



Hannah Timberlake
Ofcom
Riverside House
2A Southwark Bridge Road
LONDON
SE1 9HA

15th February 2019

Dear Hannah,

**Cost allocation and transfer pricing consultation
- Mail Competition Forum (MCF) Response**

The MCF is a forum which represents the interests of many of the leading mail and parcel operators who compete fiercely upstream with both one another and with the incumbent Designated Universal Service Provider, Royal Mail. The objective of the MCF is to support the development of conditions in the UK for fair, vibrant and sustainable competition to Royal Mail within a stable and undistorted market.

Ofcom's primary duty is to secure the provision of the Universal Service and, undoubtedly, Universal Service provision is now more secure and stable than when Ofcom took over regulation of the postal market. However it is widely recognised that Royal Mail have some challenges, notably around their complete failure to meet their own rather unambitious efficiency improvement targets and current profitability. MCF members are concerned that Royal Mail will continue to look to make up the profit shortfall by increasing prices and will seek to justify these on the back of questionable cost allocation decisions.

As the Universal Service provider, Royal Mail has the effective monopoly in letters, has market power in lightweight parcels and competes in the open market for heavier parcels. Universal Service provision by Royal Mail is funded by revenues from its USO products, its regulated Access products and its parcel operations. Since customers of captive and regulated services have little or no choice of service provision there is a clear incentive for Royal Mail to disproportionately allocate costs to these services in order to cost-justify higher prices. The consequence of this is being able to hold or offer lower prices where Royal Mail are forced to compete.

The 2019 tariff announcements illustrate this vividly, with large percentage increases for captive Access mail and lightweight parcels and much lower increases for heavier weight parcels in the competitive parcel space. MCF members have regularly called for lightweight parcels to be brought back into the regulated space.

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As such, the MCF welcomes the additional scrutiny that the Ofcom proposals bring to the subject of cost allocation and transfer pricing.

Ofcom has recognised that changes to Royal Mail's cost allocation methods have resulted in cost increases towards the captive markets and away from the competitive markets, and should be rightly suspicious. Ofcom's monitoring regime should be sufficiently robust and informed to spot, challenge and reverse any potential malfeasance in this area.

Royal Mail with its new CEO (although long time Royal Mail CEC member) are working on a new blueprint for a modern, optimised, efficient network to deliver letters, parcels and new products. The market will welcome a proactive approach to change Royal Mail's fortunes and Ofcom are right to recognise that the changes which it proposes need to be sufficiently flexible to account for any changes to operational practices that arise from this blueprint.

The MCF in particular welcome the news that Ofcom intends to supplement its static Cost Allocation Model (CAM) with a more dynamic model that enables a range of sensitivity and scenario testing.

One weakness in the current cost allocation monitoring that MCF members felt particularly strongly about was that Ofcom are only looking to see if costs had been appropriately allocated across the existing operation as presented as current operational reality by Royal Mail. For example the earlier Ofcom consultation on USPAC Margin squeeze control had a footnote 27 incorrectly explaining "RDC's are dedicated to the processing of bulk mail" when the facilities are used extensively for the processing of parcels.

The MCF is concerned that Ofcom's view of the appropriateness of Royal Mail's cost allocation is based only on whether the cost allocation is internally consistent with the operational methods used by Royal Mail, rather than also comparing Royal Mail's operational methods with those of other, major national posts (which may have adopted more cost efficient methods). We are concerned that, in the absence of regulatory price controls (other than for some 2nd Class USO services) and of any regulatory efficiency targets, Royal Mail are free to adopt inefficient operational methods so as to allocate the resulting costs in ways that artificially favour Royal Mail's competitive position.

MCF members would like to see Ofcom with the ability and insight to challenge Royal Mail's operational reality and believe better cost allocation outcomes could be made as a result. Members hope that a dynamic costing model will deliver this insight and ability.

MCF members are naturally concerned about any move from actual data to sampled data or planning values. With RM's efficiency improvement plan in tatters it is beneficial to have both actual and planning values; the gap being the benefits of doing things in the most efficient way. Royal Mail must justify any use of planning values with substantive evidence why actual data could not be provided. Members still remember the Access 2014 Zonal tilt change proposals which were based on the zonal costs of a reasonably efficient operator bearing no relation to Royal Mail's actual zonal costs or indeed the zonal tilt in play today. Ofcom need to be watchful of these opportunities to distort costing rules.

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Similarly MCF members ask that Ofcom receive detailed justification for any change in weighting or volume drivers since these clearly can have dramatic impacts on cost allocations.

MCF members urge Ofcom to:

- Proceed with the changes as proposed
- Require evidence justifying the use of modelled data over actual data where it is proposed
- Require evidence justifying the changing of weighting or volume drivers
- Proceed with an alternative dynamic costing model allowing scenario planning
- Challenge the current Royal Mail operational model if better alternatives exist
- Pay particular attention to costs allocated to lightweight parcels since these are largely captive in the overall competitive parcels market.
- Consider bringing this segment back into the mandate.
- Incentivise Royal Mail to improve its efficiency

Yours sincerely

A handwritten signature in black ink, appearing to read "Ian Paterson", written over a light blue rectangular background.

Ian Paterson
MCF Secretary