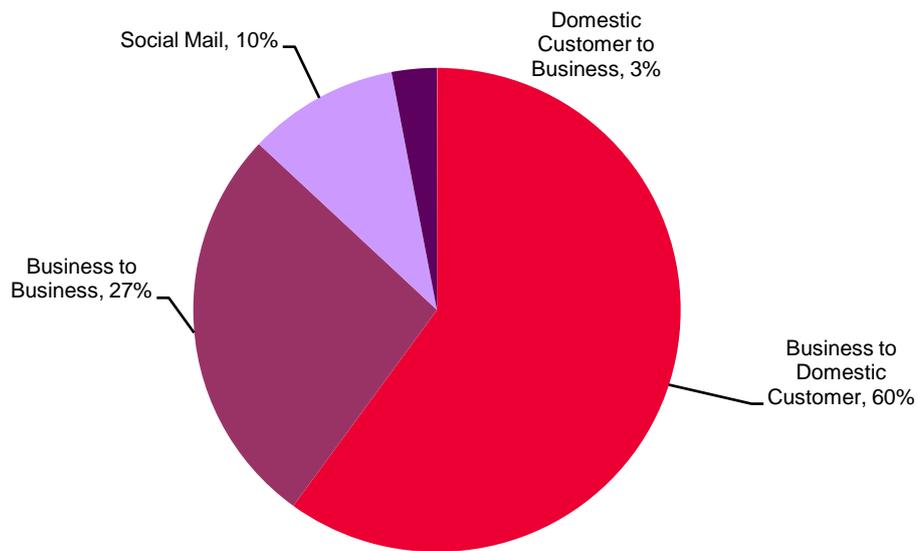
<sup>14</sup> Based on data in provided in Royal Mail's statutory accounts

<sup>15</sup> Based on addressed mail and packets, excluding heavy parcels (>2kg)

<sup>16</sup> Excluding the upstream element of revenues earned by access operators, but including access charges, and excluding end-to-end revenues of packets operators and niche end-to-end operators.

<sup>17</sup> Hooper Review, 2008

**Figure 1: Segmentation of the letters market (2009)<sup>18</sup>**



4.5 While the 13% of mail sent by residential customers amounts to over 2bn items per annum in total, mail is a low cost item for most customers. The most recent available information from the Office of National Statistics of household expenditure on services shows that the average household spend on post was around 40p, per week, equivalent to around 0.1% of average weekly expenditure. This is significantly smaller than the comparable spend on other services, as outlined in Table 1:

**Table 1: Comparison of weekly spend on different household services**

	<b>Average weekly expenditure (£)</b>	<b>% of average weekly total household expenditure</b>
<b>Telephone</b>	<b>10.80</b>	<b>2.4%</b>
<b>Electricity</b>	<b>10.20</b>	<b>2.2%</b>
<b>Gas</b>	<b>9.70</b>	<b>2.1%</b>
<b>Water</b>	<b>6.50</b>	<b>1.4%</b>
<b>TV &amp; Internet</b>	<b>5.90</b>	<b>1.3%</b>
<b>Postal Services</b>	<b>0.40</b>	<b>0.1%</b>

Source: The Office of National Statistics, Integrated Household Survey 2009

4.6 For low-income users and other vulnerable customer groups<sup>19</sup>, the proportion of average household expenditure that is spent on postal services is higher, but still

<sup>18</sup> Hooper Review, 2010

<sup>19</sup> The lowest decile in the Office of National Statistics' Integrated Household Survey.

very small compared to other forms of expenditure at approximately 0.25%. All residential customers tend to use more First Class than Second Class services, but vulnerable groups are more likely to use Second Class. Recent analysis performed by Postcomm and Consumer Focus<sup>20</sup> has indicated that the majority of residential customers use First Class stamps in preference to Second Class, but the quality of service which they need is often more comparable to a Second Class service, and the use of First Class is for convenience. Given the relatively small use of stamps in general, this will reflect the small differential (10 pence) between the prices.

- 4.7 Figure 2 below shows that prices have been rising. However, this analysis also shows that the effect relative to income is likely to be small and this will influence the price sensitivity of customers. Analysis by Postcomm and Consumer Focus has shown that price is not the most important factor for customers in their decisions to use mail. Quality of service (particularly confidence over date of delivery) and the security of mail and the relative speed of delivery, in comparison to electronic or other alternatives are more important factors in residential customers' decisions to use postal services. This is not to say that price does not matter to customers but it is not, generally, a critical factor.

## Market volumes

- 4.8 Prior to 2000, mail volumes changed in line with economic activity and demographic growth<sup>21</sup>. However, this relationship has broken down and mail volumes have declined substantially over the past few years. Since the start of the current price control in 2006, Royal Mail's volumes have dropped from 84m letters, packets and parcels delivered every day to approximately 62m (around 25%). One of the major reasons for this decline in volumes is that many sending and receiving customers are choosing electronic communication such as online banking or email rather than physical mail. This is particularly true for business mail such as invoices, statements and customer communication, which is known in combination as 'transactional mail', and which represents over half of the mail currently handled by Royal Mail. Delivery of items bought online (fulfilment) has been growing but this has not been sufficient to offset the decline in other types of mail. While it is not clear how long this growth in fulfilment volumes will continue (as increasing amounts of music, films and books can be delivered online), the majority of fulfilment items such as clothing and electronic goods are not electronically substitutable.
- 4.9 The impact of volume decline on Royal Mail has been magnified by some customers switching to lower-value products, which reflects three factors:
- Bulk mail has increased significantly over the past 30 years and now accounts for the majority of all mail volumes. E-substitution has been slower to affect bulk mail than single-piece mail such as social mail, which has been significantly replaced by electronic communication;
  - There have been substantial additional declines in First and Second Class single piece mail as customers seek to save money through moving to bulk mail. Over

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<sup>20</sup> Postcomm and Consumer Focus, Residential customer needs from a sustainable universal service in the UK, November 2010.

<sup>21</sup> As set out in the Hooper Review, 2008.

the past five years single-piece mail has declined by 40% whereas bulk mail has declined by less than 5%.

- Large customers have largely moved to alternative (access) operators, where we estimate 80%-90% of the end price is paid to Royal Mail and 10%-20% is retained by the other operators.
- 4.10 This has been offset to an extent by increases in fulfilment items which tend to use higher-priced products such as packets and parcels. But the net impact has been negative. We have estimated that the move to lower-priced products has reduced Royal Mail's revenue by approximately 10% over this period.
- 4.11 While access competition has grown significantly during the period of the current regulatory framework since 2006, there has been very little development of end-to-end competition, which involves companies providing the whole service from collection through to sorting and delivery. This market was fully liberalised in 2006, but there has been little effect on the extent of competition. Operators other than Royal Mail, who deliver entirely through their own networks needed to be licensed by Postcomm, and are in general either couriers operating on a very small scale or wider market participants offering a niche delivery service. Such operators account for significantly less than 1% of total mail volumes.
- 4.12 The exception relates to packets and parcels, where other operators have increased their market share in delivering larger packets items below 2kg, which were generally delivered by Royal Mail. Royal Mail have consequently seen less of the benefit of fulfilment growth, in part because of competition and the loss of market share.

## Market prices

- 4.13 Although stamp prices had previously risen over time, until 2006 these price rises did not keep pace with inflation. More recently, however, stamp prices have risen substantially. The price of a First Class stamp for a standard letter, for example, has risen from 26p in 2003 to 46p from April 2011 which equates to a nominal increase of over 75% (and a real increase of 40%). Second Class stamps have increased from 20p to 36p (80%) over the same period.
- 4.14 Since 2006, the majority of Royal Mail's products have been subject to a price control. The price control was set such that average prices would fall by 1% per annum in real terms, but subject to a number of adjustment mechanisms. In practice, largely due to the volume adjuster which has allowed Royal Mail some price rises to offset the impact of volume decline, prices have risen on average in real terms, and stamp prices have risen faster than bulk mail prices.
- 4.15 The trend in Royal Mail's stamp prices is shown in Figure 2 below.

**Figure 2: First and Second Class stamp prices 1983 to 2011<sup>22</sup>**

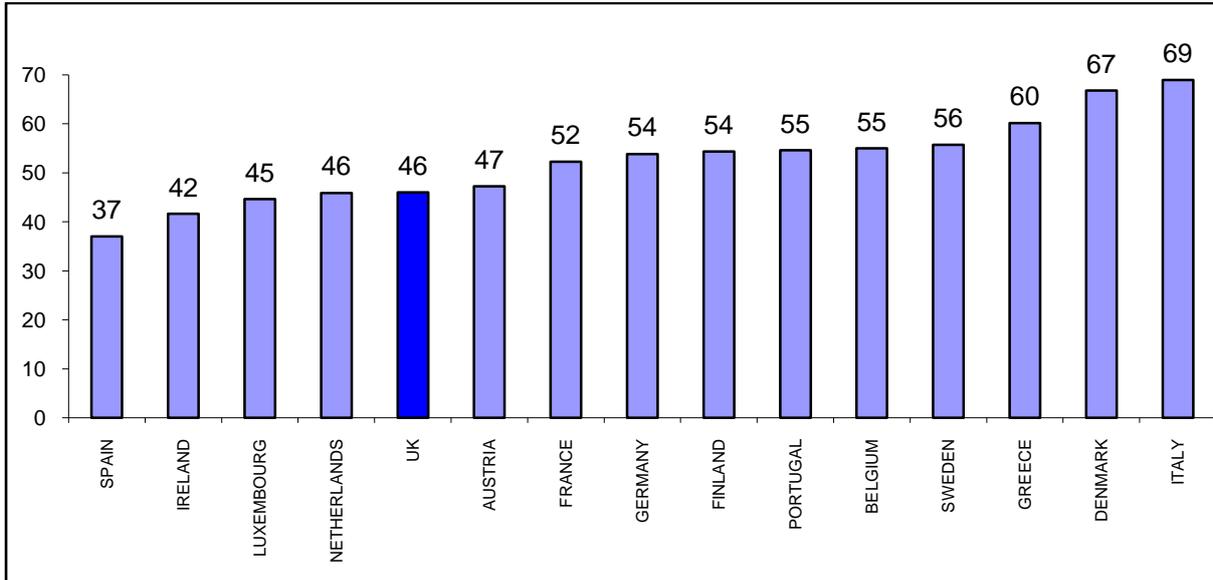


4.16 Until recently Royal Mail's prices compared favourably with those in other EU countries. Due to the more recent price rises, its prices for basic weight stamps are now much more aligned with international comparators, although Figure 3 shows that a like-for-like analysis of prices across First Class services, Royal Mail's prices for 0-100g services remain low.<sup>23</sup>

<sup>22</sup> Source, Ofcom analysis

<sup>23</sup> It is important, however, to recognise the caveats that need to apply to international comparisons - in particular the universal service requirements vary considerably between different EU member states, it does not include both a first and second class service for most countries, and other countries offer more than one service in the 0-100g range. In addition, costs will vary significantly due to factors such as geography and quality of service standards.

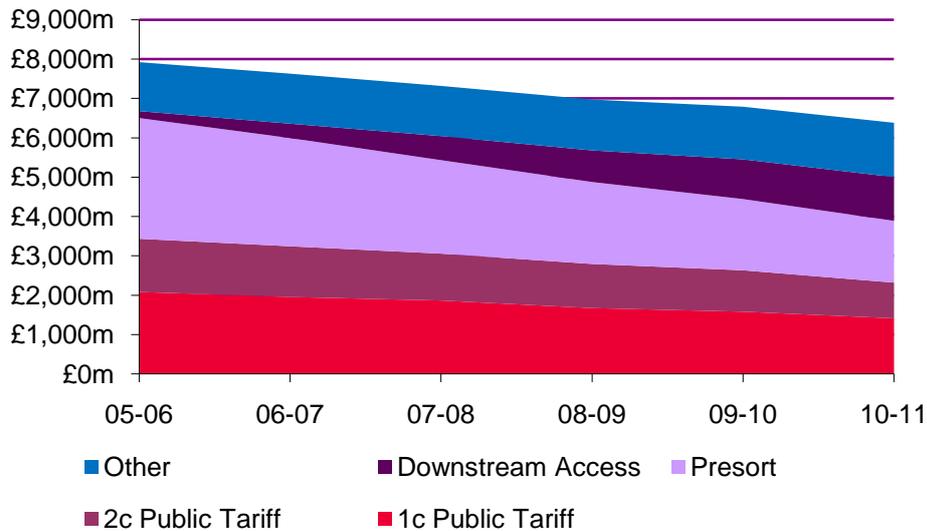
**Figure 3: EU-15 average First Class stamp prices up to 100g using UK volume weights, May 2011<sup>24</sup>**



4.17 However, the overall impact of higher prices has not been enough to offset the impact of volume decline. Revenues have declined each year in real terms, and have in the last two years been declining in nominal terms. The overall change in revenues and product mix since 2006-07 is set out in Figure 4 below.

<sup>24</sup> Source: Royal Mail

**Figure 4: Royal Mail revenues, by product type: 2005-06 to 2010-11 (real terms)<sup>25</sup>**



## Royal Mail's costs

- 4.18 Given the impact of declining volumes and changes in mix on its revenue, it is important for Royal Mail to make significant reductions in cost. It is part-way through a modernisation programme, which it began in 2006-07 and which has resulted in investment of approximately £2bn in capex and related one-off costs (such as redundancy payments).
- 4.19 Based on this modernisation programme, Royal Mail has developed a Restructuring Plan. The Plan includes cost reductions of around [X] costs in real terms by 2015-16 to offset the impact of falling volumes and revenues. The cost savings include:
- Lower costs of handling mail in mail centres as a result of modernisation of Royal Mail's sorting machines.
  - Lower costs in delivery offices as a result of the introduction of "walk sequencing" machines that sort mail in order of the address to which it will be delivered.
  - Lower costs across the mail centre and delivery network resulting from re-optimisation of working patterns to reflect best practice and the opportunities from modernisation.
  - Significant reductions in the number of managers across Royal Mail, at a faster rate than cost reduction in operational areas.
- 4.20 As set out in Figure 5 below, this level of efficiency improvement is needed to offset the forecast revenue decline, but is significantly higher than Royal Mail has been able to achieve in the past. Since volumes have started to decline in 2006, Royal Mail has

<sup>25</sup> Source: Ofcom analysis of submissions from Royal Mail

in most years been unable to reduce costs at a sufficient pace to offset the rate of decline in its revenues.

**Figure 5: Royal Mail's actual and projected change in costs and revenue: 2003-04 – 2015-16<sup>26</sup>**

[X]

Royal Mail could conceivably accelerate the pace of cost reduction, but this is subject to significant uncertainty over the speed at which it is able to achieve the targets set out in the Plan. Some important objectives of the modernisation programme have been delayed in recent years due to difficult industrial relations and problems with operational implementation of the modernisation programme. Delays cannot be easily recovered, as there are limits to the achievable pace of cost reduction. A six-month delay, for example, would cost Royal Mail around [X] over the life of the Plan.

## Royal Mail's financials

- 4.21 Royal Mail recently published its annual results for 2010-11 which show that Royal Mail Group made a profit of £39m (down from £180m the previous year), and total revenues declined to £9.2bn (down from £9.3bn) due to a 4% fall in core revenues. The newly-formed UK letters and parcels and international business (UKLPI), comprising Royal Mail Letters and Parcelforce, made a loss of £120m compared to a like-for-like profit of £20m the previous year. The contributory factors to the Royal Mail Group's performance in 2010-11 are presented in below.

**Table 2: Royal Mail Group's performance in 2010-11<sup>27</sup>**

Group Business Unit	Revenues (£m)	Profit (£m)
UK Letters, Parcels and International	6,857	(120)
European Parcels (GLS)	1,485	118
Post Office Limited	776	21
Other	38	20
<b>Total</b>	<b>9,156</b>	<b>39</b>

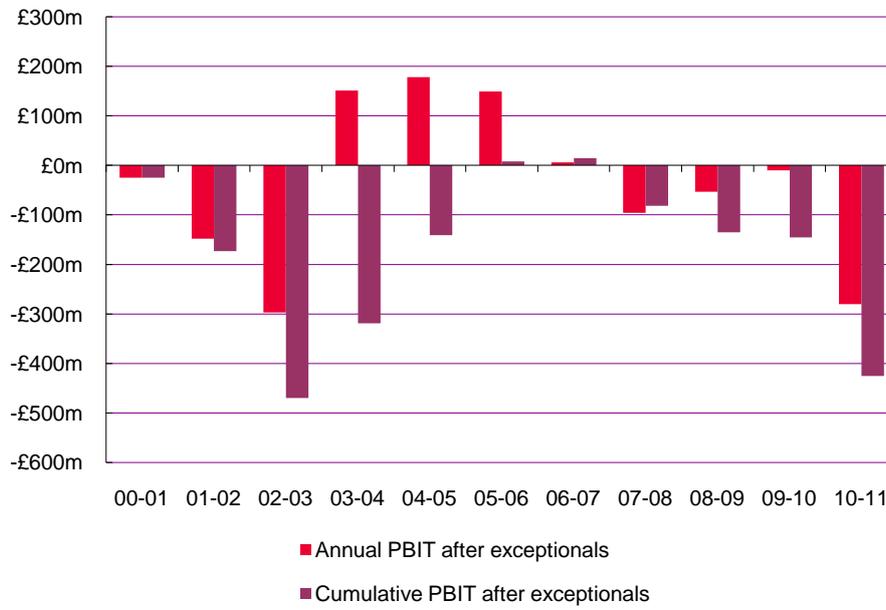
- 4.22 Since the last price control was set, Royal Mail's financial position has been consistently weak. Royal Mail Letters, the business which has held the universal service network for much of the past decade, has accumulated unpredicted and

<sup>26</sup> Source: Ofcom analysis of Royal Mail Restructuring Plan. Costs include: people costs, non-people costs, inter-business costs, overhead allocations and depreciation & amortisation.

<sup>27</sup> Source: Royal Mail's Statutory Accounts

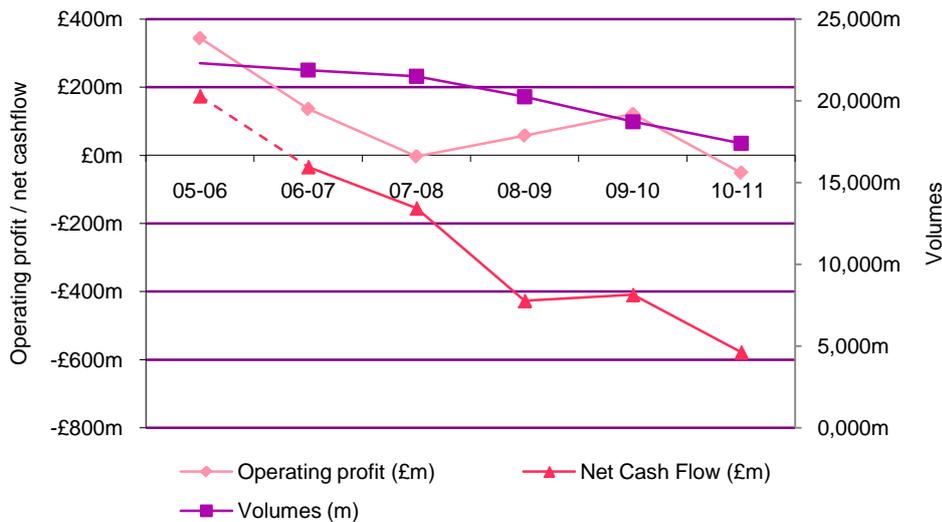
sustained losses. The overall profitability of Royal Mail Letters' business, and therefore its ability to finance the universal service, has fallen sharply and proved changeable over the past ten years, as illustrated by Figure 6 below. The figures for 2010-11 represent Ofcom's analysis of the comparable profitability of Royal Mail Letters by comparison to the prior years, given that it reported Letters profitability as part of UKLPI.

**Figure 6: Royal Mail's historic profitability 2000-01 to 2010-11<sup>28</sup>**



4.23 In addition, while profit has been weak and inconsistent, cash flow has been worse. Figure 7 summarises our analysis of Royal Mail Letters' operating profitability, cash flow and volumes from 2005-06 to 2010-11. It shows that the Letters business's profits and cash flow have fallen consistently, with the decline in addressed mail volumes being a significant contributory factor. For 2010-11, since Royal Mail moved to reporting UKLPI data, Letters performance represents our analysis of Royal Mail's performance on a like-for-like basis with prior years

<sup>28</sup> Source: Ofcom analysis, Royal Mail's Regulatory Accounts

**Figure 7: Royal Mail Letters' operating performance 2005-06 to 2010-11<sup>29</sup>**

- 4.24 As shown by Figure 7 above, Royal Mail Letters has incurred a series of net cash outflows in recent years. Over the period 2005-06 to 2010-11, net cash flow has been significantly worse than profit, due to the cash cost of investment in modernisation and funding the historic pension deficit. In addition, over the period of the current price control there has been a significant gap between projected and actual cash flows. We have estimated that there has been a cumulative cash under performance of over £3bn from 2006-07 to 2010-11, relative to the cash flow projected by Postcomm when the price control was set in 2006.
- 4.25 This level of underperformance over the current price control period demonstrates the challenge faced in developing a regulatory framework. The cost reductions achieved by Royal Mail have been delayed when compared to its original modernisation plan and have as a result been insufficient to keep up with the pace of volume decline. This has brought the sustainability of the universal service into question. The universal service network has consumed significant cash for the past three years and continues to do so.
- 4.26 An approach to regulation which leaves Royal Mail and its shareholder with this pattern of risk is unlikely to be consistent with ensuring the financial sustainability of the universal service. We will need to ensure that the new regulatory framework has regard to these risks. In developing our proposals, we have assessed whether such an outcome can be achieved through a new approach to economic regulation.

## Impact of regulation on Royal Mail's financial position

- 4.27 As discussed above, Royal Mail's current price control has limited the prices set by Royal Mail since 2006. The assumptions within the price control formula have not proved robust to the pace of volume decline and change in mix. Postcomm did not predict the extent of volume decline or change in mix<sup>30</sup> and the assumptions

<sup>29</sup> Source: Ofcom analysis, Royal Mail's Regulatory Accounts and Restructuring Plan

<sup>30</sup> Both Postcomm's consultation and Royal Mail's responses forecast that volumes would stay broadly flat across the price control period

underlying the regulatory formula were proved wrong at a fairly early stage. The efficiency targets also proved to be difficult to achieve given the changes in market conditions.

- 4.28 The model of competition facilitated by the current regulatory framework, and specifically the use of an “access headroom” control also guaranteed a significant margin within which access operators could compete, leading to Royal Mail rapidly losing substantial upstream bulk mail volumes. It was envisaged that the nature of the access headroom control would be re-assessed during the original price control period, but there was difficulty coming to agreement over the appropriate data to be used, and only moderate changes to the structure and level of the control have been made in 2011-12.
- 4.29 As a result of the difference between expected and actual outcomes, Royal Mail has sought to re-open areas of the price control. It first sought a change to the terms of the price control within the first year of its implementation, as the scale of its underperformance became clear. Subsequent applications were then made relating to the effectiveness of the control, including an application for significant price rises for large customers, which were designed to yield an additional £100m revenue in 2011-12. However, such applications and any subsequent changes to the price control do not deliver regulatory certainty, and may dilute incentives to improve efficiency. The future regulatory framework should seek to move away from this approach, and instead be flexible to changes in the market and provide incentives for efficiency.

## Government’s ongoing role

- 4.30 Alongside changes to the regulatory framework for post, the Postal Services Act 2011 includes provisions relating to the Royal Mail Pension Plan (RMPP), and the removal of certain restrictions on the ownership of Royal Mail. These provisions permit the government to take action to address some aspects of Royal Mail’s current financial position. It is doing this in two ways, firstly by seeking to address Royal Mail’s pension deficit through a State Aid application to the European Commission, and also through a restructuring of its debt. The restructuring and pension deficit measures are subject to European Commission approval.
- 4.31 In June 2011 the UK notified the European Commission of the funding deficit in the RMPP. Under these proposals Government will assume responsibility for historic pension liabilities accrued by members of the RMPP up to a specified ‘cut-off’ date of 31 March 2012. Royal Mail will retain responsibility for a smaller, fully funded plan and for all future pension benefits accrued by employees after the cut-off date.
- 4.32 In addition, the UK notified the Commission of proposed measures to restructure Royal Mail’s balance sheet, including restructuring up to £1.7bn of the company’s debt. On 29 July 2011 the European Commission confirmed that it had opened an in-depth investigation to ascertain whether the UK plans to restructure Royal Mail, by relieving it of its pension deficit and restructuring its balance sheet, are in line with EU State Aid rules.
- 4.33 Following the completion of the State Aid process, the government has stated its intention to dispose of some or all of its shares in Royal Mail to a private investor. This should ensure that future funding can be provided by the financial markets, and should therefore help Royal Mail to become more financially sustainable. The detail of how and when this will be achieved is yet to be determined, including the timing of

any transaction, which will be dependent on a wide range of factors, including financial market conditions.

- 4.34 The other area of legislation which could impact Royal Mail's finances would be changes to the VAT regime. Currently, many of Royal Mail's products, including some bulk mail supplies and access charges, are exempt from VAT. Following implementation of the Act, this may change in April 2012 as some services are removed from regulation. It is likely that HMRC will reassess the scope of the VAT exemption, including its application to access charges, but the outcome of that review cannot be predicted at this stage.

## The future regulatory framework

- 4.35 The Act requires Ofcom to carry out its functions in a manner that we consider will secure the provision of a universal postal service. It is our view that significant decisions on the appropriate medium term regulatory framework need to be taken now, alongside the above outlined government action outlined above, to secure that duty. In particular, given that the current price control will not be effective beyond 31 March 2012 we need to decide what, if anything, should replace these safeguards.
- 4.36 The government has made clear through the regulatory provisions in the Postal Services Act and through separate correspondence to Ofcom and Postcomm<sup>31</sup> that it views future regulatory certainty as important, and that the intention of the changes in the Postal Services Act is to provide the regulator with powers to deliver that regulatory certainty, in the context of the continuing primacy of the universal service.
- 4.37 In considering the options for future regulation, we are aware of the need to ensure that the universal service can be provided in a financially sustainable manner, and that users of postal services, including individual consumers, are adequately protected in relation to quality of service, price and choice.

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<sup>31</sup> <http://www.bis.gov.uk/assets/biscore/business-sectors/docs/p/11-874-postal-regulatory-framework-letter-to-ofcom-postcomm>

## Section 5

# Financially sustainable universal service

## Introduction

- 5.1 This section summarises our approach to the financeability of the universal service, In particular, we:
- set out our interpretation of financeability, in the context of Royal Mail's universal service obligation;
  - assess Royal Mail's planned modernisation programme, and the potential risks associated with its plan; and
  - describe how a reasonable commercial rate of return might be determined in respect of the provision of a universal service.
- 5.2 As set out in section 3, our primary duty requires us to carry out our functions in a way we consider will secure the provision of a universal postal service, and to have regard to the need for the provision of the universal service to be:
- financially sustainable, including the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred for the purpose of, or in connection with, its provision; and
  - efficient after a reasonable period.
- 5.3 In April 2011, Postcomm set out initial views on what the regulator should have regard to when assessing the financeability of the universal service in the context of a future regulatory framework. Since then, Ofcom's duties in the Act have been finalised, and the government has set out in a letter to Postcomm and Ofcom its intentions in relation to those duties. In this section, we set out our approach to financeability, considering each of the different elements of the primary duty as follows:
- The need for the provision of the universal service to be **financially sustainable**. Noting that Royal Mail is the only operator currently capable of providing the universal service, we consider the specific risks faced by Royal Mail, and whether it has the potential to improve its financial position over the forthcoming period to ensure that the universal service is provided on a financially sustainable basis.
  - The need for the financial sustainability of the universal service to include a **reasonable commercial rate of return** for its provider, Royal Mail. We assess different options for defining a reasonable commercial rate of return, based on market evidence and regulatory precedent.
  - The need for the provision of the universal service to be **efficient**, after a reasonable period, and to remain so, including the need for the regulatory framework to provide appropriate incentives for efficiency.
- 5.4 We set out below our further analysis in respect of these areas, and our provisional conclusions for their treatment within the regulatory framework.

## Financial sustainability

- 5.5 In the light of our statutory duties, we consider that the concept of financial sustainability needs to take into account both the need for Royal Mail to be able to earn a reasonable commercial rate of return (on expenditure incurred in the provision of the universal service), and the level of risk to which Royal Mail (including its shareholders from time to time) is exposed in providing the universal service. Overall:
- The universal service needs to be financially sustainable in the short term – i.e. the revenues attributable to the universal service network need at a minimum to cover their costs.
  - The universal service needs to have an expectation of a reasonable commercial rate of return in the medium term to long term – the base case should be that if successful, Royal Mail will earn a profit consistent with commercial companies in comparable industries.
  - The risks around achieving such a commercial rate of return need to be manageable and consistent with the level of return assumed and the financial sustainability of the universal service. The universal service provider should not be expected to manage a greater level of risk than would be accepted by a commercial investor.
- 5.6 In summary, in order for the universal service to be financially sustainable, the regulatory framework needs to provide for short-term cost recovery and a medium-term return on investment, taking account of an appropriate level of risk. We consider below how these requirements can be assessed in the context of Royal Mail's current and expected future financial position.

## Scope of financial sustainability

- 5.7 The Act places a duty on Ofcom to have regard to “the need for the provision of a universal service to be financially sustainable”. It also requires the “provision of a universal service to be efficient”. Our duty to have regard to the need for the provision of a universal service to be financially sustainable “includes the need for a reasonable commercial rate of return for any universal service provider on any expenditure incurred by it for the purpose of, or in connection with, the provision by it of a universal postal service”.
- 5.8 Royal Mail is currently the only postal operator capable of providing the universal service, and this is likely to remain the case for the foreseeable future. We are proposing accordingly that Royal Mail should be formally designated as the Universal Service Provider. The financially sustainable provision of the universal service is therefore inextricably linked to the financial position of Royal Mail. In our view, the provision of the universal service will only be financially sustainable if the universal service provider, Royal Mail, is able to finance its business in the short, medium and long term. As we have explained the challenges facing Royal Mail are significant. In the context of declining volumes it has become increasingly difficult for Royal Mail's revenues to cover the largely fixed costs of the delivery network that are necessary to provide the universal service.
- 5.9 Increased prices cannot be relied upon as a longer-term means of improving revenue as they will also inevitable exacerbate the decline in mail volumes. It is for this reason that we attach such importance to the considerable efficiency improvements that are

likely to be necessary to reduce Royal Mail's costs. We consider that only by becoming more efficient and reducing costs will Royal Mail's revenues cover its costs, such that the universal service is financially sustainable in the long term.

- 5.10 In the light of our duty to have regard to the need for the provision of the universal service to be financially sustainable, we are particularly concerned with Royal Mail's ability to finance those activities required to provide the universal service. So we must identify the costs that related to universal service activities and also the revenues that are attributable to universal service activities. Such activities will be used for products sold as universal services, but in many cases, such as delivery, the same activities will also be used for the provision of other services. The revenues from both sets of services will need to be taken into account in assessing whether the universal service activities are financeable. Specifically, we need to take into account the contribution that both sets of products can be reasonably expected to make towards funding the costs which are joint and common as between the core universal service network and other parts of the integrated network.
- 5.11 The appropriate starting point for considering the financeability of the universal service is therefore to define the boundaries of the activities that are central to the provision of the universal service, and the associated revenues from services which share the use of those universal service activities.
- 5.12 We consider that the boundaries of the business that are central to the provision of the universal service encompass that the costs and revenues (and associated assets and liabilities) which are required for the efficient provision of the universal service. This should, as a general principle, include all revenues and costs of those regulated and unregulated products that depend on the core universal service network activities for their efficient provision.
- 5.13 Our proposal is that this should include the revenues and costs which were formerly provided by the integrated upstream and downstream network activities of the Letters division of Royal Mail Group, and on which Royal Mail has provided regulatory reports to Postcomm. Since the internal restructuring in December 2010, this business activity is now managed by Royal Mail's new, expanded UK Letters, Parcels & International (UKLPI) division.
- 5.14 We recognise that the business identified above differs from how Royal Mail has restructured (and now operates) its business, as well as from how that business would raise finance in practice. This will provide challenges which will need to be addressed through the regulatory accounting framework.
- 5.15 We will continue to monitor the use of the universal service network, and also monitor the appropriate scope of the business for regulatory reporting. If Royal Mail's operations change such that the universal service becomes more clearly separate from the rest of the network, the appropriate scope of business reporting may also have to change.
- 5.16 Equally, we recognise that the universal service activities are financed as part of Royal Mail Group Limited, the legal entity which holds the obligation to provide the universal service. This legal entity also undertakes a wider set of business activities, including GLS (operated via a separate subsidiary) and Parcelforce (part of the UKLPI division within Royal Mail Group Limited). In this context it is impossible to separate the universal service from other activities in assessing the actual form and cost of external financing for the universal service. We will therefore have regard

where relevant to the wider financial position of this group of activities and will require Royal Mail to provide sufficient complementary reporting to allow us to monitor its ability to continue to finance the universal service.

- 5.17 We have set out in Section 8 our proposals for cost transparency, LRIC and regulatory reporting, including accounting separation, that we consider are required to provide the information necessary.

## Royal Mail's July 2011 Restructuring plan

- 5.18 As set out in earlier sections Royal Mail's financial position, if not addressed through appropriate actions, is in our view, currently threatening its ability to finance its activities as the universal service provider. As Royal Mail's owner, the government is currently applying to the European Commission to approve State Aid through a pension deficit solution and debt restructuring to seek to ensure the long-term viability of the business. This application to the European Commission recognises the need to modernise and generate efficiency savings as being critical to responding to declining market conditions and improving longer-term financial sustainability.
- 5.19 Royal Mail proposes to ensure that it remains a going concern through a series of operational modernisation, restructuring and other cost saving initiatives. It provided Postcomm and Ofcom with a draft Business Plan in November 2010, the summary of an updated version in January 2011 and a final Restructuring Plan in July 2011<sup>32</sup> – all of which seek to deliver cost savings in a changing market environment. The Restructuring Plan as presented to Ofcom includes the submission in respect of modernisation and pricing which has been presented to the European Commission, alongside supporting evidence in the form of models and detailed business analysis.
- 5.20 Royal Mail's states in its Restructuring Plan that it requires significant cost savings to address the combined impact of anticipated volume declines and structural market changes largely as a result of recession and e-substitution. The revenue projections in Royal Mail's plan allow for some price rises, but within the plan these are shown to be insufficient to offset continued volume decline. The Plan therefore includes the continuation and acceleration of Royal Mail's modernisation programme which seeks to reduce operating costs in real terms in each year of the Plan at a rate which is comparable with the fastest rate of cost savings achieved by Royal Mail in recent years. The planned cost reductions are largely underpinned by two main elements:
- **A programme of investment-enabling measures** – aimed at ensuring that Royal Mail has the appropriate equipment and physical infrastructure in place to respond to a dynamic market. This includes a complex programme to rationalise mail processing, by roughly halving the number of mail centres from the 69 at the start of the programme, while increasing the proportion of mail that can be mechanically sorted, by investing in letter sorting, flat sorting and walk sequencing machines. Initiatives in delivery focus mainly on responding to changes in the product mix (such as increasingly higher weight packets), by investing in trolleys and vans to ensure staff have the right equipment to deliver mail.

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<sup>32</sup> Covering the plan period 2010-11 to 2015-16.

- **Improved resource management performance** – aimed at increasing productivity and ensuring that resources are effectively matched with the workload. In this respect Royal Mail has implemented initiatives to spread best practice across both mail centres and delivery offices to eliminate cost variation where possible and improve performance and adjusting resources as volumes and workload fall.

5.21 Although by the end of the plan period Royal Mail is likely to be a smaller business than it is today given the scale of the expected volume declines, if it can achieve its projected savings, its financial position would be greatly improved. The improvement in cash flow includes a benefit of approximately £300m from the removal of the pension deficit payments with effect from 2012-13.

### Figure 8: Royal Mail's profit and cash flow plan projections<sup>33</sup>

[X]

5.22 However, we recognise that Royal Mail's ability to achieve the improvements in the plan is subject to significant risks. Our scenario analysis on the plan, summarised below, highlights the sensitivity of Royal Mail's financial projections to both endogenous and exogenous risks. These include:

- revenue risks (including mix and market share);
- cost inflation risk (including changes to pension contributions); and
- cost reduction risk – including the ability of the proposed measures of modernisation to deliver the cost savings within the planned timeframe.

5.23 While it appears that Royal Mail's plan has the scope to return the business to profitability, it is also clear that its financial position remains challenging in the short term and highly dependent on external factors such as a pension solution.

5.24 We consider below a variety of evidence as to how a reasonable commercial return might be defined for Royal Mail. Our analysis indicates that if Royal Mail is to achieve a level of operating profitability that represents a reasonable commercial rate of return, similar to a comparable operator in a competitive market, before the end of the Plan period, then price rises, potentially significant, are likely to be necessary, despite efforts to achieve cost savings. The need for price rises could be greater as a result of small changes to the assumptions within the Plan. Adverse changes in underlying assumptions could, absent mitigating actions, result in disproportionately large effects on Royal Mail's profitability. This reinforces the need for Royal Mail to have the flexibility to respond to changing market circumstances.

## Assessment of the Plan and the key risks arising

5.25 As part of our work in considering the future regulatory framework, it is important that any final proposals the regulator consults upon will allow Royal Mail to recover sufficient revenue to cover the efficient costs of providing the universal service and allow a reasonable commercial rate of return, in a form consistent with our primary duty as outlined above.

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<sup>33</sup> Source, Ofcom Analysis, Royal Mail Restructuring Plan

- 5.26 On this basis, in order to assess the financial sustainability of the provision of the universal service we have focused on both the cost and revenue projections of Royal Mail. We have conducted an operational review of Royal Mail's plans to reduce costs and respond to declining revenues.
- 5.27 Our analysis is based upon:
- Royal Mail's Restructuring Plan document, as presented to the European Commission in support of its State Aid application;
  - the supporting regulatory model suite which provides detailed analysis underlying the Plan, (these models have been made available to Ofcom);
  - supporting information from Royal Mail on the assumptions within the Plan (including reviews commissioned by Royal Mail from PwC of the plan and Deloitte of the market context); and
  - independent reviews by our consultants of the assumptions within the plan and the likely scenarios (Frontier Economics on costs and revenues, CEPA on financeability and modelling). A redacted version of CEPA's report will be published alongside this consultation. Frontier's analysis is based on and includes significant amounts of information provided by Royal Mail in confidence and we have not published it given our general duty to keep such information confidential..
- 5.28 We have, in turn, assessed Royal Mail's cost and revenue projections, including the assumptions underpinning such forecasts.

### **Royal Mail's cost projections for 2010-11 to 2015-16**

- 5.29 The case for modernisation is clear and well documented. Royal Mail will need to achieve significant operational cost savings over the course of its Plan to 2015-16 in response to a declining market and diminishing revenues. Without such efforts, Royal Mail is unlikely to reach a financially sustainable position, thereby jeopardising its ability to provide the universal service.
- 5.30 Royal Mail's central case, as set out in its Plan is that it can:
- Deliver substantial cost savings quickly, returning it to a financially sustainable position, by primarily concentrating on the largest areas of expenditure at Mail Centre and Delivery Office level.
  - Reduce Mail Centre costs by [X] by 2015-16, through a rationalisation programme, better automation and working practices and more consistent performance across its estate.
  - Reduce the costs of delivery by over [X].
  - Achieve savings in costs of around [X].
- 5.31 The resulting effect is that Royal Mail anticipates that if can achieve operational cost savings in excess of [X] by the end of the plan period in 2015-16. Figure 9 below illustrates Royal Mail's expected evolution of its cost base.

### Figure 9: Royal Mail's projected cost base<sup>34</sup>

[X]

#### Royal Mail's revenue projections for 2010-11 to 2015-16

5.32 Royal Mail's central case, as set out in its Plan projects that over the period from 2010-11 to 2015-16:

- Mail volumes will decline by over 20%, leading to a decline in revenue of over [X].
- Switching to cheaper products (including access) will continue reducing revenue by around [X].
- This product downtrading will be offset by switching towards more expensive packets and away from letters, for a net revenue gain of over [X].
- Price changes between will raise a net total of approximately [X].<sup>35</sup>

5.33 The resulting decline in forecast revenues is between [X] to [X]. This is illustrated in Figure 10 below.

### Figure 10: Royal Mail's revenue projections for the period 2010-11 to 2015-16, split by product<sup>36</sup>

[X]

## Ofcom's approach to considering Royal Mail's central case

### Cost projections

5.34 Royal Mail has a detailed set of models which allow it to forecast costs. We have, with the support of Frontier Economics, conducted an operational review of Royal Mail's cost reduction plan (otherwise known as the efficiency review). These cost reductions are intended to ensure that the provision of the universal service will become more efficient, and the provision of the universal service will become financially sustainable in the medium and long term. Royal Mail's model includes forecasts around other cash costs including ongoing pension contributions and capital expenditure. We have focussed on operating costs, as the success of Royal Mail's modernisation is dependent on its ability to reduce these costs over the Plan period.

5.35 Our review has primarily focused on mail centres and delivery offices (DOs) (given together they account for around 75% of Royal Mail's people costs). These are therefore the areas with both most risk and, potentially, opportunity. Given the scale,

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<sup>34</sup> Source: Ofcom analysis, Royal Mail Restructuring Plan

<sup>35</sup> This analysis does not factor in the any further price changes Royal Mail may make in addition to those assumed in the Plan.

<sup>36</sup> Source: Ofcom analysis, Royal Mail Restructuring Plan

clearly any delays to cost savings and the failure to embed efficiencies in DOs would have significant impacts on Royal Mail's ability to become profitable and the universal service sustainable. The review has also made an assessment of planned volume related costs savings (marginality) and pay and headcount savings throughout the pipeline. Specifically, we have reviewed:

- The scope for Royal Mail to make cost savings, and
- The risks associated with Royal Mail achieving these savings

- 5.36 This analysis forms the basis of a detailed review of Royal Mail's operations and proposed changes, identifying the robustness of Royal Mail's planned changes and areas where there could be scope for Royal Mail to make further cost savings by changing its operations. Mail Centre and Delivery Office cost analysis has also been supported by econometric benchmarking by Frontier of the relative performance that Royal Mail achieves across its offices. Such comparison of relative performance provides an effective estimate of the cost savings that Royal Mail could achieve by improving performance across its business up to the standard it already achieves in the best units.
- 5.37 Overall, whilst Frontier's analysis indicates that Royal Mail's cost reduction targets are significant (in the context of its achievements to date), they reflect a reasonable base case. However, Frontier has highlighted and drawn our attention to a number of risks and opportunities that exist with the execution and achievement of Royal Mail's Plan. We explain these further in the section on sensitivities.
- 5.38 On this basis, our analysis suggests that alternative projections to Royal Mail's assumed central case are also plausible. We present a non-confidential summary of our scenario analysis below.

### **Revenue projections**

- 5.39 Our approach to considering revenue projections and their uncertainties has been to review Royal Mail's approach to define its central case for volume decline (as set out in its Plan). Like for costs, Royal Mail has a detailed set of models which aids it to forecast volumes and revenues. By understanding its methodology and assumptions used, we have been able to comment on the plausibility of the central case offered and consider whether alternate cases and scenarios are plausible.
- 5.40 Our analysis has shown that one of the most important determinants of Royal Mail's volume forecasts is its assumptions around e-substitution. Due to the lack of evidence to support an analysis of future trends around e-substitution, Royal Mail's volume projections are based on business judgements given existing trends. It is therefore also one of the volume drivers that is subject to the greatest uncertainty. Royal Mail is projecting that the rate of e-substitution remains significant over the plan period.
- 5.41 Royal Mail's mail volumes and therefore revenues can be divided into segments by sender or content, each with different characteristics and behaviours. Our analysis has indicated that across these different segments, the different customers (both senders and receivers) are likely to respond differently to e-substitution alternatives. For example:

- transactional mail customers (i.e. customers who send / receive statements or invoices) are likely to be driven by how much companies need to invest in new technologies and end customers' acceptance of alternatives, and this is likely to vary between different senders such as financial institutions, utilities and government institutions;
  - fulfilment mail customers will be impacted by cultural changes such as future trends in online shopping between physical items such as clothes, and user preferences in respect to formats which can be substituted, such as the shift to music, book content and video downloads;
  - direct mail customers will be impacted by relative response rates of customers to different media, prices for electronic alternatives for advertising, and the ability to use different media together effectively.
- 5.42 To consider the possible impact of e-substitution on mail volume projections further we have modelled e-substitution at this more detailed content-level, by considering the current penetration rates (i.e. the proportion of mail that has already switched to electronic alternatives), and forecasting whether and by how much this might accelerate or decline based on our understanding of the characteristics of the different senders / receivers of that type of mail.
- 5.43 Based on this analysis, we consider that Royal Mail's approach to defining its central case revenue projections is reasonable.
- 5.44 Recent analysis of the mail market concluded by various sources (and broadly consistent with Royal Mail's evidence provided to Ofcom) has shown that the market is likely to be in a transitional period, and as such past relationships do not always provide a reliable guide to the future and therefore over reliance on economic models to predict future trends may not be reliable. Royal Mail has used a combination of economic models and commercial judgements to form its revenue projections.
- 5.45 Volumes may also be impacted by changes in price. Royal Mail increased prices significantly in 2011-12, and it is possible that some prices may have to rise further to cover their costs. If this results in price rises higher than assumed in the Plan, this would also be likely to result in faster volume decline. Price rises will result in lower volumes, as some customers will be unwilling to pay higher prices and stop sending mail or move to alternatives. This effect (price elasticity) is taken account of in Royal Mail's models, which assume that the use of mail declines with higher prices. However, it is possible that the large price rises in 2011-12 and will result in a change to the way customers respond to such price changes. There is no observable precedent for the impact of significant price rises at a time when volumes are already declining, and the rate of price related volume decline will therefore be subject to significant uncertainty and risk.
- 5.46 Royal Mail has assumed that price elasticity increases where there are high price rises. Given the lack of evidence for the size of this effect, Royal Mail has additionally used internal commercial judgments to assess the impact and adjust the results. On balance, our assessment is that the combined assumptions around e-substitution and price elasticity result in plausible central case for volume decline. However, Royal Mail has not directly modelled how the 2011-12 price rises or any future price rises may specifically impact the pace of e-substitution.

- 5.47 Our analysis therefore indicates that whilst the central case for revenue is an appropriate assumption to use within Royal Mail's Plan, it has also shown that there are a number of risks and sensitivities that could result in significant deviations from the central revenue projection made by Royal Mail in its Plan.

## Risks and sensitivities

- 5.48 Our analysis of the detailed methodologies used within Royal Mail's modelling indicates that its approach to revenue forecasting, including the underlying assumptions used, indicates that its central projections seem plausible for the purposes of business planning. However, we recognise that there remains considerable uncertainty underlying each of its key assumptions (e.g. market volume growth, price elasticity, e-substitution, etc) which are difficult to predict in isolation. At the business plan level, these individual sources of uncertainty combine to demonstrate that Royal Mail faces significant risk to its revenue outlook.
- 5.49 In addition, the revenue risks are magnified by the 2011-12 price increases for the largest users of mail, and, if implemented, any further price rises, as there is little evidence as to the potential response of customers to price rises of this scale.
- 5.50 With respect to costs, our analysis of Royal Mail's performance against its previous plans suggests that Royal Mail is making relatively good progress against certain aspects of its modernisation programme, but that progress in other areas has been slower than anticipated. This has contributed to the decline in profit for 2010-11, as outlined in Section 4.
- 5.51 Given the level of uncertainty of the projections in Royal Mail's plan we have further examined the key cost and revenue risks that our analysis has identified. Whilst the level of downside risk is of particular importance given our duty to ensure the provision of a universal service, we have also sought to understand the potential opportunities to Royal Mail from outperformance against its plan. The key specific cost risks we identified are:
- Royal Mail's ability to achieve its projected benefits of modernisation in delivery offices primarily through enabling measures and resource management performance;
  - Royal Mail's ability to realise cost savings from increased mechanisation, and to re-optimize its cost base to reflect with greater mechanisation and lower volumes; and
  - potential changes to the pace of modernisation, including those which would arise from any future industrial disputes, which can significantly impact the benefits achieved from the programme.
- 5.52 The key specific revenue risks we identified are:
- the underlying rate of e-substitution and consequent volume reduction which relates to the technological shift from mail to electronic alternatives, and which differs across the different uses of mail and the different types of customer dependent on both user preference and ease of substitutability;
  - potential changes to demand following price rises which have yet to fully manifest from 2011-12 price rises;

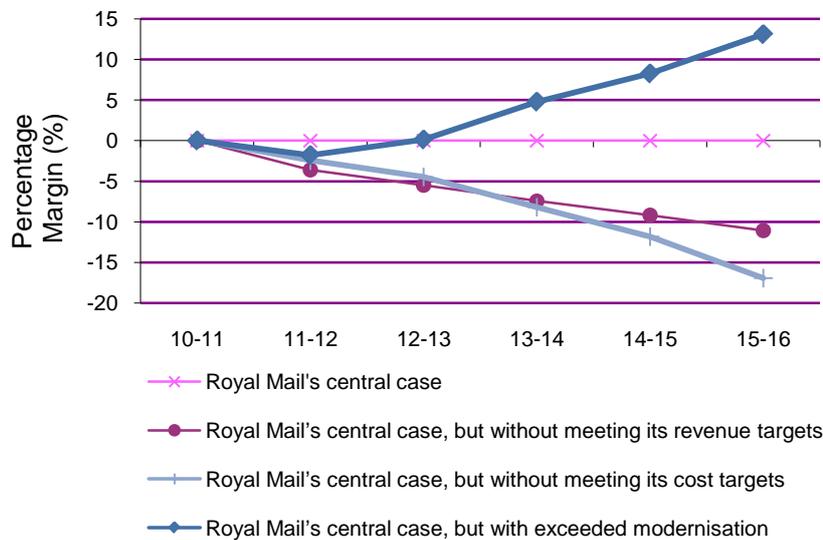
- uncertainty regarding GDP trends and forecasts becoming increasingly volatile; and
- dynamic shifts in market conditions which alter the expectations for packet, access and bypass volumes.

- 5.53 Our analysis suggests some of these risks are largely downside risks. Significant price rises may increase price elasticity (the rate at which volume decline is linked to price rises) and any future industrial disputes could delay the pace of modernisation, as in 2009-10.
- 5.54 However, in most cases, the sensitivities around Royal Mail's future performance also include the potential for outperformance. Volume decline could be slower than forecast, as Royal Mail's forecasts assume very significant rates of e-substitution for some types of mail.
- 5.55 In addition, our analysis indicates that while Royal Mail's plans to reduce costs are ambitious compared to its past performance, the timescale assumed to be needed to deliver resource management improvements is longer than some other companies have needed to deliver comparable programmes. Our analysis indicates that, once enabling measures are in place, it might be feasible to re-optimize the network quicker than assumed by Royal Mail.
- 5.56 We have used cost and revenue sensitivity outputs to produce a set of combined financial scenarios. These scenarios represent plausible outcomes that provide an indication of the financial sustainability of the universal service and likelihood of generating a reasonable rate of return. The scenarios incorporate the interaction of risks and have been modelled to indicate the potential impact on Royal Mail's finances. A potential set of outcomes/scenarios for the scale of divergence between Royal Mail's cash generation in the central case and alternative scenarios is shown in Figure 11 below. Figure 11 shows how Royal Mail's operating margin<sup>37</sup> could vary from its central case in our plausible scenarios.

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<sup>37</sup> Measured as operating cash flow / revenue

**Figure 11: Potential outcomes for the financial sustainability of the universal service – deviations of operating margin from Royal Mail's central case<sup>38</sup>**



- 5.57 As Figure 11 illustrates, the Ofcom range of sensitivities for Royal Mail's future volumes and the potential range of scenarios for the modernisation programme, we consider there could be a wide range for the future profitability and cash generation of Royal Mail.
- 5.58 Based on our analysis, it appears that potential volume uncertainties in the individual customer segments present a lesser risk to Royal Mail's financeability than a failure to modernise sufficiently. However, the scale of both sensitivities is large and both, if not mitigated by the regulatory framework, could pose a significant risk to Royal Mail's finances. The risks to revenues which are largely exogenous are, however, generated from varied sources (by sender or content), with different characteristics and behaviours. While this may change over time it seems that in the short term this diversity reduces Royal Mail's exposure to a sudden, catastrophic decline in volumes. Price increases may also help adjust for falling volumes where elasticity effects only become fully apparent over time.
- 5.59 These risks, and the longer-term decline in the use of mail, indicate that Royal Mail's ability to drive efficiency gains and cost reductions which offset anticipated revenue decline is likely to be essential to the long term sustainability of the universal service. These risks are different to the demand risks, as they are largely within Royal Mail's control. As discussed above we can see that the delivery of such efficiency improvements is highly dependent on the successful resolution of a number of factors, most notably:
- **Efficiency of delivery of the universal service** – In the context of significant volume decline, Royal Mail was not able to achieve the improvement in efficiency of 1.5% per annum which it expected over the period of the 2006 price control, which was itself lower than assumed by Postcomm based on its assessment of what could be achieved at the time. Modernisation has started, but is currently

<sup>38</sup> Source: Ofcom analysis, Frontier Economics

running behind the original timetable outlined in previous plans, due to the effects of industrial action and to Royal Mail's delays in deploying cost-saving initiatives at the desired pace. Despite taking into account the likely lower cost variability than that used within the volume adjustment mechanism under the current price control, our analysis indicates that cost reduction in the last regulatory period has not been able to keep pace with revenue decline

- **The regulatory framework providing sufficient incentives** – This does not appear to have applied over the current period due to a number of factors such as public ownership (which has reduced Royal Mail's flexibility in securing finance) and of re-opening mechanisms.

- 5.60 Royal Mail's future modernisation programme, designed to generate the necessary efficiency gains and support a financeable universal service, is ambitious, but our analysis indicates that the operational programme appears to be achievable and consistent with programmes implemented by other postal operators. There is a clear link between the enabling measures proposed and the level of cost reduction which Royal Mail expects to occur as a result of its proposed approach to resource management following implementation of those measures.
- 5.61 Equally, our analysis highlights that where the central case includes the potential for Royal Mail's shareholder to earn a commercial return on its activities, the actual return will remain highly sensitive to the actual pace of modernisation and the actual rate of volume decline, if Royal Mail is not otherwise able to mitigate the impact. The level of risk is due to the operational gearing of the postal network, where the high level of operating costs means that a small change in operating costs has a very significant effect on Royal Mail's profitability.
- 5.62 This is demonstrated by Figure 12, which shows that delaying Royal Mail's modernisation has a material impact on its profitability and cash flow. Given an indicative operating margin of around 8%, as discussed below, the graph shows that a 1% shortfall in efficiency against the base case has a material impact on Royal Mail's future profitability, potentially reducing profit by up to 50%.

**Figure 12: Impact of modernisation on profitability and cashflow<sup>39</sup>**

[X]

- 5.63 In addition, significant investment is still required and we have identified that there are material market and operational risks to delivering a reasonable commercial return on such investment in the timescale which would typically be required by investors. Our proposal for a new regulatory framework has to ensure that there are sufficient and appropriate incentives for any shareholder of Royal Mail to realise the benefits of the modernisation programme so that Royal Mail can become cash positive, and for those incentives to be robust to normal fluctuations in demand or operating performance.
- 5.64 In summary, our sensitivity analysis indicates:

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<sup>39</sup> Source: Ofcom analysis, Frontier Economics

- Royal Mail's plan represents an appropriate base case, and the likelihood of outperformance and underperformance against the Plan should be broadly comparable;
- There are a wide range of sensitivities for the outcome of many of the inputs to the Plan, including the rate of e-substitution;
- There is a significant level of fixed cost and operational gearing within the network, and a change to the rate of e-substitution or the pace of modernisation could have a very large impact on Royal Mail's profitability; and
- The regulatory framework therefore needs to both provide incentives for the successful delivery of modernisation but also to be robust to the risk that small changes in the assumptions underlying the Plan can have a very large impact on Royal Mail's ability to finance the provision of the universal service.

### **Future price changes**

- 5.65 During August Royal Mail submitted two documents to us that set out potential pricing changes in 2012-13. In providing these documents to Ofcom, Royal Mail was clear that the proposals were at that stage only indicative, had not been subject to its governance process or received any formal internal approval.
- 5.66 Royal Mail will not be in a position to confirm all its pricing proposals for 2012-13 until the completion of the current consultation process. Nonetheless, its indicative proposals suggest that it will consider implementing material increases in prices in 2012-13 if given flexibility under the new regime. The increases are likely to vary by product group.
- 5.67 Under our proposals on pricing it will be for Royal Mail to determine the appropriate levels and balance of any future price changes, subject to the safeguard cap described in Section 6 below. We have concluded that this is likely to be the most effective way of dealing with the current major market uncertainties and that Royal Mail should have the incentive to ensure that price increases do not prejudice the long term viability of the universal service. As we have noted earlier, however, we are also of the view that increases in prices will be required to ensure the short term and ongoing sustainability of universal service.

### **A reasonable commercial rate of return**

- 5.68 Postcomm's April consultation explained the need for the regulator to understand what would represent a reasonable level of return for Royal Mail's provision of the universal service, and how this relates to the risks facing Royal Mail.
- 5.69 As Royal Mail's universal service network is largely based around people, and these operating costs are significantly higher than the value of its tangible assets, Postcomm considered whether the approach in the current price control, which allows an 8% pre-tax real return on Royal Mail's tangible net assets, was still appropriate or whether an alternative such as a return on sales would now be more relevant. Postcomm also explained its view that such operating costs posed a very significant risk to Royal Mail's ongoing profitability and that any private investor would be likely to need to earn a return that adequately compensated for all relevant risks.

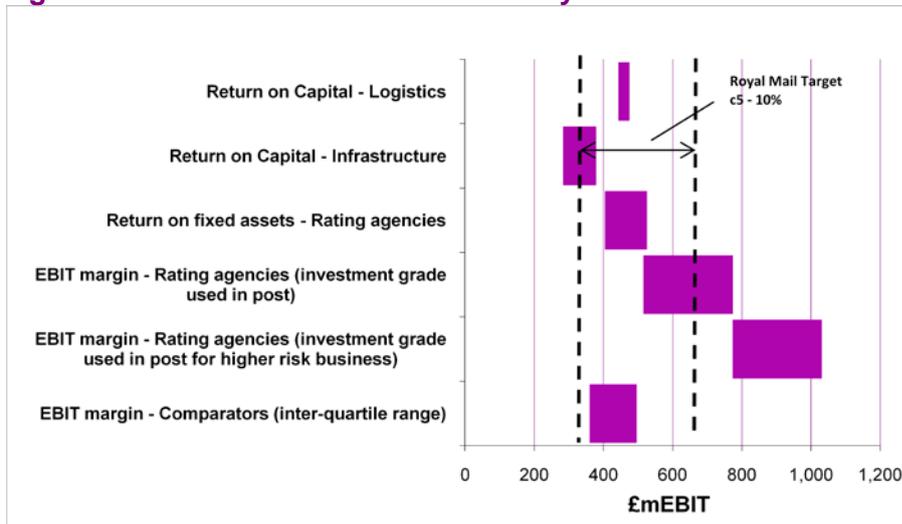
- 5.70 In responding to Postcomm's consultation, Royal Mail argued that a commercial return for the universal service is one where all of the revenues generated from services sold through the whole of the universal service network are sufficient to cover all the costs associated directly, or in connection with, the activities to provide the universal service, plus a reasonable commercial rate of return. It noted that its Plan coupled with its indicative 2012-13 pricing proposal would improve the core universal service network's return of [X] by the end of the plan period to be more in the range of [Y]. This would also be more consistent with Royal Mail's expected return across Royal Mail Group by 2015-16.
- 5.71 The Act requires Ofcom to have regard to the need for a universal service provider to earn a "reasonable commercial rate of return" as set out above. Whilst the Act does not provide further guidance on what is meant by a reasonable commercial rate of return, there is significant regulatory precedent in allowing regulated companies to earn and retain a profit (variously described as the allowed profit or allowed return). In UK regulation, including Postcomm's 2006 price control, this has been measured as a return on their investments in the asset base (the regulatory asset base (RAB)) necessary to deliver the regulated service. Returns above the allowed profit will be achieved by efficient operators, and the benefits will then typically be shared with customers at the time of a subsequent price control.
- 5.72 In order to identify what might constitute a reasonable commercial rate of return we have considered:
- market evidence as to the returns achieved by comparable companies;
  - the risks and uncertainties about both Royal Mail's plans for modernisation and restructuring in the context of a declining market; and
  - the impact of the government's intention to privatise Royal Mail.
- 5.73 As noted above the current price control was based on a RAB and a cost of capital which was assumed in 2006 to be relevant to Royal Mail. Given the outcome of the control was very significant underperformance of around £3bn, which resulted from the labour-intensive nature of Royal Mail's cost structure, and the level of operational gearing, we have considered this approach against other potential measures in assessing what commercial return might be appropriate in respect of financing the provision of the universal service.
- 5.74 We have considered market evidence on approaches linked to returns on capital employed, as well as those linked to an operating margin, i.e. the level of operating profit or cash flow as a proportion of revenue. Such an approach might be more appropriate for a company with very low levels of tangible assets, where the market value of the company's assets is more likely to diverge significantly from their tangible value. With regard to a return on capital approach, we have considered:
- an infrastructure approach comparable to the current regime;
  - an approach linked to market evidence about returns on the market value of assets for logistics companies managing comparable networks to Royal Mail; and
  - evidence from rating agency guidance on returns on assets for financially sustainable comparable companies.

5.75 We have compared the level of return under these approaches to that which could be measured by an approach of using an EBIT operating margin as a measure of financeability. We have used EBIT as a proxy for operating cash generation, since Royal Mail’s plan shows that as the costs of modernisation reduce, the operating cash flow and EBIT become broadly comparable towards the end of the plan. In coming to an estimate of a reasonable rate of return we have considered:

- market evidence from returns earned by comparable companies;
- evidence from rating agency guidance on returns for financially sustainable comparable companies; and
- evidence from rating agency guidance on the potential returns required for comparable companies facing financial challenges similar to those faced by Royal Mail.

5.76 Given the difficulty of using market evidence, which varies between different companies and over time, Cambridge Economic Policy Associates (CEPA) were instructed to consider the market and suggest appropriate ranges necessary to deliver a reasonable commercial rate of return. The evidence from a review of returns of a range of comparator companies, and the views of financial market stakeholders indicates that there is a wide range, of 5% to 10%, EBIT<sup>40</sup> margin which could be consistent with the level of return that we might consider to constitute a reasonable commercial rate of return for these purposes. Figure 13 highlights the range of returns under each of the measures.

**Figure 13: Indicated EBIT constructed by different measures<sup>41</sup>**



5.77 This provides a wide range of potential outcomes, with the different levels reflecting:

- varying types of investors will have different considerations in respect of required returns dependent on their perception of the risks associated with investment in Royal Mail and the most relevant comparators;

<sup>40</sup> Earnings before interest and tax

<sup>41</sup> Source: Ofcom analysis, CEPA Financeability report

- Royal Mail's ability to establish a track record of profitability, which will affect the considerations of rating agencies and investors over time; and
- the extent to which the universal service network remains part of a diversified group, which will affect its ability to raise finance.

5.78 Our analysis indicates that under a return on regulatory capital (RAB) approach, the consequent EBIT margin for Royal Mail would be towards the lower end of the range at around of 5%-6%. Therefore, while being below some of the market indications for comparable companies, this lower range would be more consistent with the return implied/allowed in previous price controls.

5.79 However, based on the market evidence, this level of return does not appear to provide a return from the activities required to provide the universal service which would be likely to result in Royal Mail being able to raise finance from capital markets. The first test for a large company such as Royal Mail would be whether it would be able to achieve investment grade status, in the short or medium term. Companies that do not have a financial profile consistent with investment-grade ratios may be unable to raise finance, particularly during periods where the availability of finance is restricted. This reflects a different scenario to other companies regulated by Ofcom, where the return on regulated assets is more consistent with the returns observable in capital markets.

5.80 In this case, we would tend to point towards the higher end of the range at 8%-10%. In practice, the attainment of an investment grade credit rating would be likely to need both a track record of profitability, and potentially for Royal Mail to remain part of a diversified group, due to the need to diversify efficiently the risks associated with the postal industry.

5.81 Our analysis indicates that the benefits to investors of Royal Mail being part of a wider group are consistent with market perception of the significant levels of risk described above. These risks can be in part managed through diversification, but financial investors will also consider the specific risks faced by Royal Mail given its status and obligations as the universal service provider, and seek evidence that management has been able to address those risks in practice. The use of these margin outcomes within the regulatory framework will also need consider:

- the operational risks faced by Royal Mail, and the extent to which they are asymmetric;
- the need to ensure with a reasonable probability that the provision of the universal service would be financially sustainable, even in a realistic downside scenario; and
- the wider regulatory risks, including whether these are asymmetric.

5.82 While a certain element of judgement is necessary, these risks all point towards Royal Mail being assumed to need to earn a level of return towards the top half of the 5% to 10% range on the activities required for the provision of the universal service, bringing it more in line with its peers and more likely to be consistent with encouraging investment in the network.

5.83 On this basis, we have assumed a base case for an indicative return of 8% margin on these activities when considering our options for the future regulatory framework

in Section 6. We have also used such indicative financeability benchmarks to assess plausible outcomes that indicate the financial sustainability of the universal service.

- 5.84 At present the analysis provided to us both by our advisers and by Royal Mail, indicates that this level of return represents a realistic target for Royal Mail in seeking to achieve financing for the wider borrowing entity (Royal Mail Group Limited) on reasonable commercial terms. The actual level will be impacted by the form of financing, including the form of any privatisation, and the level of diversification within the wider Royal Mail Group, which will be the scope taken into consideration by the current shareholder and any future provider of external finance. We will be able to assess these impacts and their effect on the provision of the universal service being financially sustainable and efficient using the regulatory reporting proposed in Chapter 8 below.
- 5.85 As highlighted by Figure 13 above by comparison with the summary of Royal Mail's historical performance in Section 4, this rate of return on the universal service activities is significantly higher than Royal Mail's current operating margins, and this highlights the need for the regulatory framework to include some flexibility around the level of pricing, together with providing the incentives for Royal Mail to reduce its costs.

## Provisional Conclusions

- 5.86 In conclusion, therefore, having performed further analysis as described above and considered all the responses to consultation, we are considering the following assumptions in coming to our proposals for a regulatory framework:
- The integrated universal service network defines the appropriate boundaries of the business which is central to the provision of the universal service.
  - Royal Mail's ability to execute and deliver on its business plan is of primary importance to the achievement of a financially sustainable universal service, and there remains significant downside risk to the delivery of the plan.
  - A regulatory framework which provides sufficient safeguards against downside risk, coupled with the intrinsic efficiency incentives underpinned in Royal Mail's business plans, is likely to provide the best opportunity to deliver sufficient cost saving pressures.
  - An indicative EBIT margin range of 5% to 10% is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return commensurate with the level of risk within the business.

*Question 5.1. Do you agree with the assumptions set out in paragraph 5.86 above. If not, please set out your reasons.*

## Section 6

# Securing the provision of the universal service and protecting customers

## Introduction

- 6.1 The regulatory framework for post needs to secure the provision of a universal service, in light of the current exceptional circumstances facing the Royal Mail and the postal sector. As discussed in Section 4, Royal Mail is currently in financial difficulties, raising dangers to the future provision of the universal service. This has been the result, at least in part, of major changes in the market, as consumers' preferences have moved away from using post. The regulatory framework must recognise these facts, and must provide the most effective way for the universal service to continue to be provided efficiently and into the long term.
- 6.2 As noted in Section 3, Ofcom can impose regulatory conditions, including in relation to the provision of a universal service, and access. These services combined account for approximately 60% of Royal Mail Letters' revenues: regulation in this area might, therefore, impose significant restrictions on Royal Mail's prices and/or behaviour. Given the potential impact of regulation on Royal Mail, it is important that options are considered alongside the current context of falling market volumes and Royal Mail's financial position. As set out in Section 4, the universal service is currently not financially sustainable. Volumes were 25% lower in 2010-11 compared to the start of the current price control in 2006-07. Due to its high fixed cost base and slower than planned progress on its modernisation plan, Royal Mail has been unable to reduce its costs to keep pace with these volume declines and as such unit costs have increased significantly.
- 6.3 Therefore as discussed in Section 5 it is likely that there will need to be price increases to ensure the universal service is financially sustainable regardless of the regulatory framework that is put in place. However, price increases are only part of the answer. To ensure the long term sustainability of the universal service, Royal Mail must also make significant cost reductions and efficiency improvements.
- 6.4 Alongside this it is important to ensure that universal service customers are protected and that individual universal services remain affordable for all users. We have therefore also considered the potential impact of our proposals on customers and competitors in this context.

## Securing the provision of the universal service

- 6.5 The Act gives us a primary duty to carry out our functions in relation to post in a way that we consider will secure the provision of a universal postal service, and an amendment to the Communications Act clarifies that in the case of a conflict between that duty and any of our Communications Act duties, where we are regulating post, the duty to secure a universal postal service takes precedence.
- 6.6 Section 5 above discussed the requirement that our regulatory framework needs to take account of the finances of Royal Mail. The Act states that in performing this duty Ofcom must have regard to:

- the need for the provision of a universal postal service to be financially sustainable (including the need for a reasonable commercial rate of return for any universal service provider on investment related to the universal postal service); and
  - the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 6.7 The Act also sets out, in Section 31, the minimum that a universal postal service must include – for example the delivery and collection of letters six days a week (and other postal packets five days a week), and a service of conveying postal packets at affordable, uniform prices throughout the UK. These minimum requirements, which form the baseline for what must be provided (and so, in one sense, the baseline for minimum regulation), can only be changed by the Secretary of State, with the approval of Parliament.<sup>42</sup>
- 6.8 The Act requires Ofcom to make a universal service postal order setting out a description of the services that they consider should be provided in the UK as a universal postal service and the standards with which those services must comply. The Act gives Ofcom the power to impose designated universal service provider (DUSP) conditions on a universal service provider to require it to provide a universal postal service in accordance with the standards set out in the universal service postal order.
- 6.9 As set out in Section 2, we have provisionally designated Royal Mail as the universal service provider. Royal Mail is currently in practice the only postal operator capable of fulfilling this role. The Act permits Ofcom to designate more than one operator as a universal service operator, but this power is restricted to two cases: (a) where Ofcom has made a procurement determination under section 45 of the Act, and (b) where a postal administration order has been made under Part 4 of the Act (in other words, effectively, where Royal Mail has become insolvent). Further, the Act restricts case (a) above by preventing Ofcom from making a procurement determination (i.e. to tender part of the universal postal service) for a period of 10 years. So Royal Mail will remain the universal service provider for at least the next 10 years.

### **Ensuring the provision of the minimum requirements**

- 6.10 The Act provides that it is for Ofcom to determine how best to ensure that the universal services set out in the universal postal service order are secured.
- 6.11 Ofcom could choose to impose a regulatory obligation on Royal Mail to provide universal services to the standards specified in the order, or we could decide to impose no regulatory obligation to do so, and instead rely on Royal Mail to provide the universal service without being obliged to do so.
- 6.12 In the absence of a DUSP condition, there would be no obligation on Royal Mail to provide the universal service to the standards required. In effect it would be left to Royal Mail to determine how the universal postal service order should be implemented. We note that Ofcom would be able to monitor the provision of the universal service and intervene, if necessary, by imposing a condition if Royal Mail

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<sup>42</sup> Save that the pricing uniformity requirements can only be changed by primary legislation.

failed to deliver the universal service as described in the order. This approach would give Royal Mail the maximum level of freedom in the delivery of the universal service. However, there would be no guarantee that the universal service would be provided. While Ofcom would be able to impose a DUSP condition at any time (after investigation and consultation), any remedy would take effect after there was a failure to provide the universal service and there may be harm caused to consumers or the market in the intervening period.

- 6.13 In our view, the advantage of imposing a DUSP condition on Royal Mail is that this would clearly set out its obligations in the provision of the universal service and provide a framework for Ofcom to ensure the universal service is provided to the specification set out in the order. In addition, the DUSP condition could more specifically describe the services to be provided.
- 6.14 On balance, given our primary duty to secure the provision of the universal service, we consider that a regulatory condition should be imposed on Royal Mail to provide the universal service as set out in the order. We will consult on the proposed text of both the order and the DUSP condition in the regulatory conditions consultation later in the year.

*Question 6.1: Do you agree with our proposal to impose a regulatory condition on Royal Mail to require it to provide the universal service as set out above? If not, what alternative approach would you suggest?*

## Postcomm's April consultation

### Postcomm's analytical framework

- 6.15 As part of its review of the regulatory framework post 2012, Postcomm considered that a fundamental review of the regulatory safeguards that apply to Royal Mail was required. It noted that this included whether it remained appropriate to retain a price control given the current market conditions and Royal Mail's finances and, if so, what the dimensions of this control should be.
- 6.16 In its April 2011 consultation, Postcomm set out a policy framework comprising four principles to assess the available options for regulatory safeguards. The four principles proposed at that time were aligned with Postcomm's statutory duties and also with the expected legal framework as set out in the Postal Services Bill.
- 6.17 These principles were:
- **Principle 1: Supporting the sustainability of the universal service** – This has two key components:
    - in the short- to medium-term, providing Royal Mail with the opportunity to recover the costs of providing the universal service and make a reasonable return; and
    - in the longer-term, providing the appropriate incentives so that Royal Mail achieves substantial and sustained improvements in efficiency.
  - **Principle 2: Effective protection for customers and users** – This includes protecting users of postal services from unreasonably high prices or low quality of service in relation to universal service and access products.

- **Principle 3: Enabling efficient entry and competition** – This includes the importance of considering how the regulatory framework can enable efficient entry and competition where this provides benefits to users and will not compromise the efficient provision of the universal service.
- **Principle 4: Ensuring that the regulatory framework minimises the risk of regulatory failure**– In particular, interventions should be the minimum necessary; proportionate and targeted in addressing the issues identified; transparent and as simple as possible; and practicable to implement and to ensure compliance with.

6.18 Postcomm set out five options for the regulation of universal service and access products:

- a) No ex ante price control regulation
- b) An ex ante price control on one universal service product only (for example Second Class stamps)
- c) Ex ante price control on universal service products only
- d) Ex ante price control on universal service products and a separate control on access products (two baskets)
- e) Single ex ante price control on universal service and access products (one basket)

6.19 Postcomm also set out its initial assessment of these options against its analytical framework. However, it did not propose one option over another for the initial proposals consultation and committed to gathering further evidence to inform the appropriate option for the new regulatory framework.

### Responses to Postcomm's consultation

6.20 Aside from Royal Mail, all respondents considered that ex ante price controls should remain in some form. Customers, Consumer Focus, trade bodies and the CWU considered that as Royal Mail would continue to have market power a price control should be retained in order to incentivise efficiency improvements, prevent anti-competitive behaviour (such as cross-subsidisation into more competitive markets), and to protect captive customers from excessive pricing strategies and/or reductions in quality of service. Where they expressed an opinion, the respondents who supported ex ante price controls did not consider that a price control on a single universal service would provide sufficient protection for users of other universal service products as it was not a sufficiently close substitute.

6.21 However, whilst supporting some ex ante controls, a number of other operators considered that Royal Mail should be given more pricing freedom to ensure it could recover its costs. The CWU also considered that Royal Mail should be allowed to recover its costs and that price controls for access products should be removed.

6.22 Many respondents commented on the importance of accounting separation and cost transparency under any of the options set out in the April 2011 consultation. One end-to-end operator considered that the regulator should be cautious about further deregulation until cost transparency and accounting separation had been implemented and disclosed to the market.

- 6.23 Royal Mail advocated an ex post approach to postal regulation, by which they mean that all ex ante regulation on Royal Mail's "prices, products and conduct" should be removed and the only legal constraints on Royal Mail's behaviour should be those imposed by competition law. Royal Mail argued that it should not be treated in the same way as other regulated companies as the declining volumes and considerable uncertainty over future levels of demand in the postal market differentiate it from these industries. In particular, Royal Mail argued that there was no need for price control regulation because its behaviour would be constrained by:
- competition from non-postal alternatives, e.g. e-substitution;
  - uncertainty regarding the location of "tipping points", i.e. where a pricing change will lead to customers moving permanently and substantially away from mail, not in line with past or existing elasticities;
  - the threat of end-to-end competition; and
  - the threat of regulation, either under the Postal Services Act 2011 or the Competition Act 1998.
- 6.24 Additionally, Royal Mail considered that the removal of regulation would be good in its own right, as well as to ensure the financial sustainability of the universal service in the longer term, because it would:
- give Royal Mail more freedom to make commercial decisions on its pricing and product mix;
  - still provide incentives to Royal Mail to become efficient as it cannot rely on price increases alone to ensure the long term sustainability of the universal service;
  - increase innovation and the meeting of customers' needs as a result of removing "regulatory bureaucracy";
  - allow Royal Mail to charge "fair" prices for access services;
  - reduce the direct costs of regulation, e.g. compliance and auditing; and
  - lead to a better working environment.

### **The viability of a price control in the current context**

- 6.25 We consider that the more conventional approach to regulation adopted in the past has failed in the recent circumstances affecting the postal sector. To date, the approach adopted has, like that used in most other utility sectors, been based on price controls. This approach, in usual circumstances, is an effective means of preventing private operators from earning excessive profits, and in so doing provides incentives for firms to reduce costs while protecting consumers from excessive prices. It is an approach that is widely used by regulators, including Ofcom, to regulate private operators with significant market power.
- 6.26 The recent experience of postal regulation has, however, in our view demonstrated all the weaknesses of price controls, with none of the benefits. In a highly uncertain market, price controls have removed flexibility from Royal Mail to adjust to changes in demand, while at the same time Royal Mail has been unable to improve efficiency;

not just at the rate expected by the regulator at the time when the price control was set, but also not at the rate set by its own internal targets at the time.

- 6.27 Given Royal Mail's likely enduring market power for universal service and access products and the prevailing level of efficiency, the standard regulatory approach would be to impose some form of price control. In principle a price control would:
- provide incentives for Royal Mail to move towards the efficient level of costs;
  - protect customers from excessively high prices, and therefore, ensure universal service prices remain affordable; and
  - provide a level of confidence to customers (and competitors) over the future path of prices.

### **Royal Mail is not currently making excessive profits**

- 6.28 Typically a regulator would impose a price control on a company that was making or had the ability and incentive to make excessive profits to the detriment of consumers.
- 6.29 Since the last price control was set in 2006, Royal Mail's financial position has been consistently weak and there are signs that this is continuing. Royal Mail Letters, the business which has held the universal service network for much of the last decade, has accumulated unpredicted and sustained losses over the last decade. The overall profitability of the Royal Mail Letters business, and therefore its ability to finance the universal service, has fallen sharply and proven changeable over the past 10 years. We have estimated that there has been a cumulative cash under performance of over £3bn from 2006-07 to 2010-11, relative to the cash flow projected at the time the price control was set in 2006.
- 6.30 Whilst, as outlined in previous Sections, Royal Mail is undertaking a modernisation programme which will reduce its costs in delivering the universal service, there are limits to the pace of change that is achievable. Given Royal Mail's current financial position and the fact that some prices are presently below cost, it is likely that in the short term significant price increases would be required under a price control if Royal Mail is to be able to cover its costs (including a reasonable rate of return).
- 6.31 Constraining Royal Mail's pricing may appear positive for customer groups in the short term. However, it would potentially pose a risk to Royal Mail's ability to recover its costs and therefore increase the risk that the universal service is not sustainable. A more plausible counterfactual to allowing Royal Mail greater pricing freedom is therefore not lower priced postal services, but rather the deterioration in quality of service and Royal Mail's failure to meet its universal service obligations.
- 6.32 In 6.64 below we discuss the potential for Royal Mail to make excessive profits in the future and how we propose to address that risk.

### **Royal Mail needs to be able to react to a changing market**

- 6.33 As we have seen in sections 4 and 5, many of the challenges currently facing Royal Mail can be explained by the rapid changes in the market and the difficulties Royal Mail has had in reacting to them. For example, the rapid volume decline since 2005-06, the change in product mix and the unforeseen speed of growth in access

competition. Additionally, there has been a link between the strength of the economy and volumes of mail. The economic climate over the past few years will have further depressed mail volumes as the amount of business activity, and therefore transactional mail, has been less.

- 6.34 Price controls inevitably constrain the pricing freedom of the regulated entity. Therefore, a price control would reduce Royal Mail's freedom to adapt to unexpected changes in the market and its operating environment. In volatile market conditions, the company may need to make or unmake decisions quickly, experiment with different approaches, run trials of new services or methods. The constraints intrinsic in a price control would restrict Royal Mail's freedom to do so.
- 6.35 It is possible to attempt to anticipate changes in the market and to take these into account in setting the price control, as well as to design price controls so as to allow for potential changes, e.g. adjustment mechanisms, re-openers. Indeed Postcomm attempted to do both these things in setting the 2006 price control. However, there are two problems with such approaches. First, adjusters are unlikely to be able to predict or to resolve all potential circumstances. Indeed the more sophisticated we attempt to make a price control the more potential there is for unintended consequences. Second, adjusters and re-openers are also likely to reduce the incentive properties of any price control.

### **The current price control has not prevented significant price increases**

- 6.36 Typically one of the key objectives of a price control is to prevent significant price increases. However, if in the near term, Royal Mail found itself unable to become profitable under the terms of a price control, it would have to return to the regulator to request further price rises, as it has done in the past. Whilst we would press Royal Mail to increase efficiency rather than raise prices, we would also need to recognise our primary duty to carry out our functions in a way that we consider will secure the provision of a universal postal service, having regard to its financial sustainability. This duty could therefore mean that customers may not have any more certainty over the future path of prices or be afforded sufficient protection from high prices related to Royal Mail's inefficiency.
- 6.37 Indeed since the first price control in 2003, stamp prices have risen substantially. The price of a First Class stamp for a standard letter, for example, has risen from 26p in 2003 to 46p from April 2011 which equates to a nominal increase of over 75% (and a real increase of 40%). Second Class stamps have increased from 20p to 36p (80%) over the same period.
- 6.38 Since 2006, the majority of Royal Mail's products have been subject to a price control. The price control was set such that average prices would fall by 1% per annum in real terms, but subject to a number of adjustment mechanisms. In practice, largely due to the volume adjuster which has allowed Royal Mail some price rises to offset the impact of volume decline, prices have risen on average in real terms, and stamp prices have risen faster than bulk mail prices. In addition, in November 2010, Royal Mail applied for significant price rises for large customers to earn an additional £100m revenue in 2011-12.

### **In the current context a price control is unlikely to provide significant efficiency incentives**

- 6.39 One of the most important benefits of a price control is the strong theoretical incentive it places on the regulated company to reduce its costs towards the efficient level (in the absence of a competitive market). However, a price control achieves this by restricting the regulated company's revenues so that the only way it can increase profits is by cutting costs. Royal Mail is currently loss making on its universal service business. It is also in the public sector, which significantly weakens the profit incentive and therefore the efficiency incentives.
- 6.40 Additionally as set out in Section 4, while Royal Mail has taken significant cost cutting steps, it has not so far been able to deliver sufficient efficiencies to remain financially sustainable in the face of rapid and unexpected volume losses (as the combined result of competition and market decline) or regulatory intervention. There is in our view little reason to believe that the efficiency properties of an RPI-X price control will be sufficiently effective while Royal Mail remains in the public sector and given current market circumstances.
- 6.41 These factors combined make setting an efficiency factor for a price control that will meet all the objectives set out above extremely difficult given the current market conditions and Royal Mail's finances.

### **The risk of regulatory error is great**

- 6.42 There is always a risk of regulatory error in setting price controls. In particular, the regulator needs to make a series of assumptions about, for example, the trajectory of volumes, costs and prices. These assumptions are then applied to the structure of the price control with the aim of achieving the regulatory objectives. For example, if we decided to impose a price control, Ofcom would have to determine the timeframe over which Royal Mail could recover its costs and a reasonable return through price increases. In addition, the structure of the control (through the number of baskets and limits on rebalancing) could limit to an extent the price rises in the short to medium term for specific customer groups.
- 6.43 However, as set out below, we believe that in the current context the likelihood and consequences of regulatory error are great.

#### Likelihood of error

- 6.44 As we have seen above there is significant uncertainty about the future of the postal sector. While there has clearly been a structural decline in mail volumes worldwide, and particularly in the UK, it is difficult to separate this from the cyclical decline linked to the current economic climate and its effect on business transactions and therefore mail volumes. Furthermore, there is great uncertainty about the speed and comprehensiveness of e-substitution, i.e. the replacement of physical mail by electronic communications.
- 6.45 While it is logical to assume that changes in prices for postal services will have some effect on volumes, it is currently impossible to predict with any certainty what this effect will be. The elasticity assumptions previously used by Royal Mail and Postcomm are historic in nature and based on evidence from periods of relative price stability. It is unclear to us that these assumptions are reliable in the current context.

- 6.46 It is possible that significant increases in postal prices may lead transactional customers to further invest in electronic platforms (or accelerate this investment) and/or encourage switching by providing financial incentives to their customers, for example by charging for paper bills or statements. Against that, many companies have already invested in the technology required for electronic communication and we consider that price is not the only driver for electronic substitution (given the significant price differential that exists between physical mail and electronic alternatives).
- 6.47 To date consumer preferences have represented the greatest barrier to substitution of transactional mail to electronic alternatives and that this remains an important constraint. Equally, we recognise that receiving customers' preferences are changing and this is likely to continue over the next four to five years, which will have an impact on mail volumes generally. In addition, for some types of transactional mail where the customer pays the provider directly for services (such as utility bills), the senders of mail are likely to be able to influence the switching rate, at least to an extent.
- 6.48 Given these circumstances, the likelihood of substantial regulatory error is significant.

### Consequences of error

- 6.49 As set out in Section 5 Royal Mail's letters business has costs of approximately £6bn, and its current and expected level of profitability is small by comparison to the sensitivities around its cost and revenue forecasts. It has very little buffer to protect it from unforeseen circumstances or even small variations from its forecasts.
- 6.50 Royal Mail's universal service and access products make up about 60% of Royal Mail's total letter revenues, and their prices indirectly constrain the prices of many of Royal Mail's other services. If we were price controlling this set of products any error would have a very significant effect on Royal Mail's overall financial viability.
- 6.51 In setting a price control, we have to expect that the risk placed on Royal Mail would be consistent with that faced by a commercial operator, and with the level of return assumed in setting the assumptions within the price control. However, the exposure that Royal Mail would have to volume and cost differentials would be very significant, and based on our modelling assumption for a reasonable return the range of potential outcomes for its finances could be very wide.
- 6.52 For Royal Mail, the implication of underperformance against a long-term control, whether due to factors within Royal Mail's control such as the pace of modernisation or factors outside its control such as changes to underlying demand or the mix of mail, could be that the provision of the universal service is threatened.
- 6.53 The alternative would be to have a short-term control, or a rate of return control. In such a control, the risk of Royal Mail being unable to perform its universal service obligations is reduced, and customers are protected from excessive prices by a price control. Such a control is used in some countries where the focus is on encouraging efficient investment in networks and providing a framework which supports the financing of such investment.
- 6.54 However the efficiency incentives of such a control are weak. In this case, Royal Mail would be aware that it would not see the benefit of improving efficiency through increased profits, as the benefits of efficiency would then be passed to customers through lower prices. If achieved, such lower prices would support the use of mail

and therefore the sustainability of the universal service. However the weaker incentives on Royal Mail would be more likely to result in no improvements in efficiency.

- 6.55 Therefore, the consequences of regulatory error in relation to price controlling Royal Mail appear very significant.

### Initial conclusions

- 6.56 In summary, the likelihood and consequences of regulatory error are in our view too great to place confidence in an effective price control.
- 6.57 Royal Mail should be in a better position than the regulator to determine the quantum and structure of price increases required to return it to a sustainable financial position (although there is no guarantee absent a price control that its price increases would stop at this level). Royal Mail should also have the incentive to do this in a manner which is consistent with the ongoing and long-term health of the postal sector which, in turn, should help maintain the viability of the universal service.
- 6.58 This points us to the option of allowing Royal Mail pricing freedom given the current circumstances.

### **Summary**

- 6.59 Overall, therefore, although there are some aspects of a traditional price control-based approach which might appear to be capable of meeting some of our statutory objectives, the present and particular circumstances here suggest to us that there are considerable risks that such an approach could impede the process of addressing the structural problems underlying the business.
- 6.60 Given Royal Mail's financial situation, the structural changes in the postal sector and the Government's plans to privatise Royal Mail, the imposition of a price control would appear – at this time and in this specific context – unlikely to secure the fulfilment of our duties under the Act. Indeed some of what would usually be regarded as benefits of a price control could become significant risks in these particular circumstances.
- 6.61 We therefore consider that a traditional price control is not an appropriate option for the near term, and we do not therefore propose to impose one.

*Question 6.2. Do you agree that a price control is not an appropriate option at present for regulating Royal Mail's prices? If not, please explain why and how a price control could be implemented effectively.*

## **Safeguards are necessary in the absence of a traditional price control**

- 6.62 Notwithstanding our provisional conclusions above, the risks that led us to consider a price control remain. In particular, we remain concerned that:
- Royal Mail will have the incentive and ability to increase prices instead of taking on the efficiency challenge, and could do so in such a way that results in a longer term detriment to the universal service;

- Vulnerable consumers in particular are likely to be adversely affected by price increases; and
- Royal Mail will have the incentive and ability to make competition more difficult.

6.63 Royal Mail has argued that all ex ante regulation is unnecessary as its behaviour is constrained by:

- competition from non-postal alternatives, e.g. e-substitution;
- uncertainty regarding the location of “tipping points”, i.e. where a pricing change will lead to customers moving permanently and substantially away from mail, not in line with past or existing elasticities;
- the threat of end-to-end competition; and
- the threat of regulation, either under the Postal Services Act 2011 or the Competition Act 1998.

### **Royal Mail may just increase price and not make efficiency savings**

6.64 It seems likely, however, that some of these constraints will be more binding on Royal Mail, in the near term at least, than others. In particular, we remain concerned that Royal Mail may increase prices to generate positive cash flow rather than address the efficiency challenge whether under its current public or potential private management structure.

6.65 At first sight Royal Mail's current plans suggest that competition from non-postal alternatives is not acting as a strong constraint. Royal Mail recently increased prices in 2011-12 by 12% on average and by 15%-20% for the majority of large customers. However, the variation of price increases within its price rises suggested some constraint as Royal Mail applied relatively smaller price increases to services more at risk from e-substitution (e.g. direct mail).

6.66 Therefore, while it would be wrong to rule out wider competitive constraints on Royal Mail's pricing entirely, to rely on them as a safeguard against excessive pricing at such a time of uncertainty in the market would also appear to be risky. However, it is in our view possible that e-substitution will become a significantly greater constraint in the medium term.

6.67 As noted above, there is also a concern that price increases greater than 10% which Royal Mail has put into the market this year will reduce confidence in the market, further accelerating switching away from mail. Customers may reasonably expect further large price rises in the short term and have little confidence in the future path of prices.

6.68 However taken together, although we cannot rule out that Royal Mail's price increases may have an impact on the pace of electronic substitution bringing forward substitution that would have happened anyway, we consider it unlikely that such changes will threaten the financial sustainability of the universal service, particularly if supported by Royal Mail using a less regulated environment to engage actively with its customers and to seek to increase their confidence in its future path of prices. We do not agree with Royal Mail's argument that certain price changes and customer responses will lead to 'tipping points' where there is a step reduction in the level of

demand. Royal Mail's customers are highly diversified, both in number and in their uses of mail, and it seems unlikely that any one customer or group of customers can affect the kind of short-term impact suggested.

- 6.69 There is also a risk that an approach without any ex ante price regulation would create uncertainty for customers over the future path of Royal Mail's prices. This may encourage customers to accelerate any planned electronic substitution or incentivise receiving customers to switch to electronic alternatives. This risk may be increased if Royal Mail were to implement further price increases in addition to its price rises in 2011-12. Customers might realistically expect Royal Mail to continue to increase prices each year until this strategy is no longer profitable.
- 6.70 Royal Mail has also argued that the potential threat of end-to-end competition will constrain its behaviour. End-to-end competition has the potential to provide a constraint on pricing for some services, particularly access and retail bulk services. We currently consider it is unlikely that end-to-end competition will develop for universal service products. The pace of development of end-to-end competition indicates that such competition alone may be insufficient to constrain Royal Mail's prices over the next regulatory period, and limitations on its scope mean that it is unlikely to provide a constraint for Royal Mail's smaller customers.
- 6.71 Finally, Royal Mail has argued that the potential for Ofcom to regulate will constrain its behaviour. For such a threat to be credible, and not to remove all regulatory certainty, some non-price regulation will be required. We propose below a form of regulatory reporting and a monitoring regime which can ensure that regulation is a credible threat if Royal Mail's behaviour were to conflict with our primary duty to the provision of the universal service. In an environment in which the only legal constraints on Royal Mail were imposed by competition law (as proposed by Royal Mail), any response may not be capable of effectively addressing concerns as they arise.
- 6.72 We consider that individually the factors set out above would not be sufficient to constrain Royal Mail's behaviour. We have also considered whether the combination of these factors would be an effective constraint. In our view, due to the level of uncertainty over the impact of price increases (particularly large price increases) on future demand and whether end-to-end competition is a realistic proposition in the medium term, it is not clear Royal Mail would have sufficient constraint on its pricing for its retail bulk and access products. We also consider that there is unlikely to be sufficient constraint in relation to universal service products in the near term.
- 6.73 In addition, it is important to note that while these factors may provide some constraint to Royal Mail's retail and wholesale bulk mail prices, they are unlikely to provide a constraint in relation to universal service products. Competitors are unlikely to target consumer or small business customers. There is significant switching to electronic alternatives within these customer segments, with some applications such as the use of mail for social correspondence and postcards declining much faster than business mail. This is likely to be as a result of changing customer preferences through a technological shift, and less driven by Royal Mail's prices.

### **The impact on consumers and competition**

- 6.74 We also need to consider the impact on consumers – and particularly vulnerable consumers – of price rises, particularly given the lack of certainty regarding what might happen to prices subsequently. We need to ensure we have sufficient

information to allow us to determine whether the regulatory framework is working effectively to secure our statutory duties.

- 6.75 There is also a risk that, in the absence of regulation, Royal Mail could foreclose the market to efficient access competition by refusing to supply access on fair and/or equivalent terms, engaging in price squeeze, cross-subsidisation and/or predation. As set out in section 7, this could also have an impact on the likelihood of end-to-end entry as any entrant would not be able to use access volumes to provide a full end-to-end service to its customers. This would be likely to result in less choice for customers and, given the uncertainties as to whether non-postal alternatives do provide a sufficient constraint, in unreasonable price increases and/or degradations in quality. While the threat of competition law investigation and the significant penalties that could be imposed if Royal Mail was found in breach may constrain its behaviour, we do not consider, on the evidence before us, that this constraint is likely to be sufficient to address the risks we have identified above.

### **We consider regulatory safeguards are an essential counterbalance if Royal Mail is to have pricing freedom**

- 6.76 These risks identified above are in our view significant and imply that commercial freedom cannot be provided without sufficiently strong safeguards. With the right safeguards in place, however, we believe the risks are manageable – and taken together present a package that is the most suitable for the current circumstances.

- 6.77 We therefore propose to grant Royal Mail commercial freedom for a period sufficiently long to provide regulatory certainty and incentives for efficiency improvements, subject to major regulatory safeguards in the following areas:

- Monitoring and potential for re-regulation;
- Ensuring that a basic universal service is available to all; and
- Competition and innovation.

- 6.78 Later in this section we also consider for how long this regime should apply and the factors which might lead to an earlier intervention or review.

*Question 6.3: Do you agree with Ofcom's proposals to put in place regulatory safeguards as described above? If not, please provide reasons.*

### **Safeguard 1: The potential for re-regulation supported by monitoring**

- 6.79 As set out above, at this point in time, taking into account the market conditions, the degree of uncertainty about future market trends and Royal Mail's financial position, we are proposing to give Royal Mail pricing freedom, i.e. not to impose a price control across all or most of Royal Mail's universal service or access products. However, we have duties under the Act and the Communications Act, in particular:

- To carry out our functions in a manner that we consider will secure the provision of a universal postal service, and in doing so to have regard to the need for the provision of a universal postal service to be:

- Financially sustainable (including the need for a reasonable commercial rate of return); and
  - Efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 6.80 We also have duties under Section 3 of the Communications Act 2003, including to further the interests of consumers in relevant markets, where appropriate by competition. We are also required to take into account the desirability of promoting competition in relevant markets; the desirability of encouraging investment and innovation in relevant markets; the needs of persons with disabilities, of the elderly and of those on low incomes; the different interests of persons in the different parts of the UK, of the different ethnic communities in the UK and of persons living in rural and in urban areas.
- 6.81 We are proposing to allow Royal Mail pricing freedom because of the specific financial and market context, and with the view that this will be the most effective way of securing the provision of the universal service, including the requirement that it become both financially sustainable and efficient over a reasonable period of time. In order to assess whether the approach we have taken is working, we need to have sufficient information and confidence in this information to enable us to identify quickly any issues, investigate and propose any further regulatory action that may be required.
- 6.82 Therefore, we are proposing to monitor particular measures and information to determine the impact of the change in regulatory framework and to allow us to assess whether there is a need to intervene to protect the universal service, customers or competitors. This should enable us to intervene if there were significant deviations relative to the expected outcomes that would potentially threaten the long term sustainability of the universal service. Relevant factors that might indicate that regulation was failing to meet one of our key obligations under the Act, which might suggest the need for intervention, include if Royal Mail's profitability was significantly in excess of relevant comparators and little or no progress had been made in improving efficiency levels.

### **What should we monitor?**

- 6.83 Regardless of whether a monitoring regime involves ongoing measurement or periodic reviews, it will be important to set out the specific areas for review and ensure that the required information is collected for these measures.
- 6.84 The information we require for effective monitoring falls broadly into four areas: financial performance; operational performance; consumer harm; and competition.

### **Financial performance**

- 6.85 We propose that it will be necessary to monitor operating margins, both at an absolute level and between products and/or markets (i.e. competitive and non-competitive, in relation to cross-subsidisation). Using the regulatory reporting outlined in Section 8, we can measure profit and cash flow as a margin on sales and/or an appropriate measure of return on capital. This will allow us to assess Royal Mail's performance, and in particular any consumer protection concerns that may arise. This measure is likely to be most effective with an implicit measure, such as a comparison of margins against those earned by companies in comparable

competitive industries, to allow Royal Mail's performance to be assessed in the context of its progress in delivering efficiency.

### Operational performance:

- 6.86 We propose that it will be necessary for Ofcom to monitor and for Royal Mail to report transparently on:
- Royal Mail's performance against its own efficiency targets, e.g. its modernisation/restructuring plan and/or internal targets; and
  - Quality of service targets, to prevent Royal Mail from reducing costs through quality degradation.

### Customers/Consumers

- 6.87 As we have discussed earlier in this document we consider that Royal Mail will have the ability to significantly increase prices to customers and consumers. Therefore, we propose that monitoring the prices for all universal services will be necessary.
- 6.88 Overall price and revenue increases would need to be considered in conjunction with the monitoring of profit margins and efficiency, to provide a complete view of Royal Mail's performance in order to determine whether regulatory review is required.

### Competition

- 6.89 We propose that it will be necessary to monitor:
- Access prices and changes to access prices;
  - Transfer charging; and
  - Cost allocation.
- 6.90 Therefore, we are proposing that Royal Mail should be obliged to provide cost transparency and accounting separation data, as this will allow timely investigation and/or review if concerns are identified, and will allow key measures to be monitored. We set out our detailed proposals on accounting separation and cost transparency later in this document in Section 8.

### **Proposed monitoring regime**

- 6.91 In summary, we propose that the future regime should include monitoring against both short-term behaviour from Royal Mail which we assess to pose risks to the delivery of an affordable and high quality universal service in the short- or medium-term. We also propose monitoring that Royal Mail is responding to the incentives within the regulatory framework to move towards the efficient provision of the universal service. This will include monitoring of:
- Quality of Service performance, and reasons for variance against targets;
  - Royal Mail's profitability, across the universal service network and in specific markets;

- Royal Mail's modernisation, and its performance in making the provision of the universal service efficient;
- The affordability of universal service prices; and
- Cost-orientation of universal service and access products, including the impact of price changes on universal service customers.

6.92 Our intention is that the combination of these factors should result in a robust regulatory framework which will provide incentives on Royal Mail to support the efficient provision of the universal service. We also expect that the monitoring framework can support the postal market, through providing relevant information to the market about Royal Mail's performance and the impact of the regulatory framework on customers.

6.93 We intend to issue a final decision on our proposals in February 2012. If we conclude that the proposed measures in respect of monitoring are appropriate, then alongside that decision we propose to take forward further work on how the monitoring regime can be implemented to best meet our duties. We expect that this would require further work on the affordability of postal services and how this can be monitored over time, and also the role of cost-orientation in monitoring Royal Mail's prices. We will seek to engage with industry participants on how these factors and Royal Mail's financial and operational performance should be monitored, and what level of public disclosure is appropriate.

*Question 6.4: Do you agree with Ofcom's proposals to put in place a monitoring regime? If not, please provide reasons.*

## **Safeguard 2: Ensuring that a basic universal service product is available to all**

6.94 It is likely that material price increases will be required in some areas to ensure Royal Mail can cover its costs and earn a reasonable commercial rate of return. It is also likely that Royal Mail will use any pricing freedom to increase prices more in areas where customers are less price-sensitive and have lower price increases in more price sensitive areas.

6.95 In February 2011, Postcomm published a discussion paper on affordability.<sup>43</sup> In this they used the Living Costs and Foods survey<sup>44</sup>, which found that postal services comprise 40 pence of the £455 average weekly household expenditure. On the basis that direct postal services make up around 0.1% of average household expenditure and no more than 0.25% of expenditure for low income households, Postcomm concluded that universal services remain well within household budgets. While the issue of affordability is more complicated for small businesses, it is our working hypothesis that if prices are affordable for consumers they will also be affordable for small businesses.

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<sup>43</sup> Postcomm, The building blocks for a sustainable postal service, Universal Service – Discussion paper on affordability, February 2011.

<sup>44</sup> ONS, 2010, Family Spending: A Report on the 2009 Living Costs and Food Survey (online), [http://www.statistics.gov.uk/downloads/theme\\_social/family-spending-2009/familyspending2010.pdf](http://www.statistics.gov.uk/downloads/theme_social/family-spending-2009/familyspending2010.pdf).

6.96 However, although prices for residential customers are likely to remain affordable in the short to medium term as a proportion of household expenditure, we still have concerns over whether there is sufficient protection for vulnerable customers, particularly given that pressures on such customers can vary over time and also within years.

### **Vulnerable consumers**

6.97 We consider that vulnerable consumers are those customers identified in Section 3 of the Communications Act, including customers with disabilities, the elderly and those on low incomes; the different interests of persons in the different parts of the UK and of the different ethnic communities in the UK.

6.98 Research undertaken jointly by Postcomm and Consumer Focus has shown that most residential customers use First Class when sending letters.<sup>45</sup> However, only 20% of these customers considered their mail needed to be received the next day. Over half of the mail sent by residential customers is estimated to be greeting cards (e.g. birthday and Christmas cards).

6.99 In addition, while all demographics of residential customers use First Class more than Second Class, the profile of residential customers who send Second Class items is weighted more heavily to those living in rural areas, retired, with a disability, with lower household incomes and without access to the internet. The evidence suggests that vulnerable consumers are more likely than other classes of consumer to use Second Class when sending letters. We therefore consider that vulnerable consumers are likely to need some protection from significant price increases, which as set out above, Royal Mail would be able to introduce if, as proposed, we give it pricing freedom.

### **Options for ensuring a basic affordable universal service product**

6.100 We could provide a level of protection for vulnerable customers by imposing a safeguard cap on one or more classes of stamps. This would not fix the exact price and Royal Mail would retain some flexibility, but within given boundaries. We would not expect this to significantly constrain Royal Mail's pricing freedom for other products.

6.101 The objectives of a safeguard cap would be:

- Ensuring a basic affordable universal service product available to all;
- Protecting vulnerable consumers from ongoing price increases;
- Allowing Royal Mail to make a reasonable commercial rate of return on the safeguarded product; and
- Minimising the effect of the safeguard cap on Royal Mail's wider pricing freedom so as not materially to affect wider financeability and/or efficiency incentives.

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<sup>45</sup> Postcomm and Consumer Focus, Residential customer needs from a sustainable universal service in the UK, November 2010.

Structure of a safeguard cap

6.102 We have considered two broad options: an index-linked approach and a price ceiling.

6.103 With the index linked approach we would set the maximum price for the product we were protecting and then allow it to increase in line with RPI each year. That is, having set the maximum price we would keep it the same in real terms by only allowing it to increase by inflation each year. If we have set the level of the safeguard cap correctly (i.e. to allow Royal Mail to make a reasonable commercial rate of return) the index-linking will ensure that Royal Mail continues to make a reasonable return overall whilst protecting consumers from further increases in price (in real terms).

6.104 With the price ceiling approach we would set a maximum price for the product for a defined period, during which it would remain the same in nominal terms. The price ceiling approach is the simplest approach, but we consider that it has some significant disadvantages. While it provides an upper bound on pricing, in real terms it falls in line with inflation each year, making it more likely that in the medium term it would impinge on Royal Mail's ability to make a reasonable commercial rate of return. This implies setting a generous ceiling that allows some protection against inflation. However, this would allow Royal Mail to immediately price at that level, which might undermine the objective of protecting vulnerable consumers.

6.105 Therefore, we propose it is most appropriate to use the index-linked approach.

Scope of safeguard cap

6.106 We have considered four options for the scope of a safeguard cap to protect vulnerable customers. These are:

- First Class stamps (all weights) – [X] of Royal Mail's volumes and [X] of revenues;
- Second Class stamps (all weights) – [X] of Royal Mail's volumes and [X] of revenues;
- Second Class stamps for standard letters – [X] of Royal Mail's volumes and [X] of revenues; and
- Both First and Second Class stamps (all weights) – around 10% of Royal Mail's volumes and around 20% of revenues.

6.107 As can be seen above, putting a safeguard cap on both First and Second Class stamp products would directly constrain approximately 20% of Royal Mail's revenues. It would also impose indirect constraints on a wider group of products, e.g. both First Class and Second Class meter or PPI business mail and First Class bulk services. Protecting all First and Second Class stamp products would conflict with our objective of minimising the effect of a safeguard cap on Royal Mail's wider pricing freedom, as it would encompass a significant proportion of Royal Mail's volumes and revenues. We have therefore considered whether there is a need to set controls on the prices of First Class stamp services at all.

6.108 Although the Postcomm / Consumer Focus research found that most residential consumers use First Class for all or most of their mail, it also showed clearly that in

the majority of cases they do not need a First Class service, i.e. only 20% said that it needed to arrive next day. Therefore, while a safeguard cap on First Class stamps would control the product which consumers currently predominantly use, it may be unnecessary as when asked, consumers say they do not typically actually need the service (i.e. next day delivery) that First Class provides.

- 6.109 We consider that it is therefore likely that the majority of First Class customers would be able to switch to the Second Class product to fulfil their needs, if Royal Mail increased its First Class prices to a level that they were no longer willing to pay, in light of their actual needs. Also, as discussed in paragraph 6.99 above research suggests that vulnerable residential consumers (elderly, low income and rural) are already more likely to use Second Class than other customers.
- 6.110 We have also considered what impact controlling Second Class stamp prices would have on Royal Mail's pricing freedom. The prices of business mail services are only very loosely constrained by stamp prices, as there are currently large discounts and the extra costs for businesses of using stamps would be significant. A Second Class stamp price cap would not in our view significantly limit Royal Mail's overall pricing freedom on the remainder of services (over 90% of its revenue) and therefore should not impact how it sets its prices for the majority of other services in 2012-13 and beyond. Therefore, taking into account both consumers' needs and the impact of a safeguard cap on Royal Mail's wider financial position, we are proposing that it is appropriate to place a safeguard cap on at least some Second Class products, but not necessary to protect First Class stamp prices.
- 6.111 We therefore turn to the question of whether to control all Second Class stamp products or just the price of Second Class standard letters. Standard letters account for almost two-thirds of Second Class stamp revenues (and as the lowest price point, a greater share of volume of close to 90%). Additionally, the Standard letter format is suitable for personal correspondence and most greetings cards, i.e. the vast majority of consumer usage.
- 6.112 We note that the majority of customers have very limited access to alternative means by which to send physical items. The Post Office network of over 11,000 branches across the UK provides widespread access to packet and parcel services and although alternative courier services exist, at this time these are principally used by business customers and are generally more competitive at higher weight levels.
- 6.113 However, such services are relatively little used by Second Class customers, and evidence indicates that much of this usage appears to relate to small businesses rather than vulnerable customers. We have no evidence on consumer usage to support the extension of a safeguard cap beyond the Second Class standard letter. However, we remain open to the possibility that there are certain other Second Class stamp products that are essential to vulnerable consumers and should also be protected.
- 6.114 We would welcome engagement from customer groups on this issue, particularly evidence relating to the use of, and reliance upon, Royal Mail's packet and parcel services by different groups of customers, including access to alternative services and the affordability of those services by comparison with Royal Mail's offering.

### Level of a cap

- 6.115 As noted above, we accept the basic premise that stamp prices have to increase significantly.
- 6.116 We propose a range for the level of the safeguard cap of 45p to 55p for stamps for Second Class standard letters.
- 6.117 In making this proposal we have taken into account the need for Royal Mail to materially increase prices in order to support the sustainability of the universal service. We note that setting the cap at 45p may constrain Royal Mail's pricing freedom both directly and indirectly, which may have implications more broadly for the universal postal service. However, we have also considered that customer groups may have significant concerns regarding the potential for Royal Mail to increase Second Class stamp prices and that it would be inappropriate not to give customer groups an opportunity to express their views.
- 6.118 If Royal Mail were to increase prices to the level at the top of the range this would be a very significant price increase, although the safeguard may be more of a constraint in later years. However, such a safeguard cap would provide Royal Mail with greater freedom to deal with unforeseen circumstances in the future.

### **Proposal**

- 6.119 In summary, we provisionally propose that in order to protect vulnerable consumers we should put in place a safeguard cap on Second Class standard letters. Our initial view is that we should set the maximum price for stamps for a Second Class standard letter between 45p and 55p (as discussed above) from 1 April 2012, and then to limit any increase in that maximum each year to RPI.

*Question 6.5: Do you agree with Ofcom's proposals for an index-linked safeguard cap on standard letters from 45p to 55p? If not, please provide reasons.*

### **Safeguard 3: Competition in the mail market**

- 6.120 The final safeguard we are proposing is in relation to the competitive framework. We consider that competition in principle brings substantial benefits, especially in terms of increasing pressure on Royal Mail to improve efficiency. The potential for Royal Mail to lose business as a result of competition is however also a potential risk to the provision of the universal service, if it results in a position where Royal Mail, as the only operator capable at present of offering the universal service, cannot remain viable. Given our primary duty, the assessment of competition needs to balance these factors.
- 6.121 In summary, we propose to impose an obligation on Royal Mail to provide access to its network at the IMC to competitors. We set out our thoughts and proposals on competition in the next section.

### **Duration of approach**

- 6.122 Above, we have proposed that Royal Mail should have pricing freedom and set out the safeguards we propose are necessary to address the resulting risks. We have also set out above – regarding the potential for re-regulation – that there are circumstances in which we may consider it necessary to review our position.

Therefore, in the absence of a review being triggered by the monitoring regime, a key question is how long Ofcom should leave before reviewing its approach. In general we think the period would need to:

- provide sufficient incentives to improve efficiency;
- provide sufficient certainty for Royal Mail (including any potential investor) over the future regulatory framework;
- address the risk of Royal Mail increasing prices rather than targeting efficiency improvements; and
- allow the benefits of a financially sustainable universal service to be shared with customers.

6.123 These questions are similar to the questions we would ask ourselves when setting the duration of a price control. In the past when setting price controls in the electronic communications sector, Ofcom has preferred durations of four years, as we considered this strikes a reasonable balance between keeping prices in line with costs and providing incentives to reduce costs.<sup>46</sup> However, as discussed above, these price controls have been applied to companies in relatively good financial health, possibly already making strong profits, and on only on parts of their business. The challenges facing Royal Mail are of a different order.

6.124 It is likely that an indefinite duration would provide greater certainty to Royal Mail and any potential investor over the future regulatory framework. For this to be appropriate we would need a high degree of confidence that the minimum safeguards (set out above) would provide effective incentives to constrain Royal Mail's behaviour and/or any intervention required could be sufficiently timely to ensure there was no significant harm to the universal service and the market. Given our analysis of Royal Mail's potential ability and incentive to make excessive profits in the future, we do not consider it appropriate for this approach to have an indefinite duration with no further review. In any event, we would always have to retain the ability to intervene, if it was necessary to do so to secure our statutory duties.

6.125 However, we do consider that the duration of the future regulatory framework would need to be sufficiently long to allow Royal Mail to return to viability (in accordance with its plan) but short enough not to allow Royal Mail to take unreasonable advantage of the situation (over and above the behaviour that might be identified in the monitoring regime).

6.126 Given the challenges facing Royal Mail we propose that the future regulatory framework (pricing freedom and safeguards) would apply for a period of seven years. However, we propose to leave open the possibility of reassessing the level of the safeguard cap in about two years time, in the light of any relevant changes in the market and consumer patterns of use. As set out above, we in any event retain the ability to take regulatory action sooner than this if we consider that we should do so in order to secure our statutory duties.

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<sup>46</sup> Due to a new electronic communications directive, price controls in this sector can now only be set for a maximum of three years.

*Question 6.6: Do you agree with Ofcom's proposal that the approach outlined above remains in place for seven years? If not, please provide reasons.*

## Section 7

# Competition

## The role of competition in ensuring a universal service

- 7.1 The previous section set out the overall proposed approach to regulating Royal Mail. This recognised that competition has a potentially important role in ensuring that Royal Mail is incentivised to be efficient. This Section focuses on the role of competition, and sets out our policy proposals in this regard. It starts by setting out the potential benefits of competition, and then the costs in terms of sustaining the financeability of the universal service. It describes the two main models of competition: end-to-end and access, and sets out our proposed policy position in relation to each.
- 7.2 Ofcom has a number of general duties under the Communications Act 2003, including a duty to further the interests of consumers in relevant markets, where appropriate by promoting competition. However, the Postal Services Act 2011 makes clear that Ofcom's primary duty in relation to postal services is to carry out their functions in a way that they consider will secure the provision of the universal postal service. In performing that duty, Ofcom must have regard to the need for the provision of a universal postal service to be financially sustainable and efficient. In the event that Ofcom's general duty relating to the promotion of competition conflicts with that primary universal service duty in relation to postal services, priority must be given to the primary universal postal service duty.
- 7.3 While competition has well proven benefits with regards to driving efficiencies, encouraging innovation and reducing prices, it does so by taking business away from the incumbent. It is, in part, the threat of business failure that creates these benefits. Given our primary duty to secure the provision of a universal postal service (as set out above), we need to be careful to find an appropriate balance between that duty and our duty to promote competition. Prior to considering the need for regulation, we therefore consider the benefits of competition, and whether they are likely to be in conflict with the need for us to secure the provision of a universal postal service.

## Potential benefits and costs of competition

- 7.4 Competition typically has a number of potential benefits, in particular, in the context of postal services it can lead to:
- **efficiency incentives on Royal Mail.** With firms competing to meet the needs of customers, competitive pressures can help promote efficiency by enhancing and tightening the internal incentives of organisations to improve efficiency thus leading to lower costs and prices.
  - **greater innovation.** With an increased number of firms competing to meet the needs of customers, firms will have an increased incentive to innovate. An innovating firm can gain market share and hence significant positive net returns at the expense of non-innovating firms; and
  - **direct benefits for customers.** Customers may benefit from lower prices and improved customer service for services which are otherwise comparable to those which would be offered in the absence of competition.

The way these benefits are realised depends on the model of competition.

- 7.5 However, competition for postal services, whilst offering potential benefits, can have a significant cost for the universal service provider. Introducing competition to a network monopoly environment inevitably leads to static inefficiencies, e.g. the duplication of deliveries to the door, duplication of sortation capacity. If competition involves duplication of fixed network costs thus leading to a reduced exploitation of economies of scale and scope, then this could increase the overall cost of production. The question for Ofcom is whether the dynamic benefits created by competition outweigh these static inefficiencies.
- 7.6 The backdrop of a declining market exacerbates these issues. Royal Mail would be exposed to volume and revenue reductions not just from the declining market but also from competition.
- 7.7 Moreover, in the context of Ofcom's primary duty, if Royal Mail were unable to react sufficiently to competitive pressures it could lose revenues and volumes to such an extent that it endangered the provision of the universal service.

## Models of competition in post

- 7.8 There are two main models of competition in the postal sector: end-to-end and access.
- 7.9 End-to-end competition is where operators other than the incumbent collect, process and deliver mail direct to the recipient, without the need to use the incumbent's network. In the UK, other operators have been able to compete for these services since 2006, when the postal market was fully liberalised. End-to-end competition in the UK, has developed in limited geographic areas only and/or for certain higher-value products, e.g.:
- Packets and parcels above 500g and/or with premium elements, where Royal Mail's economies of scale are less important;
  - Unaddressed mail; and
  - Niche competition, including document exchange services and local delivery operations that tend to be limited in scale.
- 7.10 Currently, alternative suppliers deliver fewer than 1% of letters and large letters. This contrasts with other member states where there has been significant growth in end-to-end competition. In Germany, alternative suppliers deliver about 10% of letters up to 1kg. In the Netherlands alternative suppliers account for 17% of volumes; and in both Spain and Sweden they account for 12%.
- 7.11 In the UK the only significant competition to Royal Mail is via access competition, that is where an access operator collects mail from business customers, prepares and trunks it, before handing it over to Royal Mail to be delivered. Access competition is currently subject to regulation, with Royal Mail having a wide obligation to provide access across its network. 99% of access is currently based on injecting letters and

large letters at the Inward Mail Centre (IMC access) allowing an access operator to provide a D+2<sup>47</sup> service to its customers.

- 7.12 Postcomm's March access review consultation<sup>48</sup> proposed that regulation should be continued for access, but that the framework of regulation should be modified. It proposed that an access condition should be imposed obliging Royal Mail to offer access for participation in the retail D+2 and later than D+2 letters and large letters markets for pre-sorted and high volume unsorted mail. It also proposed that the appropriate point at which access should be granted for these purposes was at the Inward Mail Centre.

## **End-to-end competition may bring significant benefits but at significant risk**

### **Potential benefits of end-to-end competition**

- 7.13 Royal Mail's delivery network remains a monopoly and accounts for by far the largest proportion of Royal Mail's costs, being around half of the total cost of the universal service network. It is also the area where cost reduction has been most difficult to achieve, and progress in delivering the modernisation plan has been slowest. End-to-end competition could provide incentives for Royal Mail to improve its efficiency within the delivery network.
- 7.14 As such there is the potential for the benefits of competition to be spread across Royal Mail's network, and this will improve the potential for the benefits to outweigh the specific costs that may arise due to reduced revenues for Royal Mail. We have seen this in part through the efficiencies within Mail Centres, where Royal Mail has delivered significant cost savings. Such efficiency savings impact the costs of both the upstream elements of the Mail Centre network (where Royal Mail faces competition) and the downstream (inward) processing where Royal Mail retains a monopoly.
- 7.15 Similarly, if end-to-end entry does not completely replicate Royal Mail's product service range or geographic footprint, there is still the potential for efficiencies more widely across Royal Mail's delivery network. This could apply where efficiencies in processing bulk mail services in certain areas could be used to reduce the costs of processing universal services and therefore to improve the financial sustainability of the universal service network.
- 7.16 End-to-end competition could also increase the potential for innovation. For example, competitive packet operators have developed innovative approaches to managing the premium elements that are offered to large customers. This has led Royal Mail to respond through development of its own 'Tracked' services, and to develop additional delivery options. By increasing or at least maintaining usage of mail, such innovation can contribute to the universal service becoming financially sustainable in the medium-term.

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<sup>47</sup> A D+2 service is where mail is delivered two days after collection from the sender of mail

<sup>48</sup> The building blocks for a sustainable postal service – Access Review 2012 Initial Proposals, March 2011

- 7.17 In addition to the benefits which can be achieved through the incentives upon Royal Mail, end-to-end competition also has the potential to provide benefits to customers through lower prices and improved customer service. However, to the extent that such competition is focussed in certain areas only, the majority of customers will need to continue to use Royal Mail for the items that the end-to-end operators cannot deliver.

### **Potential risks of end-to-end competition**

- 7.18 Other things being equal, compared to access competition, the costs of end-to-end competition are also potentially greater, as (unlike with access), Royal Mail is unable to retain the associated downstream revenues.
- 7.19 The size of the access market could also cause concerns. For example, with around 40% of letter volumes currently being handled by access providers, if an end-to-end entrant were able to rapidly gain all these volumes it could have a very significant effect on Royal Mail's viability and therefore that of the universal service.
- 7.20 As the universal service provider, Royal Mail is obliged to provide a six-day delivery service and deliver everywhere at the same price. The obligation to deliver everywhere at the same price creates an implicit cross subsidy between cheaper to serve areas and more expensive areas which creates opportunities for arbitrage. For example, a competitor may seek to offer delivery in a low cost geographic area where Royal Mail is obliged to charge a higher price because of its obligation to deliver everywhere at the same price (and by virtue cross-subsidise other higher cost areas). This risk is sometimes referred to as 'cherry picking'.
- 7.21 The risk of competitors 'cherry picking' low cost delivery areas can be offset to some extent by Royal Mail's use of zonal pricing for access (i.e. charging lower prices oriented to Royal Mail's lower costs in areas which will also be cheaper for other operators, and recovering higher revenues from the parts of the country where Royal Mail's costs are higher and which will therefore be less attractive to an entrant). The potential for geographic entry representing unfair 'cherry-picking' is reduced if not completely eliminated by zonal pricing.
- 7.22 As noted above, as part of its universal service obligation, Royal Mail is required to provide a six-day a week delivery service to all addresses. Therefore it could be argued that an alternative operator could gain a competitive advantage by, for example, delivering second class services three days a week, compared to Royal Mail's obligation to deliver every day. Such entry could still, overall, lead to net benefits, if it represented an efficient operator providing incentives on Royal Mail and benefits for customers, rather than just representing 'cherry picking' and posing a threat to the financial sustainability of the universal service.

### **Notification condition**

- 7.23 Section 41 of the Act gives Ofcom a power to impose a notification condition on every person providing or intending to provide a service within the scope of the universal postal service. Such a condition could require such persons to provide advance notice of their intention either (i) to provide a letters business on a specified scale (whether or not the person is currently providing a letters business or any other postal service), or (ii) where the person is already providing a letters business on a specified scale, advance notice of the person's intention to expand the business by a specified extent.

- 7.24 Section 41 empowers the Secretary of State to direct Ofcom to impose a notification condition. On 3 October 2011, the Secretary of State directed Ofcom to impose a notification condition by 31 March 2012. We plan to consult on this condition, including the process for notifying Ofcom of the above, before the end of the year, in order to have implemented it in line with the Secretary of State's direction.

### **Ofcom's proposal**

- 7.25 As we have set out above it is clearly possible to hypothesise forms of end-to-end competition that could have a net benefit to the universal service. For example, entry on an efficient basis and at a reasonable scale might be expected to have this effect. However, it is also possible to hypothesise forms of end-to-end competition that would have a detrimental effect on the universal service. For example, Royal Mail's Universal Service Obligation may result in competition entering that is based on an arbitrage opportunity (i.e. competition that is based on Royal Mail's price inflexibility due to its universal service obligation rather than due to underlying efficiency advantages), leaving Royal Mail to bear the cost of the most expensive areas and at such a pace and volume that Royal Mail is unable to respond.
- 7.26 As noted above we will implement the notification condition by 31 March 2012 as directed by the Secretary of State. We will assess any potential entry or growth notified to us under this condition on a case-by-case basis to determine whether we should consider taking any regulatory steps to secure our duties under the Act.
- 7.27 Meanwhile, in the event that we become aware that a postal operator is planning to enter the end-to-end market in such a way as would have triggered a likely notification condition, we will carry out the same assessment against our duties.

*Question 7.1: Do you agree with our approach to assessing end-to-end competition? If not, please give your reasons.*

### **Is it necessary to require Royal Mail to offer access?**

- 7.28 The Act allows Ofcom to impose a condition requiring Royal Mail to provide access to its postal network, which is described as a USP Access Condition. The Act sets out three tests which must be satisfied in order for a Universal Service Provider to be required to give access to its postal network. Ofcom may not impose a condition requiring such access unless it appears to it that such a condition is appropriate for each of the following purposes:
- Promoting efficiency;
  - Promoting effective competition; and
  - Conferring significant benefits on users.
- 7.29 Up until now access has substantially all been provided on the basis of next day delivery following injection at the Inward Mail Centre, the point at which over 99% of current access enters Royal Mail's network. This has enabled access operators to provide a D+2 service for original posting customers. In its March consultation on access, Postcomm proposed that an access condition should therefore be imposed for participation in the relevant D+2 and later than D+2 markets at the Inward Mail Centre.

- 7.30 Royal Mail has argued that it is not necessary for Ofcom to impose a USP access condition. Royal Mail has argued that it would be willing to offer access where it was in its commercial interests to do so and where, consistent with the objectives of the Act, it would help sustain the universal service. Furthermore, Royal Mail has provided supplementary evidence which it uses to support its argument that, in the absence of a USP access condition, it would have an incentive to continue offering access. This is because, by encouraging other operators to use its network rather than set up an end-to-end network, it maintains volumes going through its network which helps contribute to the fixed cost of providing the universal service and thus to finance the universal service. Therefore, given its concerns regarding the risks of end-to-end competition, Royal Mail maintains that it would continue to offer access on commercially acceptable terms.
- 7.31 We consider that there are two key questions with regard to access competition:
- First, whether Royal Mail should be obliged to offer access;
  - Second, if so, on what terms should Royal Mail provide access, and, in particular, should Ofcom regulate prices for access.
- 7.32 As noted above, the most common model of access (99% of volumes) is through injecting letters and large letters at the Inward Mail Centre (IMC access) for next day delivery by Royal Mail, allowing an access operator to participate in the D+2 and later than D+2 retail market. We consider below whether this form of access meets the three statutory tests set out above and then whether this is consistent with Ofcom's other duties. We do not consider other forms of access here. Annex 6 discusses our proposed approach for gathering evidence and taking forward the need for regulation in respect of other forms of access which exist on a more limited scale or where access operators are currently seeking access. Where relevant, we address the other requirements of the Act that relate to the imposition of USP access conditions, in section 9 below.

### **Stakeholders' views**

- 7.33 Royal Mail did not agree with Postcomm's proposal to require access. It argued that in the absence of a regulatory condition requiring it to provide access, access could be granted on a voluntary basis. It also argued that there was no justification for obliging it to provide access because the delivery network did not represent an essential facility.
- 7.34 Royal Mail's argument was strongly linked to two counterfactual scenarios. It considered that Ofcom's analysis needed to consider both:
- In the absence of access competition, which provides a cost-effective delivery option for other operators, end-to-end competition would be more likely; and
  - Royal Mail will offer access in any case, with the difference being only that the price will reflect a reasonable commercial rate of return.
- 7.35 Royal Mail has also proposed that it will develop an Access Framework, which will include:
- Dispute resolution based on the current approach and processes for resolving access disputes which involves a combination of Royal Mail internal escalation

processes and a set of provisions contained in access contracts, including independent mediation;

- A transparent set of principles and criteria that Royal Mail would apply to customers' requests for access;
- Pricing principles (that would ensure that prices were not deemed to be anti-competitive); and
- Guidelines on the processes and timescales Royal Mail would employ in responding to requests for access and voluntary terms for dispute resolution

7.36 Furthermore, Royal Mail has argued that it might be possible to rely on competition law as an alternative to regulation and that such an approach would be less interventionist.

7.37 The majority of respondents, including Consumer Focus, a number of user groups and a number of access operators, all supported the proposal to impose an access condition on Royal Mail. The operators also highlighted risks of moving away from regulated access. An access operator stated that Royal Mail Wholesale was not incentivised to maximise the use of access and therefore would not have the incentive to operate commercially priced access in the absence of an access condition.

7.38 Prior to assessing whether a USP access condition should be imposed, we consider evidence as to whether the three tests in the Act are met.

### **Does access promote efficiency?**

7.39 Access operators only compete with Royal Mail at the upstream part of the network. There is reason to believe that access operators appear to be genuinely more efficient than Royal Mail within those parts of the network, based on a comparison of the operations, costs and reported profits of Royal Mail and other operators.

7.40 Our analysis of the progress in making improvements in Royal Mail's efficiency in this part of the network support the potential for access to promote efficiency. We have seen this in part through the efficiencies which Royal Mail is achieving within Mail Centres, which have delivered significant cost savings, and this benefits both the upstream elements of the Mail Centre network (where Royal Mail faces competition) and the downstream (inward) processing where there is little competition. At present, the modernisation of the Mail Centre network appears to be proceeding faster than the modernisation within the delivery network, where Royal Mail does not face competition.

7.41 There is, however, also reason to believe that the current "headroom" regime has constrained Royal Mail's ability to respond to competition, i.e. by holding open what has arguably been too large a margin. This has, arguably, made Royal Mail's pricing uncompetitive for the largest customers, with access operators competing against each other for large contracts. It is therefore likely that Royal Mail's ability to respond to competition has been weaker than it could have been were Royal Mail to have had more pricing freedom to respond to competition.

7.42 In respect of the static inefficiencies that Royal Mail identified in its response to Postcomm's March access review consultation, we consider that they are

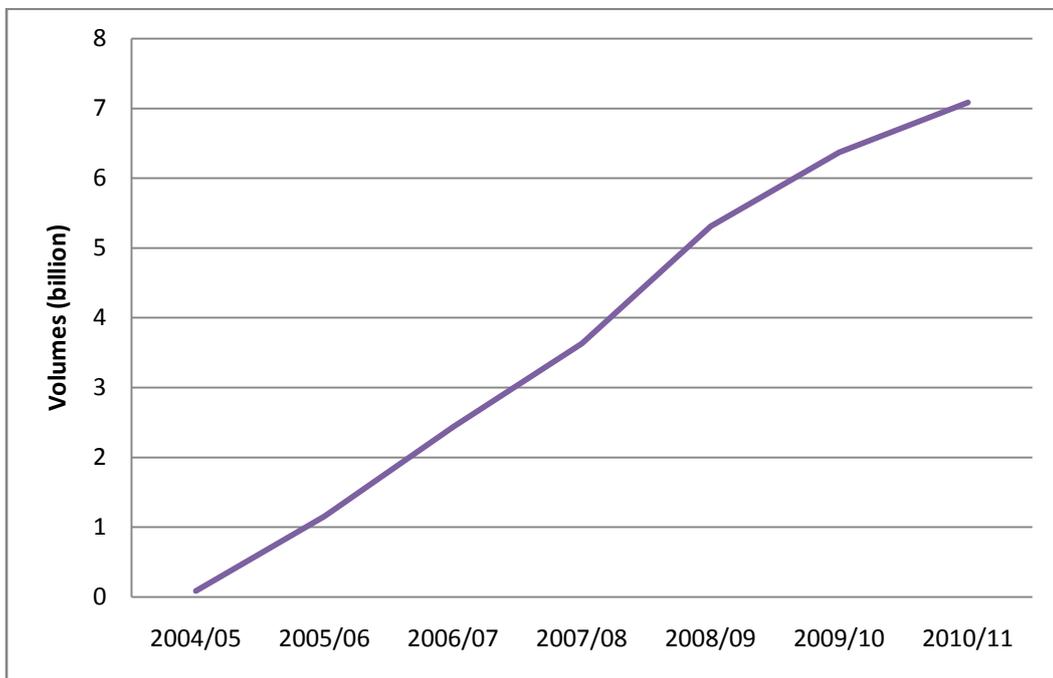
outweighed by the dynamic efficiency benefits of competition for reasons set out in more detail in Annex 7.

7.43 On balance, therefore, there is in our view good reason to believe that IMC access has led to efficiency improvements and we would expect it to do so going forward.

**Does access promote effective competition?**

7.44 Prior to the launch of access in 2003, Royal Mail faced little or no competition on the relevant markets. Since launch, access has grown rapidly. In 2010-11 access operators handled 7bn items, or around 40% of total letter volumes. There are currently 21 operators with access agreements and 15 customers that have entered into access agreements directly with Royal Mail.

**Figure 14: Growth in access volumes<sup>49</sup>**



7.45 We recognise that the lower prices offered by access operators to their customers have been a driver of the growth of access, and that wider benefits will be better assessed if Royal Mail is better able to compete through a less onerous headroom regime. However, whilst the initial pace of growth in access was facilitated by the headroom regime, we note that over half of the 7bn items handled by access operators in 2010-11 were previously customers of Royal Mail services that were not subject to any headroom regime. For example, access operators are increasingly competing against Royal Mail’s unsorted products that are not within the scope of the existing headroom control.

7.46 Royal Mail has argued that access competition has acted as a barrier to the development of end-to-end competition. However, for the reasons set out in Annex 7, we believe that the opposite is likely to be the case. We consider that end to end competition is significantly more likely to emerge as a result of access competition.

<sup>49</sup> Source: Ofcom analysis of Royal Mail’s regulatory accounts

Access allows other operators, to offer a nation-wide service to customers, even if they only offer limited geographic coverage for their own deliveries. In this model of competition, alternative end-to-end operators could contract with large senders of mail, and use a combination of access contracts and their own delivery operations to manage a national profile of mail.

- 7.47 This would be significantly more efficient for the senders of mail than a requirement to separate mail geographically and contract with different postal operators. The alternative operator would in effect be competing directly with Royal Mail Wholesale for provision of downstream services. In the absence of access competition, we consider that end-to-end competitors would be highly unlikely to be able to provide a national service to large customers, significantly reducing the attainable market within the UK. This is less of a concern in some of the other countries discussed above where competition exists, as the proportion of localised mail is higher.
- 7.48 On balance, it appears that access for the purposes of participating in the D+2 and later than D+2 markets has promoted effective competition and we consider it is likely to provide the most appropriate basis for encouraging effective and sustainable competition in the short and medium-term.

### **Does access confer significant benefits to users?**

- 7.49 As discussed above, many customers have moved voluntarily from Royal Mail to access operators, and access operators now handle around 40% of all mail. This indicates a sender preference for using access operators by comparison to Royal Mail.
- 7.50 Competition provides incentives on Royal Mail to operate more effectively in dealing with customers. Anecdotal evidence provided to Ofcom supports the view that customers consider that Royal Mail is less focussed on managing their needs than other operators. Some customers have highlighted in consultation responses to Postcomm and in discussion with us that access operators can be significantly more flexible and customer-oriented in managing their needs. IMC access may be an effective way of spreading best practice across Royal Mail's relationships with its customers.
- 7.51 However survey and market evidence indicates that the major concern for large customers is price. It is clear that access competition has led to large bulk mailers directly getting significant price savings by undertaking certain activities themselves and by taking advantage of better terms from other operators in the provision of upstream activities. In addition, access competition has now led to smaller customers gaining the benefits of lower prices. Our evidence suggests that access operators will now collect mail from customers with as few as 250 items per posting.
- 7.52 Access customers have offered significant discounts to Royal Mail's prices to win customers from Royal Mail and then reduced prices further to compete with each other. The result has been significantly lower prices for large customers. Our analysis indicates that these savings are likely to comprise up to £150m - £250m compared to Royal Mail's prices.
- 7.53 Royal Mail has argued that access competition has not generated any innovation. It has argued that access competitors have won significant volume from Royal Mail through imitating Royal Mail's services. The impact of access competition needs to be assessed in the context of the proportion of the network within which access

operators compete. In that context, we consider that some innovation has been delivered:

- Access operators have launched day certain<sup>50</sup> and hybrid mail services which have extended the services available to customers; and
- Access operators have delivered alternative approaches to meeting customer needs, including the provision of additional management information to customers.

7.54 On balance, access for the purposes of participating in the D+2 and later than D+2 markets appears to have conferred significant benefits to users through lower prices, innovation and improved customer service.

### **Is the current form of access consistent with the provision of the universal postal service?**

7.55 In theory the costs of access competition should be relatively limited. Access competition should result in avoided costs in Royal Mail's upstream network. If the price paid by access operators is comparable to Royal Mail's retail price less those avoided upstream costs, then Royal Mail should in principle be indifferent to whether access is offered. In the long run, analysis indicates that a significant proportion of upstream costs should be avoidable. In this sense access represents a form of "workshare", directly comparable to Royal Mail's own bulk products, which are also offered at a very significant discount to single piece non-bulk services.

7.56 Royal Mail's response to Postcomm's March document outlined the risk to the provision of the universal service resulting from regulated access. It highlighted that Royal Mail has not been able to earn a reasonable rate of return from offering access, and that headroom has significantly damaged Royal Mail's finances through the restrictions it places on upstream pricing. Specifically, the discount offered by Royal Mail on access has been well above the avoided costs that it saves from customers injecting further into Royal Mail's network.

7.57 We recognise that the existing headroom regime, and the prices which were set as a result of that regime, may have resulted in an adverse impact on Royal Mail's finances. However, our view is that these adverse impacts are not due to access *per se*, rather the price at which access is offered. They can therefore be resolved through pricing. Royal Mail has for some time offered significant discounts for "workshare" activities, and we do not consider that the economics of offering access are fundamentally different. We do recognise Royal Mail's charge that the economics of the current prices may be different, and we propose to move towards a regime with pricing based on LRIC, subject to a glidepath.

7.58 On that basis, given our proposals for Royal Mail to be granted significant pricing freedom on both retail and access prices, we do not consider that there should be an adverse impact on Royal Mail's finances of providing access under our proposed future regulatory framework. It is our intention (as set out further below) to ensure

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<sup>50</sup> Access operators provide their customers with a day certain D+2 delivery or D+3 delivery. These services can be compared to Royal Mail's second class service offering that does not provide a day certain delivery but a delivery by day D+3 (i.e. the day of delivery is not certain).

that the prices access operators pay Royal Mail for services are appropriate and allow Royal Mail to make a reasonable commercial rate of return on these services.

- 7.59 We also consider that the prices and quality of customer experience provided by access operators have supported the bulk mail market. Customers have repeatedly highlighted to us and Postcomm the potential risk to their use of mail if the perceived benefits of the access regime are removed.
- 7.60 Therefore, we consider that on balance access for the purposes of participating in the D+2 and later than D+2 markets is consistent with the provision of the universal postal service.

### **Ofcom proposes to require Royal Mail to offer IMC access**

- 7.61 We note that access has now developed to carry approximately half of all mail. We consider that a move towards a different approach to the regulation of access, such as the voluntary regime that Royal Mail is advocating in which we would impose no regulatory condition to provide access, could look very different from the current form of access with consequent impacts on customers and competitors. Thus, even if we concluded that a move to such a position was appropriate, we would wish to ensure that such a move was gradual in order to avoid a risk of regulatory error. While Royal Mail may also have an incentive to make such changes gradually, we consider that there is also a possibility that it may have a different incentive to make changes over a shorter period of time in order to disrupt the market and encourage customers to switch to Royal Mail.
- 7.62 In light of this and given the benefits of effective competition described above, we do not consider that relying on competition law alone and not imposing any regulatory conditions would be an optimal outcome. Our view is that regulation will continue to be necessary if effective and efficient access competition is to continue and that Ofcom has a role to play in ensuring an orderly transition to a future access regime.
- 7.63 The Act envisages that a number of additional constraints may be imposed on Royal Mail, who at present are still the only provider of downstream services to other operators. It provides the following important potential safeguards:
- An effective dispute resolution process, specifically outlined in the Act
  - The ability to impose regulation to protect against excessive pricing or price squeeze if necessary
  - The ability to impose publication, accounting separation and cost orientation requirements if necessary
- 7.64 We are not confident that Royal Mail will have the incentives to offer adequate wholesale products, including appropriate safeguards, to its competitors. We have also not seen evidence that Royal Mail is currently engaging with access operators in developing an Access Framework to substitute for the safeguards outlined in the Act. Given the important role access currently plays in the postal sector and the benefits it has brought to users of postal services, on balance, we consider that an obligation to provide access to Royal Mail's network at the Inward Mail Centre is appropriate from April 2012. This will enable us to ensure that the safeguards identified above can be implemented, and that the model of competition supported by the provision of access will continue.

*Question 7.2: Do you agree with Ofcom's proposals to impose an obligation on Royal Mail to provide access at the Inward Mail Centre? If not, please give reasons.*

## On what terms should Royal Mail provide access?

- 7.65 Under the Act, we can impose price controls in a USP access condition only if it appears to us that the provider concerned might otherwise impose excessive prices or engage in price squeeze with adverse consequences for users of postal services<sup>51</sup>.
- 7.66 As regards imposing a price control to address the risk of excessive pricing, Postcomm's April consultation proposed that no price control should be applied to access products if there was no price control on universal service products. It set out various options in the event that a price control was imposed on universal service products, including no direct price control of wholesale services, controlling wholesale product prices together with a separate retail universal services price control and a combined price control for universal and access products.
- 7.67 As discussed in Section 6 of this document, we do not consider that it is necessary to impose on Royal Mail a price control to address the risk of excessive pricing.
- 7.68 By contrast, we do have concerns about a risk of price squeeze and have therefore focused below on how we propose to address those concerns.
- 7.69 Postcomm's April consultation identified a number of different options to address the risk of price squeeze (as described in the Act, which can also be referred to as "margin squeeze") which could make access competition unsustainable. Margin squeeze occurs where an operator who is dominant in the wholesale market and also operates in the retail market reduces the difference between its retail and wholesale prices such that there is insufficient margin available to other operators to compete with its retail prices.
- 7.70 Currently, the pricing dimension of margin squeeze is regulated through "access headroom". This requires Royal Mail to maintain a minimum margin between retail prices and equivalent access prices. The level of headroom is linked to the commercial terms agreed between Royal Mail and access operators prior to 2006, although it was amended in 2011 to reflect differences identified between the level of headroom and relevant costs.
- 7.71 Postcomm proposed four approaches to margin squeeze regulation beyond 2012. These were all related to measures of the costs of providing upstream services. Postcomm considered the alternative options of using Long Run Incremental Costs (LRIC) which would be more consistent with competition law, or Fully Allocated Costs, which includes a full allocation of overheads and is the costing system used by Royal Mail at present in its reporting to us (and previously to Postcomm). Royal Mail's FAC system is subject to cost transparency requirements previously imposed by Postcomm, and has been reviewed by Postcomm and its independent auditors. On that basis, the options considered by Postcomm were:
- Option 1 – ex post competition law enforcement

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<sup>51</sup> Section 38(5) of the Postal Services Act 2011

- Option 2 – monitoring against LRIC
- Option 3 – interim control linked to FAC, representing a glide path from current regulation towards Option 1 or 2
- Option 4 – no change to structure or form of control – potential resetting of level towards FAC.

7.72 Postcomm indicated a preference for Option 2, but noted that this was subject to provision of LRIC data, and depending on the implications of that data, there might be a need for a glide path.

7.73 In considering the need for margin squeeze regulation, Ofcom will take into account the wider regulatory framework it is proposing and the role of access competition within that. The appropriate level of regulation will need to be consistent with the overall aim of the regulatory framework to deliver a financially sustainable and efficient universal service.

### Responses to consultation

7.74 Royal Mail strongly disagreed that any margin squeeze regulation was required. It argued that competition law was sufficient to address the risk of margin squeeze, particularly given the well-established nature of the access operators.

7.75 By comparison, Consumer Focus and access operators supported Options 3 and 4. In addition to being concerned about the potential for reduced margins and anti-competitive behaviour from Royal Mail, access operators were also concerned about Royal Mail's incentives in developing a LRIC model, and the implication that Royal Mail could create a bespoke costing model which would then be used to set its own prices without assurances regarding the robustness of the underlying costs.

7.76 A number of customer groups were more supportive of Option 2. The customer groups suggested that a move to a monitoring regime could be supported by voluntary undertakings from Royal Mail.

### Ofcom's analysis

7.77 We have assessed the headroom regime currently in place by Postcomm for Royal Mail. The headroom regime was put in place in 2006 (and revised in 2011) to address the risks of margin squeeze by Royal Mail against other operators. It was successful in precluding margin squeeze for large customers, but also prevented Royal Mail from competing actively in the market. Royal Mail has in consequence lost around 90% of the market volumes for the products most popular with large customers and subject to a headroom control.

7.78 Postcomm has consulted extensively on changes to the headroom regime, including in April. It is clear from consultation responses that access operators, supported by customers, user groups and Consumer Focus, view access competition as good for the market, and that protection against margin squeeze should be a part of maintaining that competition.

7.79 Ofcom's primary duty in relation to postal services is to secure the provision of a universal postal service. Therefore, in assessing whether protection is appropriate, we need to consider whether it is consistent with that universal service duty.

- 7.80 Earlier we discussed the role of competition. The Act and our proposed regulatory framework involve giving Royal Mail significantly more commercial freedom than is presently the case. Royal Mail will have greater commercial freedom to negotiate contracts with its larger customers, and so to price on a commercial basis in a way which reflects customers' willingness to pay in order to recover the costs of providing the universal service. All these measures will both improve the financial sustainability of the universal service and Royal Mail's ability to respond to competition.
- 7.81 In addition, we are proposing improved reporting requirements, including separate accounts for the upstream parts of Royal Mail's network where it competes with other operators. This will allow Ofcom to understand and closely monitor the impact of the prices Royal Mail offers in the market, and therefore to understand whether there is a risk of anti-competitive behaviour, including responding swiftly to any complaints.
- 7.82 We therefore consider that a framework should be in place to move to a regime where:
- access competition (and potentially end-to-end competition) exists, and helps protect customers and drive efficiencies;
  - the risk of margin squeeze is guarded against by competition law and reporting requirements; and
  - Royal Mail is free to compete with other operators, and to put retail prices into the market which are fair and competitive for larger bulk mail customers.
- 7.83 Within this document we outline the regulatory framework that should make this possible. However the building blocks of that framework are not yet all in place. Royal Mail has yet to produce the separate accounts which will allow Ofcom to observe the impact of its pricing behaviour. In addition, Royal Mail has not followed up on its December consultation on LRIC at the pace which was anticipated by Postcomm in April. There are no LRIC data currently available to assess whether any pricing below Fully Allocated Cost would be consistent with competition law.

#### Ofcom's proposals on price squeeze

- 7.84 On the basis of the analysis above we propose imposing a margin squeeze control, pending completion of Royal Mail's work on LRIC, and effective implementation of the reporting regime we are proposing to impose on Royal Mail.
- 7.85 We propose that the margin squeeze control should include:
- The same scope as the access headroom control which currently applies to Royal Mail – second class bulk mail (Mailsort 2, or equivalent services) for Letters and Large Letters
  - Ofcom monitoring Royal Mail's upstream revenues against FAC for all affected services, including a reasonable rate of return
  - FAC to exclude costs which are clearly not incremental to the affected activities (specifically, central overhead allocations, which are approximately 5%-10% of the cost base), and to be adjusted to reflect equivalence differences as discussed above;

- Subject to maintaining a minimum FAC headroom across all affected services, on individual contracts, Royal Mail not to charge below a proxy for the incremental costs of those contracts. In the absence of reliable data, we propose a relatively conservative estimate of incremental contract costs, which we estimate to be 50% of the associated Fully Allocated Costs.

- 7.86 We propose that the regulation should be reviewed within 18 months, with the expectation that we would move to a monitoring regime by 2014-15, subject to the provision of the appropriate data, that is more compatible with competition law principles and LRIC based costs. This would be considered in the context of Royal Mail's progress in providing the relevant costing and reporting information as set out above.
- 7.87 Further details of the rationale for our specific proposals, and how they would work in practice, are given in Annex 7 on access.

*Question 7.3: Do you agree with Ofcom's proposals in respect of regulating margin squeeze? If not, please give reasons.*

### **Ofcom's role in setting the Terms and Conditions for Access**

- 7.88 In its access review consultation in March, Postcomm consulted on the role for the regulator in setting the terms and conditions for access, if an access condition is included in the regulatory framework. The consultation highlighted three options:
- Option 1: No role for the regulator;
  - Option 2: Guidance provided by the regulator;
  - Option 3: Imposition of an access code.

### Postcomm's Proposals

- 7.89 Postcomm proposed Option 2, i.e. that guidance should be provided. The consultation sought views on the appropriate form of guidance, and what should be included within such guidance.

### Summary of Responses to consultation

- 7.90 The majority of respondents supported Postcomm's proposals. Royal Mail agreed that, within its own proposed unregulated access framework, such guidance would be appropriate. Operators generally argued that an open framework (Option 1) would be more appropriate if Royal Mail Wholesale had stronger incentives to compete with Royal Mail Retail for revenues and to optimise the use of the Wholesale network, but that in practice this was not the case, and therefore some intervention from the regulator was likely to be appropriate.
- 7.91 There was limited support for a detailed access code. One access operator argued for more rigorous regulatory intervention in access terms but also highlighted that this related to Royal Mail's willingness to negotiate on specific issues. Another access operator stated that an access code risked "fossilisation" of a specific form of access, at the expense of innovation and improved services for customers.

### Ofcom's proposals

- 7.92 We note the comments from respondents and consider that they all point towards there being an appropriate role for the regulator in providing guidance on the Terms and Conditions for access. We propose to include a requirement in the USP access condition that the terms and conditions for access (including price) to be offered by Royal Mail are set on a "fair and reasonable" basis. In addition, we propose to publish guidance on the basis of Option 2. We discuss in Annex 7 the potential areas to be included, recognising that some areas may require more detail than others.
- 7.93 We also consider that this should include guidance about the implementation of measures to ensure an appropriate level of equivalence between retail and access customers. This is also discussed further in Annex 7.
- 7.94 We also propose that the guidance should include guidance as to how zonal prices would be set by Royal Mail in the future, to replace the current price control which limits Royal Mail's ability to change prices to reflect the underlying costs, whilst retaining sufficient protection for customers who use zonal prices.

### **Ofcom's approach to addressing issues of non-equivalence**

- 7.95 Issues of non-equivalence arise where there are differences between the terms that Royal Mail offers to third parties compared to those offered to its own business in relation to accessing Royal Mail's network.

### Postcomm's Proposals

- 7.96 Postcomm considered that the concept of 'ensuring equivalence' should align with the concept of no undue discrimination or no undue preference.
- 7.97 Under Schedule 3, Part 1, paragraph 11 of the Act, Ofcom may include a requirement on a person not to discriminate unduly against particular persons, or a particular description of persons, in relation to access matters in a USP access condition. Postcomm considered that such a provision would provide an appropriate basis for addressing issues of non-equivalence.
- 7.98 Postcomm further identified two options for addressing issues of non-equivalence:
- Option 1: Imposing operational or process changes on Royal Mail
  - Option 2: Through a pricing mechanism whereby equivalence is ensured by making adjustments in the relativity of access prices to Royal Mail's retail prices.
- 7.99 Postcomm proposed that the choice as to which option to adopt should be determined on a case by case basis, but that where imposing operational or process changes could be readily implemented without having a detrimental impact on Royal Mail's efficiency or the financial sustainability of the universal service, Option 1 was more likely to be appropriate.
- 7.100 Other more detailed aspects of addressing issues of non-equivalence (such as the need for imposing additional reporting requirements on Royal Mail and the benefits of establishing an independent system for measuring end-to-end quality of service of access mail) are set out in Annex 7.

## Summary of Responses to consultation

7.101 Respondents were broadly supportive of Postcomm's proposals with regards to addressing issues of non-equivalence.

### Ofcom's proposals

7.102 We agree with Postcomm that 'ensuing equivalence' should align to the concept of no undue discrimination. This concept recognises that there are times when the differences between the way in which access operators, on the one hand, and Royal Mail Retail, on the other hand, access Royal Mail's network are justifiable. It also recognises that there are times when the differences are immaterial so far as access operators' ability to compete against Royal Mail. In such cases, ensuring that all terms of access are identical would not provide any benefits.

7.103 We therefore propose including a non-discrimination obligation in the USP access condition against which any allegations that differences in operational terms are important can be assessed with reference to the impact on competition.

7.104 We also consider that issues of non-equivalence should be addressed using either of the two options outlined above and that the choice of option should be made on a case by case basis. We also have a preference for imposing operational or process changes and propose to follow this option where such changes can be made without having an undue impact on Royal Mail's efficiency or threatening its ability to provide the universal service. However, if this option were to represent an inefficient remedy on a case-by-case basis, then the residual differences could be considered as part of the approach to testing for margin squeeze.

*Question 7.4: Do you agree with our approach concerning the Terms and Conditions for access, including the role of equivalence and the regulation of zonal pricing? If not, please give your reasons. Section 8*

## Section 8

# Regulatory Financial Reporting

## Introduction

- 8.1 As explained in Section 5, we must have regard to the need for the provision of a universal post service to be financially sustainable and efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 8.2 Additionally, as explained in Section 6, we now propose to give Royal Mail greater commercial freedom subject to appropriate regulatory safeguards. It is proposed that these safeguards will include effective monitoring of Royal Mail's behaviour. As explained in Section 6, we consider that there are minimum safeguards that need to be in place for any monitoring regime, including the provision of cost transparency and accounting separation data.
- 8.3 With these broad aims in mind, this section sets out our proposals for a new regulatory financial reporting framework for Royal Mail. Specifically, it considers the appropriate objectives to be addressed by regulatory financial reporting, and the financial reporting requirements necessary to meet those objectives
- 8.4 As explained in more detail below, our main proposals are that we should require Royal Mail to:
- Report separately on the different parts of its business relevant to our regulatory duties;
  - Further improve the documentation of costing and regulatory accounting more generally;
  - Increase the extent of relevant financial information that is published on a regular basis; and
  - Enhance the level of assurance that we can place on the financial information reported for regulatory purposes.
- 8.5 This section should be read in conjunction with Annex 6, which provides additional detail on some of the key proposals and the Regulatory Accounting Guidelines (set out as an Appendix to Annex 6) which sets out the detailed definitions, rules and proformas for the proposed financial reports.

## Background

- 8.6 In the consultation document entitled '*The building blocks for a sustainable postal service – Initial proposals for regulatory safeguards*', published in April 2011<sup>52</sup> Postcomm set out a range of proposals designed to ensure that Royal Mail's regulatory financial reporting requirements would be consistent with the evolving

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<sup>52</sup> <http://www.psc.gov.uk/documents/1885.pdf>

regulatory framework. These proposals concerned revenue measurement, costing (in particular zonal costing and overhead allocation guidance), accounting separation definition and implementation, transfer pricing guidance (to implement accounting separation) and LRIC data.

- 8.7 In response, Royal Mail set out its own proposals for a package of financial transparency safeguards to allow stakeholders to understand its efficiency and how it is performing financially. Other responses were broadly supportive of the accounting separation and cost transparency proposals but there were some concerns that the proposed regime should be implemented and allowed to become well established before any ex-ante controls are removed.
- 8.8 The proposals set out in this section draw on the initial proposals by Postcomm, and responses to those proposals, while taking account of the specific proposals set out in the other sections of this document.

## Objectives for regulatory financial reporting

- 8.9 In this Section, we set out our proposals for regulatory financial reporting from 2012-13 onwards, building on Postcomm's experience and initial proposals. We have developed these proposals by seeking to address a number of regulatory objectives, as described below.
- 8.10 As explained in Section 5 of this document, section 29(3) of the Act provides that, in performing our duty under section 29(1) (to carry out our functions in a way that we consider will secure the provision of a universal postal service) we must have regard to the need for the provision of a universal post service to be financially sustainable and efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times. We therefore consider that the objectives for the regulatory financial reporting should include the following:
- **Monitoring the financial sustainability of universal service provision.** As explained in Section 5, we need to be able to monitor both the ability of the activities used to provide the universal service to be financeable and earn a reasonable commercial return, and the ability of the entity with access to external financing (Royal Mail Group Limited, "RMG", the company with the universal service obligation) to continue to finance its activities; and
  - **Monitoring the efficiency of universal service provision.**
- 8.11 As explained in Sections 6 and 7, we now propose to give Royal Mail greater commercial freedom subject to appropriate regulatory safeguards, including effective monitoring of Royal Mail's behaviour. As explained in Section 6, we consider that there are minimum safeguards that need to be in place for any monitoring regime, including the provision of cost transparency and accounting separation data. With this in mind, we consider that the objectives should include the following:
- **Understanding how costs and revenues are apportioned** to different products and activities within the integrated Reported Business as defined below, given that the activities are used to provide both universal services and a range of other services in markets with different competitive conditions, including downstream services to access operators.

- **Monitoring the relative profitability of different product groups** sharing these specific groups of activities, to allow us to assess relative cost orientation of general pricing levels, apply margin squeeze tests, ensure the promotion of effective competition where appropriate and, where relevant assess appropriate ex ante safeguards in relation to universal service provision.

- 8.12 In developing our proposals, we also consider that we should have regard to the key characteristics of “good” financial information. For example, we consider that the information provided by Royal Mail should be reliable and timely if it is to provide us with an early warning of any emerging concerns and issues and assist us with any timely intervention.

*Question 8.1: Do you agree with the objectives for regulatory financial reporting that we have set out above? Please provide details to support your response.*

## Proposals

- 8.13 Our regulatory financial reporting proposals, set out in this section and its supporting Annex are summarised below:

- **The Relevant Group** is defined for regulatory financial reporting obligations is to be RMG and all of its subsidiary and associated undertakings, excluding POL;
- **The Reports for the Relevant Group** should be accounts, annual updates to the Strategic Plan, and quarterly cash flow projections for the Relevant Group which should be provided to assist in the monitoring of the overall financeability of the universal service provider;
- **The definition of Reported Business** for the remaining regulatory financial reporting obligations should correspond to the scope of activities in Royal Mail’s integrated costing methodology to assess the financial sustainability and efficiency of the activities required for the provision of the universal service;
- The **Reported Business Financial Statements** should include Quarterly unaudited, and annual audited, income statement information to the level of Earnings before Interest and Tax (EBIT), and consistent operational balance sheet and cash flow information;
- **Splits of the Reported Business Financial Statements** should include quarterly unaudited, and annual audited, information to the level of EBIT, split between USO and Non-USO products and for non-Mails products;
- **Comparable information for four separated entities** that we have defined for regulatory financial reporting purposes should be provided to Ofcom;
- **Product Profitability Information** which is quarterly unaudited, and annually audited, should be provided on the basis set out in this section;
- **Royal Mail’s costing methodology** should be updated in 2012-13, in particular to reflect our proposals to extend the scope of regulatory oversight to zonal costing;

- **Royal Mail should prepare documentation and manuals**, containing appropriate levels of detail, to address the remaining areas of regulatory financial reporting and include within the Accounting Methodology and Costing Manuals;
  - **Assurance arrangements** should be revised, in particular a move to a tri-partite reporting arrangement for 2012-13 and a subsequent move to a 'fairly represents' form of audit opinion; and
- 8.14 The scope, content, and level of detail of the draft content of the USP Accounting Condition and supporting Regulatory Accounting Guidelines setting out the basis by which Royal Mail implement our proposals in its regulatory financial reporting for 2012-13 should reflect those set out in this document.
- 8.15 The proposed financial reporting requirements are summarised below and set out in more detail in Tables 1 to 5 in Annex 6. For convenience, we have grouped the requirements into categories by reference to the objectives that are addressed by each requirement, although some information will inevitably be relevant to more than one of the stated objectives.
- 8.16 For each proposed report, the tables below provide a reference to the relevant pro forma or explanation in the draft Regulatory Accounting Guidelines (described below) and the scope of the proposed report, by reference to the part of the business to be covered by that report. The tables in Annex 6 provide additional information on the proposed requirements relating to each report, including the proposed frequency of reporting, whether the information needs to be audited and/ or published, and whether it represents a new requirement for Royal Mail or the continuation of an existing obligation.
- 8.17 For the purpose of monitoring financial sustainability, we propose monitoring financial sustainability at two levels: at the level of the Relevant Group (which we propose to be RMG excluding POL, as explained below), and at the level of the integrated business activities used for universal service provision. In respect of the requirements relating to the Relevant Group, our proposals are summarised in the table below and set out in more detail in Table 1 in Annex 6.

Entity	Requirement	Format – see Appendix 1 of Annex 6	Frequency
Relevant Group	Consolidated income statement	A7.16 – Figure 1	Annual
	Consolidated balance sheet statement	A7.16 – Figure 2	Annual
	Consolidated cash flow statement	A7.16 – Figure 3	Annual
	Consolidated quarterly cash flow projection statement	A7.16 – Figure 4	Quarterly & Annual
	Strategic Business Plan	A7.16 – Figures 1-3	Annual

- 8.18 To further inform our understanding of financial sustainability and to inform our assessment of the efficiency of universal service provision, we need to focus on the specific revenues and costs of the integrated network activities within Royal Mail Group Limited that are used to provide the universal service (which we term in this

section the Reported Business). These proposals are summarised in the table below and set out in more detail in Table 2 in Annex 6.

Entity	Requirement	Format – see Appendix 1 of Annex 6	Frequency
Reported Business	Annual Income statement (to EBIT only)	A7.16 – Figure 5	Annual
	Annual Income statement for USO, non-USO and non-Mails (to EBIT only)	A7.16 – Figure 6	Annual
	Annual reconciliation of income statement (to EBIT only)	A7.16 – Figure 7	Annual
	Annual balance sheet statement	A7.16 – Figure 8	Annual
	Annual reconciliation of balance sheet statement	A7.16 – Figure 9	Annual
	Annual cash flow sheet statement	A7.16 – Figure 10	Annual
	Annual reconciliation of cash flow sheet statement	A7.16 – Figure 11	Annual

8.19 We propose that, to further inform our understanding of the basis of allocation of costs and revenues, we need to monitor the financial performance of reporting entities within the Reported Business by grouping together the relevant activities used for different types of service (downstream versus upstream single piece and bulk services, and competitive end to end services). These proposals are summarised in the table below and set out in more detail in Table 3 in Annex 6.

Entity	Requirement	Format – see Appendix 1 of Annex 6	Frequency
Reported Business - Separated	Annual Income statement - separated ( to EBIT only)	A7.16 – Figure 5	Annual
	Quarterly Income statement - separated ( to EBIT only)	A7.16 – Figure 5	Quarterly
	Quarterly reconciliation of income statement - separated (to EBIT only)	A7.16 – Figure 5	Quarterly
	Annual balance sheet statement -separated	A7.16 – Figure 8	Annual
	Annual cash flow sheet statement - separated	A7.16 – Figure 10	Annual

8.20 The information summarised below and set out in more detail in Table 4 in Annex 6 will help us to monitor the relative profitability of different product groups and better

understand the financial consequences of Royal Mail’s participation in the segments of the rapidly evolving postal market, and allow us to track the progress of the ongoing operational modernisation and structural reorganisation of Royal Mail as it affects the overall financeability and efficiency of the Reported Business.

Entity	Requirement	Format – see Appendix 1 of Annex 6	Frequency
Reported Business - Separated	Annual product profitability statements	A7.16 – Figure 12 .	Annual
	Quarterly product profitability statements	A7.16 – Figure 12.	Quarterly
	Monthly revenue and traffic information	As currently prepared	Monthly
	Annual outputs of RM costing system	As currently prepared	Annual

8.21 We will also expect to require quarterly updates of the costing and accounting methodology manuals, as set out in Table 5 in Annex 6.

*Question 8.2: Do you agree that our regulatory financial reporting proposals, set out in this section and the supporting Annex, are appropriate and proportionate? Please provide reasons and evidence to support your views.*

8.22 The remainder of this Section considers the proposed requirements in more detail. Specifically, it considers the following:

- The detailed requirements, definitions, rules and proformas for the financial information, as set out in the **Regulatory Accounting Guidelines**;
- The **scope of the proposed reports**, by reference to the part of the business to be covered by each report; and
- **Other requirements** relating to each report, including the proposed frequency of reporting, whether the information needs to be audited and whether it should be published or provided only to Ofcom.

## Regulatory Accounting Guidelines

8.23 The detailed requirements, definitions, rules and pro formas for the financial information that we propose will be required from Royal Mail to implement the new regulatory financial reporting framework are set out in a draft set of Regulatory Accounting Guidelines attached as Appendix 1 to Annex 6.

8.24 The draft Regulatory Accounting Guidelines set out our proposals for the detailed reporting requirements and rules that we consider should be contained in a USP accounting condition imposed under section 39 of the Act, as further considered in Section 9 of this consultation.

- 8.25 We propose that the final requirements, definitions, rules and proformas will be similar to those set out in this draft, although the final structure and hierarchy for these requirements will be subject to further consultation, as set out in more detail in Section 9.
- 8.26 The draft Regulatory Accounting Guidelines also subsume the guidelines already in place for Royal Mail's national product costing system (i.e. the Guiding and Methodological Principles) as well as setting out the relevant principles for zonal costing, revenue apportionment, and balance sheet and cash flow accounting. We set out our proposals for national costing in Annex 6.
- 8.27 For zonal costing we propose that the national costing rules are applied but extended to cover the necessary mark ups and mark downs necessary to reflect geographical cost differences. These zonal costing rules are included within the Regulatory Accounting Guidelines along with the National Costing Rules. Royal Mail will be required to update and document its Costing Methodology to include the implementation and use of these zonal costing rules in setting access prices.
- 8.28 In its April consultation, Postcomm considered a range of options that could be applied to the future regulatory oversight of Royal Mail's zonal costing methodology for regulatory financial reporting purposes, to support the regulatory framework for 2012-13 onwards. As explained in Annex 6, our specific proposals for 2012-13 onwards comprise defining an appropriate set of zonal costing principles as part of our anticipated Regulatory Accounting Guidelines, reviewing Royal Mail's existing model and its supporting documentation for compliance with these principles, and then requiring by March 2012 the Costing Manual to be updated (and subsequently maintained) to include the documentation of a zonal costing methodology which complies with the relevant regulatory costing principles in the RAG. These proposals are discussed in further detail in Annex 6.

*Question 8.3: Do you agree with our proposals on the rules and requirements contained in the draft Regulatory Accounting Guidelines and do you consider that they are likely to provide an appropriate and proportionate level of cost transparency and accounting separation?*

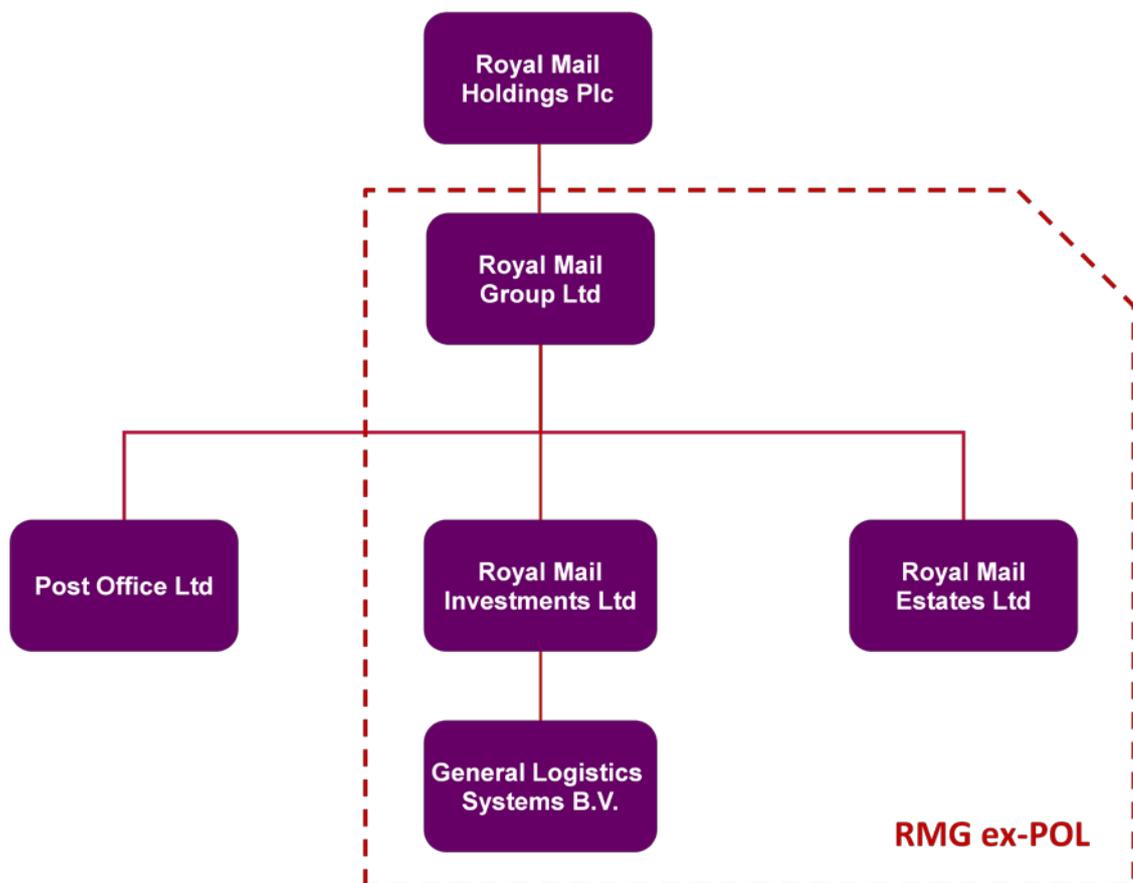
## Scope of reports

- 8.29 We have considered the proposed scope for each of the proposed reports by reference to the entity within the Royal Mail Group for which the report should be prepared.
- 8.30 The proposed scope for the various reports is at one of three levels, as follows:
- The Relevant Group;
  - The Reported Business; and
  - The separated Reported Business (i.e. "Accounting Separation").
- 8.31 The definitions of these three terms, and the rationale for those definitions and the proposed accounting obligations are set out in detail in Annex 6 and summarised briefly below.

## The Relevant Group

- 8.32 We need to properly understand and monitor the financial sustainability of the provision of the universal postal service by taking into account (among other things) Royal Mail's ability to borrow funds or to raise external finance in the market place.
- 8.33 As illustrated in Figure 1 below, we propose that the regulatory accounting obligations enabling us to carry out the assessment of the company's ability to raise external finance should apply to information relating to RMG and all of its subsidiary and associated undertakings excluding POL – which is currently subject to separate funding and financing arrangements and is proposed to remain so, as a separate publicly-owned company in due course. We refer to this consolidated regulatory financial reporting entity as “the Relevant Group” in the remainder of this Section and in Annex 6.
- 8.34 We explain in Annex 6 why we consider that the Relevant Group is the appropriate regulatory financial reporting entity for an overall financeability assessment.

**Figure 1: Corporate structure of Royal Mail, showing the Relevant Group (excluding POL)**



- 8.35 As set out in more detail in Annex 6, the financial information which we propose that Royal Mail should be required to provide to Ofcom should include the following consolidated accounts for the Relevant Group:

- Consolidated income statement, consolidated balance sheet statement and consolidated cash flow statement; and
  - Consolidated quarterly cash flow projections statement – to show a quarterly cash flow forecast for the next two years on a rolling basis, updated every quarter.
- 8.36 The proposed basis of preparation, explanation, notes, proforma and reconciliation is set out in the draft Regulatory Accounting Guidelines in Annex 6.
- 8.37 Additionally, we propose that Royal Mail should be required to provide to Ofcom, on a confidential basis, the information in its Plan on an annual basis supplied in a format consistent with these accounts for the Relevant Group

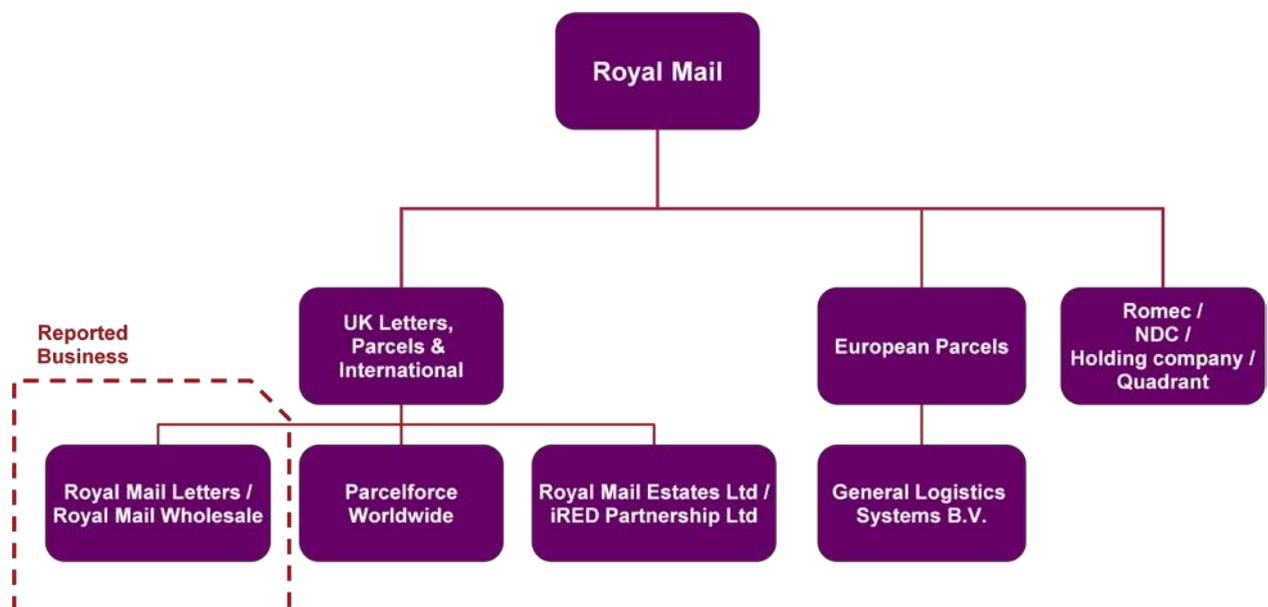
### **The Reported Business**

- 8.38 The activities undertaken by other corporate entities owned by RMG (such as General Logistics Systems B.V, the European parcels and logistics business), and the non-Letters activities of RMG itself are not currently used to support the provision of universal services, and are not included in the scope of Royal Mail's FAC costing system currently subject to regulatory oversight.
- 8.39 Therefore, at this stage, there appears to be a limited need for additional regulatory reporting requirements at these levels, other than at the Relevant Group level discussed above, in terms of understanding the basis of RMG's overall financing and its effect on the financial sustainability of the universal service.
- 8.40 We therefore propose that in other respects the scope of the regulatory financial reporting for the 2012-13 financial year onwards, including regulatory financial statements (income statement to EBIT level, and associated operating balance sheet and cash flow) should remain the activities undertaken by RMG's Letters business. We have termed this scope of activities for regulatory financial reporting purposes the "Reported Business".
- 8.41 We consider that the scope of the Reported Business should be such that it enables us to discharge our statutory duties, particularly our duty in section 29 of the Act to carry out our functions in relation to postal services in a way we consider will secure the provision of a universal postal service, having regard to (among other things) the financial sustainability and efficient provision of this service, as well as our other considerations, including promoting competition where appropriate.
- 8.42 In light of these duties, we propose that the scope of the Reported Business for financial reporting purposes for the 2012-13 financial year onwards should be the activities and services that have in the past been undertaken by the Letters business (including the downstream services sold to external customers via the Royal Mail Wholesale unit). The costs of these activities are recorded in a single integrated general ledger, and are included in the published Costing Manual which documents Royal Mail's FAC costing system for regulatory purposes.
- 8.43 The proposed scope, described in more detail in Annex 6, would mean that the Reported Business would exclude the activities undertaken by the following legal entities within the corporate structure under RMG (see Figure 2 below):
- Post Office Limited ('POL')

- Royal Mail Estates Limited ('RME')
- Royal Mail Investments Limited and its subsidiary undertaking, General Logistics Systems B.V.
- other subsidiary and associated undertakings of RMG, including iRED Partnership Limited (see Figure 2 below)

8.44 Further, in the context of Royal Mail's current organisational structure, our proposed scope of the Reported Business would also exclude the activities undertaken by ParcelForce Worldwide ('PFW') within the UKLPI operating unit.

**Figure 2: Proposed scope of the Reported Business**



8.45 In Annex 6, we expand upon our reasons for excluding RME assets from the scope of the Reported Business for regulatory financial reporting purposes, even though these assets are included in UKPLI for statutory reporting purposes.

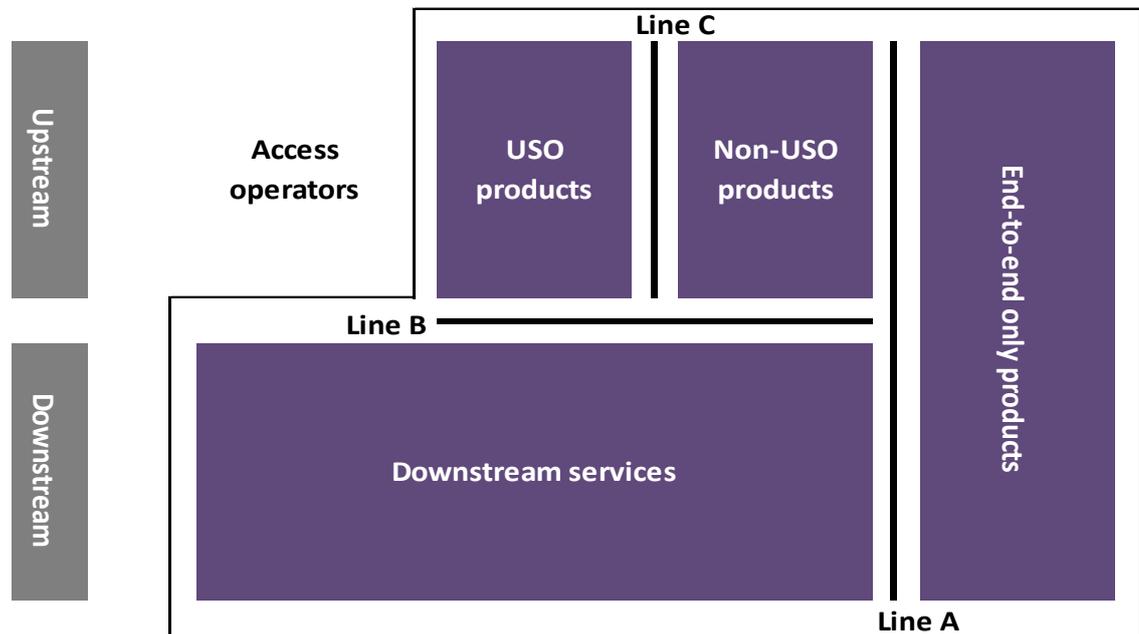
### **The Separated Reported Business (Accounting separation)**

8.46 Accounting separation involves requiring Royal Mail to produce separate financial statements for different parts of the wider RMG legal entity, and the Reported Business, which should be treated differently for regulatory purposes or that have different regulatory significance.

8.47 The Act provides us with a power to require the universal service provider to maintain a separation for accounting purposes between such different matters as we may direct. This power includes the possibility to require the separation to be maintained in relation to different services, facilities or products or in relation to services, facilities or products provided in different areas, together with requirements about the accounting methods to be used in maintaining the separation.

- 8.48 The reporting of most of the operating costs of the Reported Business for regulatory financial reporting purposes is currently supported by an integrated general ledger and product costing system. However, not all of these costs are attributed to activities that are currently related to the provision of a universal postal service, although where costs are shared, they are currently shared according to rules set out in the Initial Conditions carried over from Royal Mail's Licence.
- 8.49 We therefore consider that there is a need to separate, and by doing that understand, the respective profitability and cash contributions of the activities required for the universal postal service and the other business activities of the Reported Business.
- 8.50 Consequently, for the purpose of carrying out an effective financeability assessment of the provision of the universal postal service, we also consider it is necessary to understand how cash is spent and financed by the activities required for the universal postal service (as opposed to other activities and services) and how assets and costs which are required both for the provision of the universal postal service and for the provision of other services are shared between the services concerned.
- 8.51 We therefore propose that Royal Mail should be required to provide separate capital employed statements (as components of full balance sheets) and operating cash flow statements, as well as separate income statements before financing, for the Reported Business and separated financial reporting entities within it. As explained in Annex 6, this should only be down to the EBIT level of profitability.
- 8.52 Within the Reported Business, we therefore propose to require the provision of separated financial statements for four component entities for regulatory financial reporting purposes, as shown below. As set out in Annex 6, and illustrated in Figure 3 below, this would be achieved by dividing the financial statements of the Reported Business (income statement, balance sheet and operating cash flow) into four consistent components along the following lines:
- **Line A**, which delineates separation to be maintained for products that do not require the benefit of access to Royal Mail's integrated core universal service network;
  - Line B, in relation to Royal Mail's end-to-end products where competition is based on the provision of access to the core universal service network); and
  - Line C, which delineates separation to be maintained for USO retail products from other retail products using Royal Mail's core universal service network.

**Figure 3: Separated accounting entities**



- 8.53 These proposed separations of the Reported Business for 2012-13 were set out in the April consultation, where the rationale and objectives for the required Lines A, B and C were set out in further detail.<sup>53</sup>
- 8.54 We have reviewed the appropriateness of these proposed separations in light of our other proposals in this consultation and having considered consultation responses received by Postcomm.
- 8.55 Royal Mail identified three primary issues with requirements such as those proposed above. Specifically, Royal Mail has argued that:
- publication of this level of information will have unintended consequences which could jeopardise the financing of the universal service obligation;
  - the proposed approach of separating the business into the four entities is not consistent with a commercial return on the costs and could lead to perverse incentives; and
  - the proposal raises key issues of practicality and value of the information.
- 8.56 We understand that Royal Mail's arguments reflect a concern that the proposals will require the publication of financial information based on artificial allocations that do not reflect the true cost of providing the universal service, and that such information

<sup>53</sup> *The building blocks for a sustainable postal service, Annex B: Cost transparency and accounting separation*, April 2011, pages 37-41: <http://www.psc.gov.uk/documents/1891.pdf>

would not help Ofcom meet its duties and could be misinterpreted by third-parties such as potential investors.

- 8.57 In light of our experience of regulating other industries, we consider that Royal Mail's concerns about the way regulatory accounting information will be interpreted by third parties may be overstated. Similarly, we do not share Royal Mail's concern that Ofcom (or indeed Royal Mail) might find itself pressurised into making inappropriate decisions as a result. We also do not consider that the scope for inappropriate allocation bases to deliver misleading results is likely to be as significant as Royal Mail predicts.
- 8.58 Nevertheless, in reaching our final conclusions on accounting separation we will take into account concerns and views from Royal Mail and other stakeholders to ensure that the accounting separation requirements address our requirements and are appropriate and proportionate.
- 8.59 With this in mind, we intend to work with Royal Mail over the months ahead to better understand its concerns and how they might be managed when we finalise our requirements and the basis of their implementation.

*Question 8.4: Do you agree with our proposals set out above in relation to accounting separation? Are there any further risks that you think Ofcom needs also to consider in making decisions in this area? To the extent that you consider there to be risks associated with our proposals, how do you consider they might best be addressed?*

## Financial statements

- 8.60 To give effect to our accounting separation proposals, we consider that regulatory financial statements should be prepared by Royal Mail for each of the four component separated regulatory financial reporting entities within the Reported Business as described above.
- 8.61 As explained in Section 6, we propose that the above-mentioned financial statements should consist of (i) annual and quarterly income statements to EBIT level, (ii) annual balance sheets showing the operational assets and working capital, and (iii) annual cash flow statements showing operating cash flows.
- 8.62 We also propose that Royal Mail should be required to produce product profitability splits within the separated accounting entities defined by the core Lines A, B and C. These splits are designed to assist us in assessing the relative profitability of the different types of products sharing the use of the core universal service network, which are sold in a range of different market and regulatory environments. The proposed specification of Line A and B, and of Line C is considered in more detail in Annex 6.
- 8.63 Annex 6 also sets out more information relating to our proposals, including a discussion of
- additional income statements;
  - reporting of product profitability; and
  - the impact of the proposals on current accounting separation.

## Other requirements

- 8.64 The Initial Conditions require the publication of audited annual regulatory financial statements for Royal Mail's Letters business and within it for specified groups of Mails services undertaken by this business: universal services, other licensed services, access services and price controlled services.
- 8.65 In addition, Postcomm has previously required Royal Mail to publish the unaudited profitability of specified services as a condition of waiving price transparency conditions for the services concerned, and for 2011-12 required quarterly unpublished unaudited profitability statements for certain packets and parcels services as a consequence of removing ex ante price control and publication requirements on some services.
- 8.66 Postcomm has also received a variety of detailed confidential supporting regulatory financial reporting information from Royal Mail, some of which is also audited. These requirements for 2011-12 regulatory financial reporting are retained under the Initial Conditions.
- 8.67 The regulatory financial reporting arrangements for the 2012-13 financial year onwards are proposed to be a key part of Ofcom's new regulatory framework. We propose that Royal Mail should be required to prepare its regulatory financial reports for Ofcom for 2012-13 in accordance with our proposed Regulatory Accounting Guidelines.
- 8.68 Specifically, we propose that the Regulatory Accounting Guidelines should include guidelines about how all components of the regulatory financial reports (including national and zonal costing) should be prepared, including the basis on which the financial performance of the separated entities within the Reported Business should be accounted for. We describe our more detailed proposals in relation to the key components of the proposed Regulatory Accounting Guidelines in Annex 6.
- 8.69 In the following paragraphs, we set out our proposals for these reporting arrangements, to enable Royal Mail sufficient time to put them in place before the start of the 2012-13 financial year (subject to Ofcom reflecting consultation responses in its final decision in the new year), if we decide to adopt this approach.
- 8.70 Our proposals address, in particular, the following key issues:
- the **frequency and timing** of these reports;
  - the **assurance** provided as to the accuracy and presentation of the reports;
  - the extent of **publication** of the reports.
- 8.71 We have considered the responses to Postcomm's April consultation covering these issues, in developing the following proposals for the new reporting and disclosure framework. We have also considered the findings of a follow-up review of further work performed by Postcomm in respect of its proposals, which Deloitte undertook for Postcomm, following its earlier work in support of its April proposals. A copy of the most recent Deloitte report has been published alongside this consultation.

## Frequency

- 8.72 We propose that all the balance sheet and cash flow statements should be prepared annually, to allow monitoring of Royal Mail's financial position as it relates to the financeability of the universal service and provided, along with the associated audited income statements, within four months of the year end (as now).
- 8.73 In addition, we propose that the income and product profitability statements should be prepared quarterly on an unaudited basis, to allow us to monitor the financial consequences of Royal Mail's participation in the segments of the rapidly evolving postal market relevant to our duties, as well as to track the progress of the ongoing operational modernisation and structural reorganisation of Royal Mail as it affects the overall financeability and efficiency of the Reported Business, and hence its ability to provide the universal service via its activities.
- 8.74 As regards the existing detailed unpublished supplementary information supporting the regulatory accounts, we propose that they should be provided to us monthly, quarterly and annually as appropriate, on a similar basis to existing reports, as set out in Annex 6.
- 8.75 The current requirement is for annual audited regulatory accounts to be provided within four months of year-end. As noted above, we are not proposing to change this requirement for the 2012-13 financial year. Royal Mail's existing regulatory commitments include the provision of quarterly profitability statements within 2.5 months of quarter-end in 2011-12 (except for the first quarter, which is 3.5 months).
- 8.76 Accordingly, we propose that the more extensive quarterly financial information set out in the above proposals should be provided within 3 months of quarter-end in 2012-13.

## Assurance

- 8.77 Currently, Royal Mail's own external auditors report on whether the regulatory financial statements have been prepared in accordance with:
- the requirements set out in the Initial Conditions (as a continuation of the requirements in the Licence Condition 15), and
  - the 'Regulatory accounting principles and basis of preparation' document set out as part of the regulatory accounts.
- 8.78 The above two existing requirements are, put together, less extensive than those in Appendix to Annex 6. In particular, the principles applied for preparation of the balance sheets and cash flow statements (including the current extent of separation of the overall RMG balance sheet) are less developed than are now being proposed for the Regulatory Accounting Guidelines.
- 8.79 With respect to the 2012-13 financial year, we propose that the basic initial audit opinion provided by the auditors of the annual and quarterly regulatory accounts (as defined above) should address whether the accounts have been "properly prepared", in all material respects, in accordance with the Regulatory Accounting Guidelines

(that is, the opinion should be of the form currently provided by Royal Mail's auditors).

- 8.80 For this purpose, we consider that a clear definition of materiality is required. We consider this, alongside other details relating to the proposed audit requirements, in Annex 6.
- 8.81 At this stage, we consider that, in the short term, it may not be practical to require the full form of a "fairly represents" opinion similar to that provided by the auditors of BT regulatory accounts, as this requires the auditors to review the underlying bases of the data used, which may well not be practical in the limited time now available.
- 8.82 However, we would expect a move to the full "fairly represents" audit opinion, potentially on a phased basis, in 2013-14. The transition may start with the key reports (the accounts for the Reported Business and the separated entities) and then be extended to other reports (e.g. product profitability statements).

## Publication

- 8.83 We have considered the responses to the Postcomm's consultation, as well as Deloitte's reports<sup>54</sup> (in particular the results of its survey of relevant precedents) in developing our proposals with respect to disclosure.
- 8.84 As explained in more detail in Annex 6, we propose that Royal Mail should publish the following regulatory reports:
- annual audited and quarterly unaudited income statements, and annual balance sheets, and operating cash flow statements for the Reported Business and the four separate regulatory financial reporting entities;
  - annual audited and quarterly unaudited income statements for universal service and non-Mails products;
  - annual audited and quarterly unaudited product profitability statements for access, Relay, and PAF.
- 8.85 These reports and the requirements to extend the supporting documentation to cover Royal Mail's Accounting Methodology and Costing Manual are explained in more detail in Annex 6.

## Development of LRIC reporting

- 8.86 We anticipate that any monitoring regime may benefit from the provision by Royal Mail of Long Run Incremental Cost (LRIC) data. The implementation and use of LRIC data to meet our regulatory obligations along with the ways FAC product cost data can be modified to support LRIC was discussed in the Postcomm's April Consultation.
- 8.87 As set out in Section 7 (in respect of margin squeeze and effective end to end competition safeguards), and in delivering the objectives of Section 6 (in respect of

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<sup>54</sup> Royal Mail Accounting Separation, A Report for Postcomm, 6 April 2011.

the effective use of monitoring and competition law as the alternative to price controls), we consider that reliable LRIC data could play an important role to play in the regulatory framework.

- 8.88 LRIC offers a benchmark for setting a floor below which Royal Mail should not ordinarily price its retail products or access to its network – depending on the scope of the test required, the definition of the scope of LRIC estimates may vary.
- 8.89 In particular, LRIC data would be useful to ensure that in the long-term Royal Mail sets prices that maintain acceptable minimum headroom between the access price and the equivalent retail price to prevent margin squeeze on competitors seeking to use Royal Mail's downstream services for their own retail offers. In the long-term Ofcom proposes to monitor Royal Mail's compliance with such headroom through regular provision of suitable costing information from Royal Mail. We have proposed in Section 7 a regime based on Fully Allocated Costs, however robust and transparent LRIC data is likely to be more relevant.
- 8.90 As well as helping to safeguard against the risks of margin squeeze and predatory pricing behaviour, typically to support any investigations of anti-competitive behaviour, LRIC-based evidence data could also be used to help monitor efficient cost orientated universal service prices and more generally provide information to guard against the risks of excessive pricing and cross subsidisation.
- 8.91 In the months ahead, we intend to work with Royal Mail to better understand how it currently generates LRIC data and how it intends to do so in the future. As discussed in Section 7 and Annex 7, we then expect to review the basis of margin squeeze protection before 2014/15.
- 8.92 In the meanwhile, we expect in light of (i) our proposals relating to access pricing, and (ii) the potential for a further reduction of the margin we would expect to see between retail and access prices for relevant products, Royal Mail will consider it to be in its own interest to continue to develop and maintain a reliable basis for deriving LRIC data. However, as part of our review of LRIC data requirements, we will consider the need for more specific requirements to be imposed on Royal Mail.

## Section 9

# Proposals for a package of measures

- 9.1 We have set out in the previous sections a range of regulatory measures to secure our statutory duties and regulatory objectives. In Section 3 we summarised the key features of the legal framework and explained the relevant duties applicable to Ofcom's regulation of the postal sector.
- 9.2 In particular we explained our duty under section 29(1) of the Act to secure the provision of a universal postal service and the need, in performing our duty to have regard to the need for the provision of a universal service to be both:
- Financially sustainable; and
  - Efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 9.3 In this Section, we bring together the package of measures that we currently consider is likely best to meet our statutory duties, and assess them against the various requirements set out in the Act relating to the imposition of regulatory conditions.

## Summary of proposed measures

- 9.4 In the preceding Sections of this consultation document we have identified a number of possible measures that we could consider imposing, and have provisionally concluded that the following represent the most appropriate package of measures:
- A regulatory condition imposed under s.36 of the Act to require the designated universal service provider, Royal Mail, to provide the universal service to the specified standards, and as part of the above condition, a control on the price of second class stamps to ensure an affordable service, particularly for vulnerable consumers;
  - A regulatory condition imposed under s.38 of the Act requiring Royal Mail to provide access to its postal network to other postal operators or users of postal services, and as part of the above condition, a control on the price charged for access to prevent a margin squeeze;
  - A regulatory condition imposed under s.39 of the Act requiring Royal Mail:
    - a) to maintain a separation for accounting purposes between such different matters as Ofcom may direct;
    - b) to comply with rules made by Ofcom in relation to the identification of costs, cost orientation, and the use of cost accounting systems; and
    - c) to secure that its compliance with the above is audited annually.
- 9.5 We have set out below our assessment of how our proposals meet the specific legal tests set out in the Act which we must satisfy in order to impose conditions such as these. We also note the requirements set out in Schedule 6 of the Act that we may only impose a regulatory condition if we are satisfied that the condition:

- i) is objectively justifiable;
- ii) does not discriminate unduly against particular persons or a particular description of persons;
- iii) is proportionate to what it is intended to achieve; and
- iv) is transparent in relation to what it is intended to achieve.

9.6 We address these requirements below in relation to each proposed condition.

**Designated USP condition under section 36 of the Act (DUSP) requiring Royal Mail to provide the universal service to the specified standards, including a control on the price of second class stamps**

- 9.7 Section 31 of the Act sets out requirements that must as a minimum be included in a universal postal service. These minimum requirements meet the requirements of the Directive. As we explained in previous sections the Act requires Ofcom to secure the provision of a universal postal service and to set out in a universal postal service order a description of the services that should be provided in the universal service, and the standards with which these services must comply.
- 9.8 Section 36 of the Act gives Ofcom the power to impose a designated USP condition (DUSP condition) on a universal service provider. Section 36(3) of the Act provides that Ofcom may impose a DUSP condition only if Ofcom considers it is necessary to do so in order to secure the provision of a service of a description set out in the universal postal service order in accordance with the standards set out there.
- 9.9 As explained in earlier sections of this consultation document, in order to meet our primary duty under the Act we consider that a DUSP condition is necessary to require the provision of the universal service to the minimum required standards. As set out in Section 6 we also propose to include as part of that DUSP condition, a control on the price of second class stamps.
- 9.10 We have set out our view in previous sections that absent an obligation to do so, Royal Mail would be left to provide the universal service to the standards required and to implement the universal service order as it determines appropriate. Such an approach while giving Royal Mail maximum freedom would provide no guarantee that the universal service would be provided, nor any guarantee as to the level of pricing of any of its constituent elements. Adopting such an approach would risk Ofcom failing to carry out its functions in a way that it considers will meet its primary duty to secure the provision of a universal postal service, and would risk not providing appropriate protection for customers, in particular vulnerable consumers.
- 9.11 We consider that a DUSP condition as described above meets the relevant tests set out in Schedule 6 of the Act in that it is objectively justifiable, non-discriminatory, proportionate and transparent.
- 9.12 We consider that a DUSP condition as described above would be objectively justifiable: while Ofcom could investigate and after consultation, impose a DUSP condition, if Royal Mail was failing to provide the universal service, any such obligation would take effect after the identified failure to provide the universal service potential had occurred. In order to ensure continued provision of the universal service, it is in our view necessary and justified to require this of Royal Mail by

imposing a DUSP condition. The control on second class stamp prices would also provide a safeguard to ensure that vulnerable customers will continue to have access to a basic universal service product without significantly limiting Royal Mail's overall pricing freedom.

- 9.13 We consider that a DUSP condition as described above would not be discriminatory. The Act provides that the provision of the universal service to specified standards can only be required of a universal service provider, and Royal Mail is (and will remain for some time) the only universal service provider. There is therefore no other person on whom such an obligation could be imposed.
- 9.14 We consider that a DUSP condition as described above would be proportionate to what it is intended to achieve. In our view, this is the least onerous obligation needed to secure the provision of the universal service, and the protection that will be afforded to users of the universal service is proportionate to the regulatory burdens that will be imposed on Royal Mail as a result.
- 9.15 Finally, we consider that the proposed obligation will be transparent. This transparency consideration will be fully taken into account, once we have published for further consultation on the proposed wording of the DUSP condition.

#### Price control on Second Class stamps to ensure affordability, in particular for vulnerable consumers

- 9.16 For the reasons set out in section 6, we are proposing to include in a DUSP condition a control on the price of second class stamps.
- 9.17 Section 36 of the Act sets out the permitted subject-matter of a DUSP condition, including tariffs to be used for determining prices in accordance with which a universal postal service, or part of a universal service, is provided (section 36(4) of the Act).
- 9.18 Section 36(5) of the Act provides that, in exercising the power conferred by section 36(4), Ofcom must seek to ensure that the prices are affordable; the prices take account of the costs of providing the service or part of a service; and the prices provide incentives to provide the service or part of a service efficiently.
- 9.19 We consider that in order that customers as a whole, and particularly vulnerable customers are protected and have access to universal services, it is necessary to impose a DUSP that caps the price of second class stamp products. We consider that this is consistent with the requirement that where we impose a control on prices, we must seek to ensure that prices are affordable. We also consider that the range of levels at which we are proposing to set the cap, in combination with our other proposals to provide more freedom to Royal Mail to set prices generally, takes account of the costs of providing the service and will help to provide incentives to provide the service in an efficient manner.

#### **USP access condition**

- 9.20 The Act allows Ofcom to impose USP access conditions on the universal service provider. As we explained above, a USP access condition is a condition that requires a universal service provider to do either or both of the following: (a) give access to its postal network to other postal operators or users of postal services; and (b) maintain a separation for accounting purposes between such different matters relating to

access (including proposed or potential access) to its postal network as Ofcom may direct.<sup>55</sup>

- 9.21 Under section 38(4) of the Act, Ofcom may not impose a USP access condition unless it appears to it that the condition is appropriate for each of the following purposes:
- Promoting efficiency;
  - Promoting effective competition; and
  - Conferring significant benefits on the users of postal services.
- 9.22 In Section 7 and Annex 7 of this document we set out our proposal to impose a USP access condition for the purposes of participating in the retail D+2 and later than D+2 letters and large letters markets and we explain why we consider that the three criteria for imposing such a condition are met. Our assessment takes into account Postcomm's preliminary assessment of the application of the three criteria in its March access review consultation<sup>56</sup> which is summarised in Annex 7 along with the further analysis that we have conducted in light of points raised by stakeholders in response to Postcomm's consultation.
- 9.23 In summary, we consider that the three criteria are met for the following reasons:
- Promoting efficiency: we consider that access competition has incentivised Royal Mail to improve its efficiency upstream and that it will continue to do so going forward. In this context, we note that Royal Mail's ability to respond to competition may have been weaker under the current "headroom" regime. However, we consider that the regulatory environment that we are proposing will address that concern. We also note that Royal Mail identified various static inefficiencies in its response to Postcomm's March access review consultation. However, we consider that they are outweighed by the dynamic efficiency of competition.
  - Promoting effective competition: prior to the launch of access in 2003, Royal Mail faced little or no competition in the relevant D+2 and later than D+2 markets. As a result of Royal Mail granting access, access operators now handle around 40% of total letter volumes. Not only has access promoted effective competition in the relevant D+2 and later than D+2 markets, but we also consider that access competition provides a platform for the development of end-to-end competition. Indeed, in the absence of an access regime, we consider that end-to-end competition would not be likely to develop to any material extent.
  - Conferring significant benefits on the users of postal services: we consider that access has conferred significant benefits to users through lower prices, innovation and improved customer service and that it will continue to do so going forward.

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<sup>55</sup> See sections 38(1) and (2) of the Act.

<sup>56</sup> The building blocks for a sustainable postal service – Access Review 2012 Initial Proposals, March 2011

9.24 Section 38(8) of the Act requires that Ofcom must in particular take into account five factors when deciding in a particular case what obligations should be imposed in a USP access condition. The five factors are as follows:

- the technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed access unnecessary;
- the feasibility of giving the proposed access;
- the investment made by Royal Mail in relation to the matters in respect of which access is proposed;
- the need to secure effective competition in the long term; and
- any rights to intellectual property that are relevant to our proposal.

9.25 We consider that these factors indicate that the appropriate point of access for participation in the relevant D+2 and later than D+2 markets is at the Inward Mail Centre. In reaching this view, we agree with Postcomm's preliminary assessment. Postcomm took into account the fact that downstream access users currently inject items at this point shows that it is feasible and identified various reasons why the mail centre network provides a suitable set of premises for such purposes. Postcomm considered various alternative points of access (the Delivery Office, the Outward Mail Centre and the Outward Regional Distribution Centre) and provisionally concluded that they were not as suitable as the Inward Mail Centre. As set out in Annex 7, we have also considered the concerns raised by one operator that other points of Royal Mail's network such as the Delivery Office and Mail Preparation Units may represent suitable alternative access points. However, whether it is appropriate to mandate access at these points depends on the completion of Royal Mail's transformation plan. While we have not excluded mandating access at alternative points to the Inward Mail Centre in the future, we would first need more evidence as to why obliging Royal Mail to offer access at these points satisfies the relevant tests in the Act.

9.26 Ofcom's power to impose a USP access condition is subject to its primary duty to secure the provision of a universal postal service.<sup>57</sup> As set out in section 7 above, we consider that access for the purposes of participating in the relevant D+2 and later than D+2 markets is consistent with our duty to secure the provision of the universal service. We base that assessment on the fact that the costs of access should be relatively limited and that access competition should result in avoided costs for Royal Mail. Provided that the price paid by access operators reflects those avoided costs, Royal Mail should in theory be indifferent to whether access is offered. We note Royal Mail's concerns about the risks to the USO of regulated access. However, given our proposals for Royal Mail to be granted pricing freedom on both retail and access prices, we do not consider that there should be an adverse impact on Royal Mail's finances of providing access.

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<sup>57</sup> See section 29(2) of the Act.

- 9.27 Ofcom is permitted to impose price controls as part of a USP access condition<sup>58</sup>. However, we can only impose price controls if it appears to us that Royal Mail might otherwise fix and maintain some or all of its prices at an excessively high level with adverse consequences for users of postal services; or might otherwise impose a price squeeze (margin squeeze) with adverse consequences for users of postal services.
- 9.28 For reasons explained further in Section 7 and Annex 7, we are only proposing to impose price control measures to address the risk of a price squeeze by Royal Mail against other operators. We consider that the combination of Royal Mail's position in the relevant wholesale (downstream) markets and its vertically integrated structure provide it with both the ability and incentive to squeeze the margin of retail competitors using its downstream access product. It appears to us that such a price squeeze could give rise to adverse consequences for the users of postal services.
- 9.29 We have taken into account the Section 38(8) factors in considering whether to include a price control obligation in the proposed USP condition. We consider that the investment made by the universal service provider, and the need to secure effective competition are relevant to the decision whether to impose a price control obligation. We have provisionally concluded that, in the absence of a price control, competition may not be effective due to Royal Mail's ability to exercise its market power in the wholesale markets. In that context, we have proposed a form of control which gives certainty to Royal Mail that it will be able to change prices to reflect its costs, and therefore which will take account of investment in its network. We recognise that the headroom regime that was put in place in 2006 to address the risks of price squeeze prevented Royal Mail from competing effectively. We consider that the proposed price control measures will address those concerns. In particular, they will give Royal Mail greater freedom to price services than under the existing headroom control. Our proposal to review the regime after 18 months, with the expectation that we should move to a monitoring regime by 2014-15 as set out more fully in section 7 above, shows that we have considered how best to secure effective competition in the long term.
- 9.30 Section 38(6) of the Act requires that, in imposing price controls in a USP access condition in connection with the giving of access to a universal service provider's postal network, Ofcom must have regard to the costs incurred in the provision of that network. We have proposed a margin squeeze test based on an appropriate measure of costs, and therefore having regard to the costs incurred in provision of upstream services.
- 9.31 Section 38(7) of the Act provides that, in imposing price controls in a USP condition, Ofcom may have regard to the prices at which services are available in comparable competitive markets. In Annex 7 of this document we explained that Postcomm had considered the costs of other operators who had entered the retail pre-sorted and high volume unsorted letters and large letters markets. Postcomm noted that other operators had costs that were comparable to, and indeed may be lower than, Royal Mail's and had gained significant market share.

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<sup>58</sup> The permitted subject matter of price controls is further set out in paragraphs 3 to 5 of Schedule 3 of the Act.

- 9.32 On the basis of the information set out above, we consider that including a price control to prevent price squeeze in a USP access condition is appropriate and that the tests for imposing such a price control set by the Act are met.
- 9.33 In addition to the specific tests that have been assessed above, Ofcom must also be satisfied that the general tests that are set out in Schedule 6 of the Act for imposing regulatory conditions are also met in relation to the proposal to impose a USP access condition.
- 9.34 As regards objective justification, we have explained above and in sections 7 and in Annex 7 the reasons why we consider that imposing a USP condition requiring access at the Inward Mail Centre for participation in the relevant D+2 and later than D+2 markets will provide the basis for securing efficiencies, promoting effective competition and conferring significant benefits on users of postal services in accordance with the criteria set out in section 38(4) of the Act.
- 9.35 We have also explained in those sections that access is an important component of competition for post and that it will provide incentives for the provision of the universal service to be financially sustainable, without threatening the sustainability of the universal service. In addition, we have explained the reasons why a price control obligation is necessary in order to protect against the risk of Royal Mail imposing a price squeeze and how such an obligation will give Royal Mail increased commercial freedom in a way that will improve the financial sustainability of the universal service and Royal Mail's ability to respond to competition.
- 9.36 Given the significant benefits that providing access to the IMC for participation in the relevant D+2 and later than D+2 markets is expected to deliver, we have considered whether it would be possible to secure the same benefits without imposing a requirement on Royal Mail to offer access. In this context, we note Royal Mail's claims that it would continue to provide access at the Inward Mail Centre in the event that Ofcom did not require it in circumstances in which it helped to sustain the universal service and it was in its commercial interests.
- 9.37 However, in our view, regulating access through the imposition of a USP access condition enables us to include safeguards which we consider to be important in the current circumstances and which would not otherwise be present. In particular, by imposing a USP access condition on Royal Mail:
- operators will be able to use the dispute resolution process outlined by Schedule 3 of the Act; and
  - we will be able to impose regulation to protect against excessive pricing or price squeeze if necessary.
- 9.38 We also note that Royal Mail has proposed developing an access framework on a voluntary basis that will address dispute resolution, principles and criteria for requests for access, pricing principles and guidelines and timescales for responding to requests for access and handling disputes. However, we consider that any move towards a different approach to the regulation of access, such as the voluntary regime that Royal Mail is advocating, could look very different from the current form of access with consequent impacts on customers and competitors. Thus, even if we concluded that a move to such a regime was appropriate, we would wish to ensure that such a move was gradual in order to avoid a risk of regulatory error. While Royal Mail may also have an incentive to make such changes gradually, we consider that

there is also a possibility that it may have a different incentive to make changes over a shorter period of time in order to disrupt the market and encourage customers to switch to Royal Mail.

- 9.39 Given that we are not confident that Royal Mail will have the incentives to offer adequate wholesale products, including appropriate safeguards, to competitors and that we have not seen any evidence that Royal Mail is engaging with access operators to develop an appropriate access framework, we consider that regulation will continue to be necessary if effective and efficient access competition is to continue and that Ofcom has a role to play in ensuring an orderly transition to a future access regime. We therefore consider that the imposition of a USP access condition is objectively justified.
- 9.40 We consider that the proposed imposition of a USP access condition requiring Royal Mail to offer access at the IMC for participation in the relevant D+2 and later than D+2 markets and the inclusion of a price control within that condition is not unduly discriminatory as it reflects Royal Mail's position as the only postal operator with a downstream delivery network capable of facilitating participation by access operators in the relevant markets.
- 9.41 We consider that imposing such a USP condition is proportionate. We have explained the reasons why regulation will continue to be necessary and why any move to an alternative regime, such as the voluntary access framework that Royal Mail has proposed, would need to be implemented gradually. We have also explained why a USP access condition will enable Ofcom to implement important additional safeguards. Indeed, we consider that, without a USP condition, there is a risk of irreversible and permanent damage to the relevant markets. We therefore consider that the condition that we propose to impose is the minimum necessary in order to safeguard the provision of access and to ensure that the benefits of access competition that we have identified (and that the Act envisages) are capable of being achieved.
- 9.42 We also consider that the proposed price control obligation is proportionate, in that the obligation is necessary given the risks that we have identified that Royal Mail might otherwise impose a price squeeze. We also note that the margin squeeze control that we propose affords Royal Mail more freedom than under the access headroom control which currently applies. We consider that these measures represent the minimum necessary to ensure that access operators are protected against the risk of price squeeze.
- 9.43 We consider that a USP access condition requiring access at the Inward Mail Centre for the purposes of participating in the relevant D+2 and later than D+2 markets would clearly set out Royal Mail's obligations so as to secure maximum transparency possible. The transparency provided by the requirement to provide access will be enhanced through the guidance that Ofcom is proposing to provide. This transparency consideration will be fully taken into account, once we have published for further consultation the proposed wording of the USP access condition.

## **USP accounting condition**

- 9.44 We discuss in Section 8 the need for various regulatory financial reporting obligations that we are proposing to impose on Royal Mail, including their aims and the reasons why we consider it would be proportionate to impose them. We summarise below our main reasons from Section 8 as to why we consider that our proposals meet the

relevant legal tests and duties specified in the Act. This assessment should, however, also be read in light of our overall proposals and considerations set out in this consultation.

- 9.45 We have the power under section 39 of the Act to impose a USP accounting condition on Royal Mail as the universal service provider requiring it:
- to maintain a separation for accounting purposes between such different matters as we may direct for such purposes as we may direct, including separation in relation to different services, facilities or products or in relation to services, facilities or products provided in different areas as well as the accounting methods to be used in maintaining the separation;
  - to comply with rules made by us in relation to those matters about the identification of costs and cost orientation, including the application of presumptions in the fixing and determination of costs and charges for any purpose as well as the publication of such accounts and other information relating to anything required to be done by us in this regard;
  - to comply with rules made by Ofcom about the use of cost accounting systems in relation to those matters, including the application of presumptions in the fixing and determination of costs and charges for any purpose as well as the publication of such accounts and other information relating to anything required to be done by Ofcom in this regard; and
  - to securing that the universal service provider's compliance with those systems is audited annually by a qualified independent auditor<sup>59</sup>, including an obligation to meet the costs of the audit.
- 9.46 Our power to impose a regulatory condition, like a USP accounting condition, includes powers to impose obligations also requiring the universal service provider to comply with directions with respect to the matters to which the condition relates, and also powers to impose obligations with respect to those matters framed by reference to, or conditional on, our consent, approval or recommendation.<sup>60</sup> The process for giving, modifying or withdrawing such directions follows the statutory process for imposing, modifying or revoking regulatory conditions, including to consult for a minimum of 1 month prior to making our decision.
- 9.47 We may, however, impose or modify a regulatory condition only if we are satisfied that the general test set out in paragraph 1 of Schedule 6 to the Act is met. A similar test also applies in giving, modifying or revoking directions.<sup>61</sup>
- 9.48 We propose to implement the proposed main regulatory financial reporting obligations discussed in Section 8 and in Annex 6 by imposing on Royal Mail a USP

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<sup>59</sup> Under section 39, a qualified independent auditor means a person who is eligible for appointment as a statutory auditor under Part 42 of the Companies Act 2006 and, if the appointment were an appointment as a statutory auditor, would not be prohibited from acting by section 1214 of that Act (independence requirement).

<sup>60</sup> Paragraph 2 of Schedule 6 to the Act

<sup>61</sup> Paragraph 4(2) of Schedule 6 to the Act.

accounting condition under section 39 of the Act. In particular, we propose to impose on Royal Mail in the USP accounting condition the main regulatory financial reporting requirements, such as the general definition of the Reported Business, the basic requirements for separated regulatory financial statements, and the basic supporting assurance, disclosure, and reporting frequency requirements.

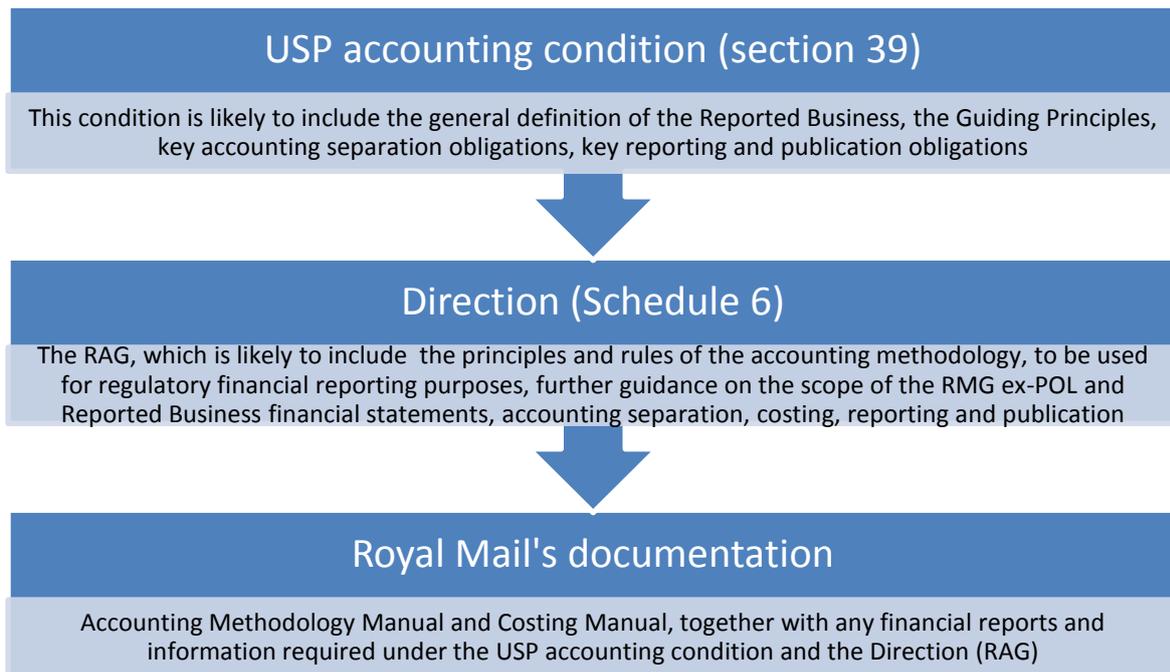
- 9.49 We also anticipate that the Condition will include guidance as to the principles with which the preparation of all regulatory financial reports that are covered by it should comply. These guiding principles, which apply to all areas in regulatory financial reporting, would be comparable to those already in place for national product costing and to support Royal Mail's Accounting Separation Commitments for 2011-12, which are included in Ofcom's initial conditions<sup>62</sup>.
- 9.50 One key requirement under the Condition should be for Royal Mail to undertake its regulatory financial reporting in line with the RAG. In particular, we anticipate that the RAG will set out the guidelines for the preparation of Royal Mail's regulatory financial reports and accounts. We also anticipate that the Condition will require Royal Mail to set out in a new document - the Accounting Methodology Manual - the details of the accounting methodology adopted in order to comply with the RAG.
- 9.51 Our policy proposals in Section 8 have been developed on the assumption that the RAG would subsume the current Methodological Principles for national product costing, and Royal Mail's Accounting Methodology Manual would be produced alongside its existing Costing Manual.<sup>63</sup> We also anticipate that the RAG will encompass more detailed requirements for regulatory financial reporting - with any changes taking effect by Ofcom giving new directions under the Condition to secure compliance with the revised RAG or by modifications to the first direction that secures compliance with the RAG, from time to time). Figure 15 below outlines our above-mentioned intended structure and hierarchy of the regulation for regulatory financial reporting.

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<sup>62</sup> <http://stakeholders.ofcom.org.uk/consultations/postal-regulation/statement/>

<sup>63</sup> In practical terms, under this proposal, the Costing Manual will also continue to be maintained and published by Royal Mail as a separate stand-alone document, with the full version made available to Ofcom.

**Figure 15: Structure and hierarchy of regulatory obligations**



9.52 However, as explained at paragraph 2.13, we are working to publish a further consultation on the proposed regulatory conditions, together with any associated legal instruments (e.g. directions), which proposed conditions and instruments would give effect to our policy proposals set out in this consultation.

9.53 We therefore summarise below our assessment of the relevant legal tests in relation to our proposals set out in Section 8 as a whole, but without seeking to draw a distinction between which of the financial reporting obligations proposed in this consultation will form part of the USP accounting condition itself and which of them will be included in the document containing the RAG as both would be needed to give effect to the proposals in Section 8.<sup>64</sup> In order to provide stakeholders with as much transparency as possible on our thinking on the detail at this stage, we set out in the appendix to Annex 6 the combined content of our proposed obligations in this consultation, which obligations we anticipate to separate out into the proposed USP accounting condition and proposed direction (i.e. the RAG), as appropriate, in that further consultation.

9.54 In light of the above, we turn to our assessment of the legal tests.

9.55 To recap, our main proposals in Section 8 are, in summary, to require Royal Mail:

- to report separately on the different parts of its business relevant to our regulatory duties;

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<sup>64</sup> As mentioned above, Royal Mail's compliance with the RAG would be secured by means of a direction under the USP accounting condition.

- to further improve the documentation of costing and regulatory accounting more generally;
- to increase the extent of relevant financial information that is published on a regular basis, and
- to enhance the level of assurance that we can place on the financial information reported for regulatory purposes.

9.56 We are satisfied that our proposed regulatory financial reporting obligations:

- are objectively justifiable;
- do not discriminate unduly against particular persons or a particular description of persons;
- are proportionate to what they are intended to achieve; and
- are transparent in relation to what they are intended to achieve.

9.57 As regards objective justification, we have explained in detail in Section 8 why we consider that these obligations are needed, including their aims and our reasons why specific detailed requirements are needed. We consider, in particular, that these obligations are necessary to ensure that we are able to discharge our duty in section 29 of the Act to carry out our functions in relation to postal services in a way that we consider will secure the provision of a universal postal service, and are consistent with our preferred monitoring regime option for the wider package of regulatory safeguards set out in this consultation.

9.58 More specifically, we consider that these obligations are objectively justifiable as they would enable us to:

- monitor the financial sustainability of Royal Mail Group as the universal service provider (having regard to the separate funding and financing of POL), and therefore assist us in securing the provision of the universal postal service;
- monitor the efficiency and returns made by the Letters business activities of Royal Mail, currently and planned to be used to provide the universal postal service (during the period relevant to the Restructuring Plan on which our reviews of financeability and efficiency in this document have been based);
- monitor the relative profitability and contributions to overall cash and returns of Royal Mail Group as the universal service provider of different activities within this integrated Letters business, at the level where costs are analysed for regulatory reporting purposes, both to assess the extent to which the pricing of universal services remains cost orientated, and to assess the relative profitability of wholesale and retail services in monitoring for the risk of margin squeeze and assessing their ability to continue to contribute to the funding of universal service activities;
- monitor the relative profitability of Royal Mail's product groups, including universal service products, using the Letters network and provided to meet the needs of users in different markets, in order to monitor the risk cross-subsidisation and

assess the relative cost orientation of the pricing used for products in these different groups; and

- understand the basis by which Royal Mail's shared costs of its integrated universal service network are attributed and allocated for the purpose of relevant regulatory decisions at both national and zonal levels.

- 9.59 Some specific detailed obligations are also objectively justifiable in discharging our general duties in section 3 of the Communications Act 200] to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.
- 9.60 We consider that these proposed obligations are not unduly discriminatory as they aim to address Royal Mail's unique position as the universal service provider and do not impose disclosure requirements which would significantly affect its market position. Some detailed aspects of our proposed obligations (see, in particular, our proposed specification of accounting lines in Section 8) also seek to reflect Royal Mail's market power in the respective markets, to which we refer to in that Section.
- 9.61 We also consider that the proposed obligations are proportionate, in that the obligations are necessary to enable us to discharge our statutory duties and effectively monitor Royal Mail's position and activities. Specifically, as explained in paragraph 9.15 above, we consider that the proposed obligations are the minimum necessary to ensure the successful implementation of our wider package of regulatory safeguards based on monitoring, as summarised in that paragraph.
- 9.62 We have also set out in Section 8 our consideration of proportionality in dealing with more detailed aspects of the proposed financial reporting obligations, including where it would be possible to impose more onerous obligations on Royal Mail than we are proposing. In so doing, we have also taken into account that Royal Mail needs the ability to adapt the details of its regulatory financial reporting to the changing circumstances of its business, which may potentially continue to be rapid.
- 9.63 Finally, we consider that the proposed obligations will be transparent. This transparency consideration will be fully taken into account, once we have published for further consultation on the proposed wording of the USP accounting condition, together with the proposed wording of the RAG by means of a direction. We further consider that the transparency of these proposed obligations are aided by our explanations in this document, including the detailed proposals for the content of the USP Accounting Condition and RAG see DACRAG Content set out in the appendix to Annex 6.

## Annex 1

# Responding to this consultation

## How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm 5 January 2012**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <https://stakeholders.ofcom.org.uk/consultations/securing-the-postal-service/howtorespond/form>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email [gavin.knott@ofcom.org.uk](mailto:gavin.knott@ofcom.org.uk) attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.
- Gavin Knott  
Floor 04  
Dept Competition Policy  
Riverside House  
2A Southwark Bridge Road  
London SE1 9HA
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

## Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Gavin Knott on 020 7981 3000.

## Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, [www.ofcom.org.uk](http://www.ofcom.org.uk), ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether

all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/about/accoun/disclaimer/>

## Next steps

- A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in February 2012.
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: [http://www.ofcom.org.uk/static/subscribe/select\\_list.htm](http://www.ofcom.org.uk/static/subscribe/select_list.htm)

## Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at [consult@ofcom.org.uk](mailto:consult@ofcom.org.uk) . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Graham Howell, Secretary to the Corporation, who is Ofcom's consultation champion:

Graham Howell  
Ofcom  
Riverside House  
2a Southwark Bridge Road  
London SE1 9HA

Tel: 020 7981 3601

Email [Graham.Howell@ofcom.org.uk](mailto:Graham.Howell@ofcom.org.uk)

## Annex 2

# Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

### Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

### During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

### After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

## Annex 3

# Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, [www.ofcom.org.uk](http://www.ofcom.org.uk).
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at [www.ofcom.org.uk/consult/](http://www.ofcom.org.uk/consult/).
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

**Cover sheet for response to an Ofcom consultation**

**BASIC DETAILS**

Consultation title:  
To (Ofcom contact):  
Name of respondent:  
Representing (self or organisation/s):  
Address (if not received by email):

**CONFIDENTIALITY**

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing  Name/contact details/job title

Whole response  Organisation

Part of the response  If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

**DECLARATION**

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name  Signed (if hard copy)

## Annex 4

# Consultation questions

A4.1 We have included a number of specific consultation questions throughout this document and we would like you to consider these when responding. We have set out these questions below for ease of reference. However, we are not seeking to limit the issues on which respondents may wish to comment and respondents are invited to include representations on any issues which they consider to be relevant.

*Question 5.1: Do you agree with the assumptions set out in paragraph 5.86 above? If not, please set out your reasons.*

*Question 6.1: Do you agree with our proposal to impose a regulatory condition on Royal Mail to require it to provide the universal service as set out above? If not, what alternative approach would you suggest?*

*Question 6.2: Do you agree that a price control is not an appropriate option at present for regulating Royal Mail's prices? If not, please explain why and how a price control could be implemented effectively.*

*Question 6.3: Do you agree with Ofcom's proposals to put in place regulatory safeguards as described above? If not, please provide reasons.*

*Question 6.4: Do you agree with Ofcom's proposals to put in place a monitoring regime? If not, please provide reasons.*

*Question 6.5: Do you agree with Ofcom's proposals for an index-linked safeguard cap on standard letters from 45p to 55p? If not, please provide reasons.*

*Question 6.6: Do you agree with Ofcom's proposal that the approach outlined above remains in place for seven years? If not, please provide reasons.*

*Question 7.1: Do you agree with our approach to assessing end-to-end competition? If not, please give your reasons.*

*Question 7.2: Do you agree with Ofcom's proposals to impose an obligation on Royal Mail to provide access at the Inward Mail Centre? If not, please give reasons.*

*Question 7.3: Do you agree with Ofcom's proposals in respect of regulating margin squeeze? If not, please give reasons.*

*Question 7.4: Do you agree with our approach concerning the Terms and Conditions for access, including the role of equivalence and the regulation of zonal pricing? If not, please give your reasons.*

*Question 8.1: Do you agree with the objectives for regulatory financial reporting that we have set out above? Please provide details to support your response.*

*Question 8.2: Do you agree that our regulatory financial reporting proposals, set out in this section and the supporting Annex, are appropriate and proportionate? Please provide reasons and evidence to support your views.*

*Question 8.3: Do you agree with our proposals on the rules and requirements contained in the draft Regulatory Accounting Guidelines and do you consider that they are likely to provide an appropriate and proportionate level of cost transparency and accounting separation?*

*Question 8.4: Do you agree with our proposals set out above in relation to accounting separation? Are there any further risks that you think Ofcom needs also to consider in making decisions in this area? To the extent that you consider there to be risks associated with our proposals, how do you consider they might best be addressed?*

Annex 5

# Glossary

ABC Model	Activity Based Costing Model.
Access	Allowing other companies operating in the postal market, or other users of postal services, to use Royal Mail's facilities for the partial provision of a postal service. Access to Royal Mail's postal facilities could in principle be at any point in the pipeline.
Access Code	A formal code that sets out some or all of the terms and conditions of access to a network.
Access slots	The times between which other operators and Royal Mail may access Royal Mail's network to inject mail items for final delivery.
Accounting Methodology Manual	Documentation of all the Accounting Methodology used by the Royal Mail to meet the requirements in this document except for the National Costing Methodology and Zonal Costing Methodology (documented in the Costing Manual).
Accounting Methodology	The methodology that enables Royal Mail to implement the rules in this document for the production of the regulatory financial reports.
Activity	Tasks (whether operational or non operational) which are required to be carried out in order to complete a relevant Business Process.
Activity Cost	Total costs attributed to an Activity.
Activity Drivers	Metrics which are used to assign Activity Costs to Sub-products in accordance with National Costing Rule 9.
Aggregate Costs	Has the meaning given to it by National Costing Rule 9.
Avoidable First Class Costs	Has the meaning given to it by National Costing Rule 3.
Avoidable Second Class Costs	Has the meaning given to it by National Costing Rule 3.
Business Processes	Operational Business Processes and Non-operational Business Processes.
Business Units	Royal Mail Group Limited is organised into business units, focused on providing clearly defined services. Business units do not produce statutory accounts unless they are separate legal entities, e.g. Post Office Ltd.

CDA	Customer Direct Access, a form of access contract between a user of access services and Royal Mail.
Cost Centre	The basic unit of responsibility in an organisation for which costs are accumulated. This could be a production or service location, function, activity or item of equipment.
Cost Element	Individual General Ledger account level detail, e.g. Basic Pay, Overtime, and National Insurance.
Cost Type	Cost figures obtained after rearranging the relevant categories of costs recorded in Royal Mail's financial records, including the General Ledger cost accounts of the Reported Business, including aggregating or separating some of those costs.
Costing Manual	The document containing Royal Mail's detailed description of the National Costing Methodology and the Zonal Costing Methodology and identifying all sources of data, and all supporting empirical data used for assumptions, used in these Methodologies. Part of the Costing Manual is published.
Current Price Control	Refers to the price control which came into effect 1 April 2006 as adjusted, most recently, from April 2011.
D+1	A retail service that aims to deliver the next working day after collection, for example, Royal Mail First Class stamped mail.
D+2	A retail service that aims to deliver two working days after collection, also known as a day C service.
Downstream	The activities of inward sortation and delivery.
Downstream access	Access to Royal Mail's postal network at an inward mail centre or at any point in the postal chain after that.
Downstream services entity	Has the meaning given to it as defined in Section 4 of the RAG
EBIT	Earnings Before Interest and Tax.
End-to-end (e2e)	Operators other than Royal Mail that provide a full postal service from collection to

	delivery.
End-to-end only products entity	Has the meaning given to it as defined in Section 4 of the RAG
EPMU	Equi-Proportional Mark-Up ('EPMU') which has the meaning given to it in Guideline 11.
Equivalence	Equivalence of treatment (in price and non-price terms) between third parties' and Royal Mail's items accessing any part of Royal Mail's postal network.
FAC	Fully Allocated Costs, used to denote a costing methodology in which all costs (including overhead costs) are allocated to the outputs of the process.
General access condition	A condition that Ofcom may impose that requires a postal operator to give access to the operator's postal infrastructure or any service within the scope of the universal service that it provides, and/or to maintain accounting separation.
General Ledger	The SAP R3 General Ledger system used by Royal Mail the National Costing Methodology in the Reported Business.
General Overheads	Has the meaning given to it by National Costing Guideline 9.
IMC	Inward Mail Centre.
International Financial Reporting Standards ('IFRS')	International Financial Reporting Standards established and published by the International Accounting Standards Board.
iRED	iRed Partnership Limited is a wholly owned subsidiary of the Royal Mail Group providing document processing services.
Letter/Large Letter	This refers to Royal Mail's definition for Letter and Large Letter. A letter is any item up to 240mm in length, 165mm in width and 5mm in thickness, weighing no more than 100g. A Large Letter is any item larger than a Letter and up to 353mm in length, 250mm in width and 25mm in thickness, with a maximum weight of 750g.
Licensed mail area	This is the range of services for which a licence under the Postal Services Act 2000 was required, broadly to send letters weighing less than 350g and/or costing less than £1 to send.

Line A	A specific line of accounting separation within the Reported Business separating products competing with other operators' products which do not require the benefit of access to Royal Mail's integrated core universal service network to ensure effective competition and the efficient provision of the universal service, from those that do, excluding any universal service products.
Line B	A specific line of accounting separation within the Reported Business separating downstream from upstream services, at the point of entry to the Inward Mail Centre, for those which are not separated by Line A above.
Line C	A specific line of accounting separation within the Reported Business within the upstream accounting entity defined by Line B separating universal service products from non-universal service products.
LRIC	Long Run Incremental Costs is a measure of the change in total costs of the firm that arises from a discrete increment in output in the long run.
Market	A market has both a product and geographic dimension. The product dimension includes all products and/or services that are regarded as interchangeable or substitutable. The geographic dimension is the area where operators are involved in the supply and demand of the product and/or services and where the competitive conditions are reasonably similar, and are different from neighbouring areas.
MCS	Mails Characteristics Survey.
OMC	Outward Mail Centre.
National Costing Rules	The requirements of the RAG in relation to the National Costing Methodology used for regulatory financial reporting.
National Costing Methodology	The rules, procedures, methods, algorithms, assumptions and other processes used by Royal Mail for the purpose of assigning the costs of the Reported Business, which it incurs in the conduct of its business, without geographic differentiation in the UK to the products it provides in the course of that business, wherever those rules, procedures, methods, algorithms, assumptions and other processes may be set out.

NBV	Net Book Value.
NGPP	National Geographic Posting Profile – The national geographic mix of a customer’s mail items. Under the national access contracts a geographically uniform price is charged to access customers, as long as their mailings reflect a typical Royal Mail mix of mail in the UK. It is based on postcode sectors and the percentages of mail going to each of the four zones agreed between Postcomm and Royal Mail.
Non-USO products entity	Has the meaning given to it as defined in Section 4 of the RAG
Overheads	Costs belonging to either General Overheads or Pipeline Overheads.
Packet and parcel services (PPS)	Services used to convey items up to 32kg which were not within the licensed mail area for the purposes of the Postal Services Act 2000 (see above), whether they are handled by mail or parcel operators, express or courier companies or any other operator. This excludes Letters and Large Letters for services without any tracking or other premium attribute.
PFW	Parcelforce Worldwide is the express parcels subsidiary of Royal Mail Group Limited.
Pipeline	Stages involved in the production and distribution process of a good or service from the initiation of the process to the delivery of the final product. In postal services the pipeline refers to the stages from collection to delivery of a postal item.
Pipeline Overheads	Has the meaning given to it by National Costing Guideline 9.
Post Office Limited ('POL')	A separately financed subsidiary of Royal Mail Group Limited.
Postal infrastructure	Both physical infrastructure (such as letter boxes) and infrastructure in non-physical form (such as information relating to postcodes or addresses or arrangements made with others for the provision of any service).
Pre-sorted	Products where the sender has sorted its mailing items to a predetermined level before handing them to the operator.

Product	A service provided by Royal Mail under a scheme made under section 89 of the Postal Services Act 2000, or under a contract for the conveyance of mail or any service similar, ancillary or otherwise related to such a service.
RDC	Regional Distribution Centre: part of Royal Mail's pipeline used to process predominantly pre-sorted items for Royal Mail.
RAG	Regulatory Accounting Guidelines.
Regulatory financial reports	The financial reports produced for Ofcom by Royal Mail in relation to the RAG; they include both the regulatory financial statements and additional financial reports produced by the Royal Mail as per the guidance in the RAG.
Regulatory financial statements	The income statements, balance sheet statements and cash flow statements produced by Royal Mail as per the guidance in the RAG.
Reported Business	The activities and services the attributable costs of which are included in the National Costing Methodology.
Resource Drivers	Drivers which are used to attribute Cost Types to Activities and determined in accordance the National Costing Rules.
Retail	A postal service serving a final customer.
Royal Mail Wholesale	A business unit within Royal Mail Group that negotiates with any postal operator or user who applies for access to Royal Mail Group's postal network.
SPHCC	Sales Product Handling Characteristic Combinations, products sub-divided based on the relevant measured characteristics (e.g. class, payment type, item size and handling method).
Strategic Business Plan	Royal Mail Group's strategic business plan for 2011/12 to 2016/17 that sets out its five year vision and which should include forecast operating and capital expenditure, expectations of changes in the postal market, details of business plan initiatives (such as projects to improve efficiency) and Royal Mail's view on appropriate quality of service targets.
Sub-products	Products sub-divided based on the relevant measured characteristics.
Universal Service Provider (USP)	Any postal operator for the time being designated as the universal service provider

	under section 35 of the Postal Services Act 2011.
Unsorted	Service where the mailing items handed to the operator are not pre-sorted.
Upstream	The activities of collection, outward sortation (where necessary – pre-sorted mail may not require further outward sortation) and trunking.
Upstream access	Access to Royal Mail’s distribution systems at a point in the postal delivery chain before the Inward Mail Centre.
USO	The obligation on the USP to provide a universal service.
USO products entity	Has the meaning given to it as defined in Section 4 of the RAG
USP access condition	A condition that Ofcom may impose that requires the universal service provider to give access to its postal network to other postal operators or users of postal services and/or requires the universal service provider to maintain accounting separation.
USP accounting condition	A condition that Ofcom may impose that requires the universal service provider to do one or more of the following: to maintain accounting separation; to comply with rules about the identification of costs and cost orientation; to comply with rules about the use of cost accounting systems; and to secure that compliance with those systems is audited annually.
Vertically integrated operator	Where one company controls or owns more than one stage of production and distribution of a good, from the acquisition of raw materials to the retailing of the final product.
Weighting Factors	Factors representing the relative proportions of resources that units of each sub-Product require from the related Activity and determined in accordance with the National Costing Rules.
Weighted Volume Drivers	Has the meaning given to it by National Costing Rule 10.
Wholesale	Postal activities that are sold as intermediary

	products to provide a retail service.
Zonal Costing Methodology	The rules, procedures, methods, algorithms, assumptions and other processes used by Royal Mail for the purpose of assigning the costs of the Reported Business, which it incurs in the conduct of its business, to the products subject to regulation under the Postal Services Act 2011 where it sets geographically differentiated prices, wherever those rules, procedures, methods, algorithms, assumptions and other processes identify cost differentials between specific zones defined by Royal Mail in accordance with its obligations.
Zonal Costing Rules	The requirements of the RAG in relation to the Zonal Costing Methodology used for regulatory financial reporting.