



# End-to-end competition in the postal sector

Final guidance on Ofcom's approach to assessing the  
impact on the universal postal service

Guidance

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## Section 1

# Executive Summary

## Introduction

- 1.1 Ofcom's primary duty in relation to postal regulation is to carry out its functions in a way that it considers will secure the provision of a universal postal service<sup>1</sup> in the interests of citizens, consumers and users of postal services. End-to-end competition has the potential to affect the provision of such a service, both positively and negatively. Where Ofcom considers that it gives rise to a threat to the provision of a universal service, Ofcom has powers to take proportionate regulatory action and will do so if it considers it is necessary and appropriate, in light of the evidence available to it.
- 1.2 The purpose of this guidance is to set out Ofcom's approach to assessing the need for regulatory intervention in relation to end-to-end competition in the postal sector, in light of the potential implications of such competition for the universal service. In the event of undertaking such an assessment, we would consider each case on its merits, based on the individual circumstances of the case. We also retain the ability to revisit this guidance at any point in the future.
- 1.3 This guidance sits within the framework set out in the Third Postal Directive (2008/06/EC) and the Postal Services Act 2011, which implements the Directive. The objective of the Directive, and of postal policy at the European level more generally, is to create a single market for postal services in the EU (via liberalisation), whilst ensuring a high quality universal service. The Postal Services Act 2011 reflects this by introducing a general authorisation to provide postal services, in place of the previous licensing regime. Given that the general approach of the Directive (which constitutes the final step in the gradual opening up of the postal services market) is one of market liberalisation, any regulatory intervention must be considered in light of this purpose.

## Ofcom's duties and powers and background

- 1.4 Section 2 of this document sets out Ofcom's relevant duties and legal powers in relation to the regulation of end-to-end competition in the postal sector. As noted above Ofcom has a duty to secure the provision of a financially sustainable universal postal service and the powers to impose obligations to remedy threats to the universal service.
- 1.5 Section 3 provides an overview of the current regulatory context for the postal sector. It looks at the current challenges facing the universal service, and describes, at a general level, the potential effect end-to-end competition may have on the provision of the universal service.
- 1.6 This section also describes the circumstances in which we would commence a review of the impact of end-to-end competition on the universal service to determine whether intervention was necessary. In particular, we describe how our ongoing monitoring of the sector will enable us to identify any future threat to the sustainability of the universal service and initiate a review in a timely manner.

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<sup>1</sup> Hereafter "universal service".

## **Assessing the impact of end-to-end competition and Royal Mail's response**

- 1.7 In Section 4 we set out the approach and financial analysis we would expect to undertake in establishing the extent to which Royal Mail's finances might be affected by entry or the expansion of end-to-end competition.
- 1.8 Section 5 sets out how, on the basis of the financial analysis, we would form a view as to whether the sustainability of the universal service is likely to be under threat from entry or the expansion of end-to-end competition. It also sets out how this would potentially affect the type of intervention that is appropriate, taking account of the factors contributing to Royal Mail's financial performance and the extent to which they are, or are not, largely within Royal Mail's control.
- 1.9 In summary, if we anticipate that Royal Mail's returns will fall below 5% to 10% EBIT margin on a sustained basis we would expect to intervene unless we conclude that this is due to Royal Mail failing to take appropriate steps to respond to the challenge posed by competition, such as failing to improve efficiency levels.
- 1.10 Companies planning to enter or expand their activities in end-to-end delivery are required to notify their plans to Ofcom (in the event that anticipated volumes exceed specific thresholds). Ofcom will also track very closely broader developments in the market to assess the current and future sustainability of the universal service. Taken together, these factors will allow us to identify the potential need for intervention early and to act quickly should the need for intervention be confirmed.

## **Options for regulatory interventions**

- 1.11 Finally Section 6 sets out the types of regulatory powers we could exercise were we to intervene in relation to end-to-end competition – such as General Universal Service Conditions or a universal service fund – and the factors we would take into account when considering each form of intervention, given the relevant circumstances.

## Section 2

# Legal framework

## Ofcom's relevant duties

- 2.1 Ofcom's principal duty under the Communications Act 2003 ("the 2003 Act") is to (a) further the interests of citizens in relation to communications matters; and (b) to further the interests of consumers in relevant markets, where appropriate by promoting competition. This duty applies to Ofcom's regulation of postal services.
- 2.2 Ofcom has specific duties under the Postal Services Act 2011 ("the Act") relating to postal services. The Act implements the Third Postal Directive (Directive 2008/06/EC, "the Directive"). As noted in Section 1, the objective of the Directive, and of postal policy at the European level more generally, is to create a single market for postal services in the EU (via liberalisation), whilst ensuring a high quality universal service. This objective has been pursued by a gradual and controlled opening up of the sector to competition, with the Third Directive representing the final step in market opening.<sup>2</sup>
- 2.3 Section 28 of the Act established the approach of the new regime; namely, that operators may provide postal services<sup>3</sup> *without* the need for any licence or prior authorisation by the regulator. The previous system of ex ante licensing was abolished and section 28 of the Act provided Ofcom with powers to impose a defined list of regulatory conditions on postal operators in given circumstances. Ofcom has no powers to impose regulatory conditions outside of these categories. Akin to the system in operation in telecommunications markets, this means that operators are generally authorised to provide postal services (subject to applicable conditions).
- 2.4 Ofcom's statutory duty, under section 29 of the Act, is to secure the provision of a universal service (see section 29(2)). In carrying out this duty, Ofcom must have regard to:
- The need for the provision of a universal service to be financially sustainable. This expressly includes the need for the universal service provider to make a reasonable commercial rate of return on expenditure incurred for the purpose of, or in connection with, the provision of the universal service (see s29(4)); and
  - The need for the provision of a universal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times.
- 2.5 Any regulatory conditions imposed by Ofcom must take account of these duties.
- 2.6 In exercising its duties in relation to post, in the event of a conflict, Ofcom's general duties under the 2003 Act, including its principal duty as set out above, must give

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<sup>2</sup> The Commission's postal policy and the history of European post legislation is described at: [http://ec.europa.eu/internal\\_market/post/legislation\\_en.htm](http://ec.europa.eu/internal_market/post/legislation_en.htm).

<sup>3</sup> A Postal Service is defined as (a) the service of conveying postal packets from one place to another by post; (b) the incidental services of receiving, collecting, sorting and delivering postal packets; and (c) any other service which relates to, and is provided in conjunction with, any service under (a) or (b). Postal packets are defined as letters, parcels, packets or any articles transmissible by post.

way to its primary duty to secure the provision of the universal service under the Act (s6A of the 2003 Act).

2.7 Ofcom has powers to impose the following types of regulatory conditions under the Act:

- Designated universal service provider (“USP”) conditions (s36-37 of the Act);
- USP access conditions (s38 and Schedule 3);
- USP accounting conditions (s39);
- Notification conditions (s41);
- General universal service conditions (s42);
- Essential conditions (s49);
- General access conditions (s50 and Schedule 3); and
- Consumer protection conditions (s51-52).

2.8 The circumstances under which each of the above regulatory conditions may be imposed are set out in the relevant sections of the Act (noted above). Some of these conditions are discussed in Section 6.

2.9 Schedule 6 of the Act provides at paragraph 1 that Ofcom may only impose or modify a regulatory condition if it is satisfied that the condition of modification:

- 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.

2.10 In addition, the Act contains a process under which Ofcom can recommend to the Secretary of State the following courses of action, and be directed by the Secretary of State to carry out such actions:

- To carry out a review of the minimum requirements of the universal service to meet user needs (s34);<sup>4</sup>
- To require contributions to a universal service fund to meet the burden of the universal service operator (s47); and

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<sup>4</sup> Note that this is not the same assessment as the review of users' needs that Ofcom is currently undertaking pursuant to section 30 of the Act, which is wider than an assessment under section 34 in that it considers the whole market for the provision of postal services in the UK, as compared to a review only of the minimum requirements of the universal service as set out in section 31 of the Act.

- To make a procurement determination (this decision cannot be taken for a period of ten years from the commencement of the Act absent (i) Royal Mail's consent; or (ii) a change to primary legislation).

2.11 However, Ofcom cannot initiate the process to set up a universal service fund (which starts with a review of the financial burden for the USP of complying with its universal service obligations) for five years, without a direction from the Secretary of State to do so.

## Regulatory conditions

2.12 There are a number of types of regulatory conditions under the Act that may be relevant to end-to-end competition. These are in addition to the designated universal service provider conditions that Ofcom has imposed on Royal Mail, which require Royal Mail to provide the universal service. The two types of condition which are likely to be of most relevance are the notification condition and the general universal service condition.

### Notification condition under section 41, and general universal service conditions under section 42

- 2.13 Ofcom has imposed a notification condition on every person providing, or intending to provide, a service within the scope of the universal service. This condition requires such an operator to give Ofcom three months' advanced notice if it is planning – in the quarter following the notification period – to: (a) enter the market and deliver more than 2.5 million letters in the UK; or (b) increase the volume of letters it is carrying by more than 2.5 million.
- 2.14 The condition does not give Ofcom the power to accept or reject an operator's proposals. It is not akin to an authorisation process but simply a system of advanced notification.
- 2.15 Ofcom has the power<sup>5</sup> to impose general universal service conditions ("GUSCs") on operators providing a service within the scope of the universal service. Services within the scope of the universal service are defined in section 40 of the Act. General universal service conditions are generally applicable and are not specifically attached to an individual operator.
- 2.16 Section 42 of the Act gives Ofcom the power to impose such obligations as Ofcom consider necessary to impose for, or in connection with, securing the provision of a universal service. This reflects the minimum legal test for imposing such obligations set out in the Directive.
- 2.17 In consequence, in order to impose a GUSC, Ofcom must first identify a threat to the provision of a universal service. It must then identify obligations which it considers are *necessary* to impose to address that threat. Any such obligation must also be proportionate to the threat identified, which means that it must be the least onerous means of addressing that threat. It must also be objectively justified, non-discriminatory, and transparent.

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<sup>5</sup> It is a discretionary power to be exercised in the light of Ofcom's statutory duties, not an obligation.

## Other regulatory conditions

### Compensation fund – sections 44-47

2.18 As noted above, the Act contains a framework under which a compensation fund could be established to support the provision of the universal service. In summary, the process is as follows:

- i) Review of the financial burden: Ofcom must first carry out a review of the extent (if any) of the financial burden for Royal Mail of complying with its universal service obligations. In undertaking this assessment, Ofcom must consider the extent to which Royal Mail is complying with its universal service obligations in a cost-efficient manner. For the first five years of the Act, Ofcom can only initiate this process if directed to do so by the Secretary of State. Section 44 of the Act contains more detail on the process that must be followed by Ofcom in this regard, including the method of calculating the burden as well as auditing and publication requirements.
- ii) Fairness of the burden: Following a finding that there is a financial burden, Ofcom is required to determine whether it considers that *“it is or would be unfair for the provider to bear, or continue to bear, the whole or a part of the burden”* of complying with the universal service obligations.
- iii) Report to the Secretary of State: If the conclusion of the review is that it would be unfair, Ofcom must then submit a report to the Secretary of State setting out the recommended course of action (if any) that Ofcom considers ought to be taken to deal with the burden. Ofcom can recommend one or more of the following courses of action: (a) a review of the minimum requirements of the universal service; (b) the establishment of a contributions fund; or (c) the making of a procurement determination.<sup>6</sup>
- iv) Direction from the Secretary of State: The Secretary of State is then required to review Ofcom's report and determine the action that Ofcom should take.
- v) Implementation of a fund: Section 46 of the Act sets out the detailed provisions that Ofcom can then make for the establishment of a fund. The rules can provide for contributions to be made by either or both of: (a) postal operators providing services within the scope of the universal service; (b) users of services within the scope of the universal service. Ofcom must make regulations<sup>7</sup> detailing the means of assessment, collection, administration and distribution of contributions.
- vi) Other statutory requirements for a scheme: The regulations made by Ofcom must secure the operation of the compensation scheme: (a) in an objective, proportionate and transparent way; (b) in a way that does not give rise to any undue discrimination between particular postal operators or users; and (c) in a way that avoids, or (if that is impractical) minimises, any distortion of competition.

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<sup>6</sup> Although the option cannot be pursued for a period of ten years absent Royal Mail's consent, or a change to the primary legislation (see section 45(14)) of the Act.

<sup>7</sup> Ofcom's regulations must (a) be approved by the Secretary of State; and (b) be subject to an affirmative resolution before each House of Parliament.

### General access condition – section 50 and Schedule 3

2.19 Ofcom also has a power to impose a general access condition on particular postal operators. This provision enables Ofcom to impose a condition requiring the operator to do one or both of the following:

- Give access to other postal operators, or users of postal services, to the operator's postal infrastructure or any service within the scope of the universal service which it provides; and
- Maintain accounting separation in relation to access as directed by Ofcom.

2.20 In order to impose such a condition, Ofcom must be satisfied that it is necessary for the purposes of (a) promoting the interests of the users of postal services, and/or (b) promoting effective competition. In addition, section 50(5) sets out the range of factors that must be taken into account when taking such a decision.<sup>8</sup> Schedule 3 of the Act sets out in detail the provisions that may be included in a general access condition.

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<sup>8</sup> These factors are: (a) technical and economic viability, having regard to the state of market development, of installing and using facilities that would make the proposed access unnecessary; (b) the feasibility of giving the proposed access; (c) the investment made by the postal operator in relation to the matters in relation to which access is proposed; (d) the need to secure effective competition in the long term; and (e) any rights to intellectual property that are relevant to the proposal.

## Section 3

# Background

## The current regulation of the postal market

### Our March 2012 statement on the new regulatory framework

- 3.1 The universal service has been under threat in recent years. Electronic substitution has resulted in a significant decline in mail volumes. Royal Mail is currently the only operator capable of providing the universal service in the UK and this is likely to remain the case for the foreseeable future. Therefore the financial sustainability of the universal service is closely linked to Royal Mail's financial position.
- 3.2 Royal Mail has been unable fully to offset the decline in mail volumes and revenues through cost reduction. As a result, it has accumulated unpredicted and sustained losses over a number of years. Further structural decline in the traditional postal market is anticipated.
- 3.3 Following a consultation in October 2011<sup>9</sup>, we published a statement in March 2012<sup>10</sup> setting out our overall approach to regulation of the postal sector and how we intended to secure the provision of the universal service. It set out our conclusions and decisions in relation to a range of issues, namely:
- We granted Royal Mail greater pricing flexibility to ensure that it can continue to provide universal services on a financially sustainable basis (this contrasted with the previous approach based on controls on many of Royal Mail's retail and wholesale prices).
  - We decided to establish an ongoing monitoring regime to track Royal Mail's performance in respect of quality of service, the affordability of the universal service, and the level of efficiency improvement.
  - We highlighted the importance of ensuring that the benefits of competition are realised in a manner that supports the universal service.
  - We imposed a safeguard cap on Second Class stamps<sup>11</sup> to ensure that a basic affordable universal service is available to all.
  - We granted further commercial and operational freedoms to Royal Mail so that it is better able to respond to customer requirements, and adapt to the challenging market environment in the postal sector (discussed further below).
  - We placed obligations on Royal Mail to provide detailed financial information to Ofcom, to a level sufficient to enable us to meet our regulatory duties.

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<sup>9</sup> Securing the Universal service – Consultation, 20 October 2011, available at <http://stakeholders.ofcom.org.uk/consultations/securing-the-postal-service/>

<sup>10</sup> Securing the Universal service – Decision on the new regulatory framework, 27 March 2012, available at <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>

<sup>11</sup> Up to 2kg.

- 3.4 We also noted that our requirement under the Act to have regard to the need for the universal service to be financially sustainable, should take into account the significant risks associated with providing the universal service.
- 3.5 In the March 2012 Statement we also set out our view that an indicative EBIT/revenue range of 5% to 10%<sup>12</sup> was appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return. This range was based on an assessment of the market evidence of the returns earned by relevant comparator companies, and regulatory precedent. We determined this was commensurate with the level of risk within the business and the need for the universal service to be financially sustainable in the long term.
- 3.6 We also emphasised the importance of our duty to have regard to the need for the provision of the universal service to become efficient before the end of a reasonable period and remain efficient, which sits alongside our duty to have regard to the need for such provision to be financially sustainable. In our March 2012 statement, we considered that it was not necessary for Ofcom to set efficiency targets for Royal Mail as the company should have inherent incentives to improve efficiency levels. However, given the importance of efficiency improvements to the sustainability of the universal service in the longer term, we noted that it was our intention to monitor operational efficiency over time. We noted that if we had potential concerns about the level of efficiency improvement, as revealed through the monitoring regime, we would, if necessary reconsider the need for price controls in relation to universal services and access.

### **Current pressures on the universal service**

- 3.7 The regulatory regime set out in the March 2012 statement was significantly shaped by market conditions, and in particular the extent of uncertainty facing the postal services market, together with Royal Mail's financial position. More recently, Royal Mail has shown signs of improvement in its finances mainly due to successive years of significant price rises. We expect this improvement to continue and should be supported by the new regulatory framework which gives Royal Mail greater commercial and operational freedom.
- 3.8 However, as discussed in the March 2012 statement, Royal Mail faces ongoing challenges and the EBIT margin of its universal service business remains below the 5 to 10% that we cited in our March Statement as being consistent with financeability. There remains a great deal of uncertainty over key factors affecting its financial performance such as the rate of mail volume decline, whether demand will stabilise and at what level. In addition, changes to the product mix are likely to have an impact on both revenues and costs. There is also uncertainty about the rate at which Royal Mail can modernise its business, including addressing the efficiency challenge.
- 3.9 Given the challenges facing the universal service, it is critically important that Royal Mail improves its efficiency. The March 2012 statement noted that if Royal Mail did not improve its efficiency it would have to continue to rely on price increases to cover its costs as demand fell, which in turn would lead to further price rises with the resultant danger of a spiral of decline. The regulatory regime we introduced was intended to provide sufficient incentives and flexibility for Royal Mail to increase its efficiency to help avoid this outcome.

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<sup>12</sup> Based on a return on sales, using a pre-exceptional measure of EBIT, except where exceptional items could be shown to be recurring (including recurring restructuring or redundancy costs).

- 3.10 The March 2012 statement also recognised that, in the right circumstances, competition could increase Royal Mail's incentive to become more efficient. As discussed below, however, it also recognised that loss of revenue to end-to-end competitors has the potential to threaten the provision of the universal service.

## Competition in the postal sector

- 3.11 There are two main types of competition in postal services: access and end-to-end. These different forms of competition provide differing advantages and potential challenges to the universal service which we discuss below.

### The different types of competition

- 3.12 Access competition is where the operator collects mail from the customer, sorts it and then transports it to the Royal Mail Inward Mail Centre, where it is handed over to Royal Mail for delivery. Access competition has been the prevalent form of postal competition in the UK for letters, growing quickly from 10% of volumes in 2006 to 44% in 2012.<sup>13</sup>
- 3.13 End-to-end competition is where operators other than Royal Mail, collect, process and deliver mail directly to the recipient, without using Royal Mail's network. This has been the main competitive model in other European countries where postal competition has emerged. There is currently very little end-to-end competition in the UK, with Royal Mail delivering over 99% of all mail items in 2011. However, TNT Post commenced a trial of end-to-end delivery operations in West London in April 2012. If conditions are favourable, TNT Post has said that it would like to roll out a broader end-to-end service at the conclusion of this trial.<sup>14</sup>

### Potential positive and negative impacts of end-to-end competition on the universal service

- 3.14 End-to-end competition is likely to result in both benefits and risks to the universal service.
- 3.15 There are a number of potential benefits from other postal operators competing with Royal Mail in the delivery of mail. Most importantly entry can strengthen the incentives on Royal Mail to improve efficiency and reduce its costs.
- 3.16 In addition, if end-to-end competition results in lower prices for certain types of users, it may reduce the rate at which volumes decline for the whole industry. Competition may also benefit customers through increased innovation and value added services.
- 3.17 However, end-to-end competition also poses a number of potential risks for the universal service. The immediate impact of end-to-end entry by lower-priced competitors is likely to be that Royal Mail will lose market share, and therefore revenues, as other operators will be delivering mail which was previously delivered by Royal Mail. On a like for like basis, the impact on Royal Mail's revenues of end-to-end competition is significantly greater than that of access competition, as Royal Mail retains 85% to 90% of the total revenue for access mail but is not involved in any part of the value chain for items processed and delivered directly to the receiving

<sup>13</sup> Ofcom, *Communications Market Report*, July 2012, available at: <http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/cmr12/>

<sup>14</sup> TNT Post UK, *TNT Post UK to launch second E2E trial*, 22 March 2012, available at: <http://www.tntpost.co.uk/ABOUTUS/News/tabid/279/EntryId/40/TNT-Post-UK-to-launch-second-E2E-trial.aspx>

customer by another operator. Royal Mail's universal service obligations – such as the requirement to deliver to every home in the UK, six days a week – also limit the company's ability to reduce costs overall in line with reduced mail volumes (whether due to the structural decline in the market or loss of market share as a result of end-to-end competition).

- 3.18 Depending on the scale and scope of entry, this loss of revenue could result in Royal Mail being unable to cover the costs of providing the universal service and therefore unable to earn a rate of return consistent with our view of financial sustainability, even if it is operating efficiently.
- 3.19 If Royal Mail's financial position is not sufficiently robust and it is not able to reduce its costs in line with falling volumes, a significant loss of revenue to competitors could lead to its financial position becoming unsustainable, which in turn could result in a threat to the future provision of the universal service. On the other hand, if Royal Mail's financial position was sufficiently healthy, then it might be able to absorb a loss of business to competitors, and the universal service would remain financeable. This would depend on the scale and scope of entry as well as Royal Mail's financial position absent competition and Royal Mail's response to competitive entry.
- 3.20 It is important to note that whether competitors are more or less efficient than Royal Mail, or whether entry is based on arbitrage or cherry picking (taking advantage of Royal Mail's universal service obligations) is not relevant to our primary duty to secure the provision of the universal service. What is of importance is the effect that that competition has on the provision of the universal service. However, the nature of the competition is likely to be relevant to the form of any remedy we may consider necessary to secure the provision of the universal service. This is further discussed in Section 6.

### **July 2012 update on Ofcom's position on end-to-end competition in the postal sector**

- 3.21 As noted above, TNT Post initiated a trial of end-to-end operations in West London in April 2012. It has indicated it would like to roll out a broader end-to-end service at the conclusion of this trial, if conditions are favourable. Given this significant development, in July 2012 we published an update on the position set out in the March 2012 statement on end-to-end competition in post ("the July 2012 update") to provide greater regulatory certainty and clarity.<sup>15</sup>
- 3.22 In the July 2012 update, we set out that we had reviewed TNT Post's business plan in conjunction with Royal Mail's restructuring plan to assess the potential impact of this entry on the future provision of the universal service. This included considering representations from other stakeholders, including Royal Mail, as well as conducting sensitivity analysis on the results of our analysis.
- 3.23 We took into account that TNT Post's market share was expected to be low in the early years of its plan and that as a result there was not likely to be a material impact on Royal Mail's cash flow position in the short term. We also considered the uncertainty surrounding TNT Post's business plan (given that it represents the first such operation of a significant scale in the UK), Royal Mail's potential commercial reactions and other key market factors.

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<sup>15</sup> Update on Ofcom's position on end-to-end competition in the postal sector, 25 July 2012, available at <http://stakeholders.ofcom.org.uk/post/end-to-end-competition/>

- 3.24 We concluded that, on the basis of the evidence provided to us and the analysis we conducted, it was not necessary, at that time, to impose any regulatory conditions on end-to-end operators to secure the provision of the universal service. However, we did note that given the ongoing nature of our duty, if circumstances change, it may be necessary to intervene at some point in the future. In the interests of providing greater regulatory certainty we also committed to providing the market with guidance on how we would approach such an assessment in the future.

### **The circumstances under which we would undertake a review of the need for intervention in relation to end-to-end competition**

- 3.25 Ofcom has an ongoing duty to act in a way that it considers will secure the provision of the universal service. We can therefore undertake a review into end-to-end competition and its impact on the universal service at any time. However it would not be sensible or efficient for Ofcom continually to be in the process of undertaking a detailed review of end-to-end competition, for example every time we received a notification from a new entrant or existing operator under the notification condition.

- 3.26 We would commence a review of the need for intervention in relation to the provision of the universal service if *prima facie*, there is a potential material threat to that provision resulting from end-to-end competition. That threat could, for example, arise due to several factors including:

- A material increase, or a notification of a proposed material increase, in the level of end-to-end competition (based on the notifications or business plans previously supplied to Ofcom);
- A material change in Ofcom's assessment of the likely scale, timing or certainty of a competitor's plans;
- A potential material change to the financial sustainability of the universal service, which might result from:
  - A significant downward shift in revenues, for example due to changes in market demand (or forecasts of future demand) or a change in economic growth forecasts; or
  - A significant upward shift in the expected level of costs; or
- End-to-end competition had developed to a level that we had previously identified might signal the potential of a threat to the universal service.

### **Monitoring regime and notification process**

- 3.27 As discussed above, the new regulatory framework implemented in March 2012 gave Royal Mail significant commercial and operational freedom. Alongside this, however, we put in place a substantial monitoring regime to keep track of quality of service, the financial performance of Royal Mail's universal service business, progress on efficiency, affordability, and changes in the market including in the competitive landscape.
- 3.28 In addition, the new regulatory framework also requires all operators who intend to establish (or expand) a competing letters delivery service to notify Ofcom of their

plans three months in advance.<sup>16</sup> This requirement, referred to as the “notification condition” is described in more detail in Section 2.

- 3.29 Together, the monitoring regime and the notification process will allow us to identify if there is a potential significant threat to the future provision of the universal service linked to end-to-end competition and thus consider commencing a review.

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<sup>16</sup> If in the quarter following the notification period they intend to: (a) enter the market and deliver more than 2.5 million letters in the UK; or (b) increase the volume of letters they are carrying by more than 2.5 million.

## Section 4

# Assessing the potential financial impact of end-to-end competition on the universal service

## Introduction

- 4.1 Section 3 set out the circumstances under which we would consider undertaking a review into the impact of end-to-end competition on Royal Mail's ability to continue to provide the universal service.
- 4.2 In conducting a full review of the impact of end-to-end competition on the universal service, we would first consider whether the expected scale of end-to-end competition was likely to be sufficient to threaten Royal Mail's financeability to the point where the provision of the universal service would become financially unsustainable. This section describes the approach we intend to take in this regard. Section 5 then describes how, having built a picture of the financial impact of end-to-end competition, we would reach a view as to whether the universal service was indeed likely to be at risk, and whether, as a consequence, there was a case for regulatory intervention.
- 4.3 This financial analysis would involve undertaking the following four steps:
- **Step one:** Determine what the financial position of the universal service would be likely to be in the absence of end-to-end competition. This would allow us to understand Royal Mail's expected profitability<sup>17</sup> in the foreseeable future absent end-to-end competition.
  - **Step two:** Consider the expected direct impact of the loss of business on Royal Mail resulting from end-to-end competition. This would involve reviewing the current and potential activities of competitors and then looking at how this would impact Royal Mail's forecast financial position (determined in step one).
  - **Step three:** Consider the impact of any potential subsequent commercial response(s) from Royal Mail, including improving efficiency. Increased competition might be expected to change Royal Mail's behaviour in relation to its commercial strategy, and its ability to make efficiency savings. The financial analysis would need to be adjusted to take this into account.
  - **Step four:** Test whether the universal service is likely to be put at risk allowing for the uncertainties associated with projections.
- 4.4 These individual steps are discussed in more detail below.

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<sup>17</sup> In this context, Royal Mail refers to its universal service business ("the reported business").

## Step one: Determining the counterfactual – Royal Mail's financial position absent end-to-end competition

- 4.5 In assessing the impact of end-to-end competition on the provision of the universal service, we would start by considering the counterfactual – i.e. the expected financial position of Royal Mail in the absence of end-to-end competition. Any assessment of the financial impact of competition would then be compared to this counterfactual. This would allow us to take into account the fact that end-to-end competition will not be the only factor affecting the universal service during this period and so allows us to isolate the incremental impact of end-to-end competition.
- 4.6 We would typically expect the starting point for determining the counterfactual to be Royal Mail's current position and most recent business plan.<sup>18</sup> Where Royal Mail's plan itself includes assumptions on end-to-end competition we would adjust these to avoid double-counting.
- 4.7 Although Royal Mail's most recent business plan is expected to be important evidentially, Ofcom would need to reach its own view of the extent to which this plan is likely to be an accurate predictor of the future. This might involve:
- *Updating forecasts in light of actual performance and recent market trends.* Depending on the length of time since the plan was originally prepared, it might be possible to provide a more realistic view by updating the plan in light of known developments.
  - *Reviewing the key assumptions to test whether they are plausible and reasonable.* All plans involve a number of important assumptions. Some of these relate to exogenous factors such as the impact of economic growth on aggregate demand, or the price elasticity of demand; others relate to factors within the control of Royal Mail, such as efficiency savings or price changes. Ofcom would need to form a view as to whether the most important assumptions in the plan (in terms of those that have an impact on Royal Mail's financial performance) were appropriate, given the available evidence.

## Step two: Assessing the direct impact of the actual and/or proposed end-to-end competition

- 4.8 The next step would be to form a view of the likely scale of end-to-end competition and assess the incremental impact on Royal Mail's financial position.
- 4.9 The starting point for this analysis would be the business plans of the relevant competitor(s). These should provide a view of the expected scale and scope of their operations over time, which could then be factored into Royal Mail's plan to gain a view of the expected direct impact of end-to-end competition on Royal Mail's financial performance (as it relates to the universal service).
- 4.10 As with any business plan that is provided to us as a regulator, we will need to form our own view on what weight to give competitors' business plans, taking into account the associated risks and uncertainties. In doing this, Ofcom will also take account of

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<sup>18</sup> The new regulatory framework implemented in March 2012 requires Royal Mail to provide Ofcom with an annual update to its business plan including its latest financial forecasts and modelling assumptions.

the possibility that such plans may attempt to anticipate, and potentially forestall, the risk of future regulatory intervention.

- 4.11 Depending on the state of end-to-end competition in the UK at the date of the assessment, the business plan of an entrant or a competitor may be untested. As such, whether the plans of entrants will actually be achieved in practice could also be subject to a high degree of uncertainty. We may, therefore, need to apply our own judgment, taking account of relevant evidence, in forming a view of the efficacy of competitors' plans and on the likely impact of end-to-end competition on Royal Mail's financial performance.

### **Step three: Assessing Royal Mail's potential commercial responses to end-to-end competition**

- 4.12 To understand fully the potential impact of end-to-end entry it would also be necessary to consider the potential for commercial response(s) by Royal Mail to mitigate the direct impact of increased competition. As discussed in Section 3, under the new regulatory framework, Royal Mail has significantly more commercial and operational freedom to set its prices and make product changes in a timely manner than was previously the case. There is a range of ways in which Royal Mail might respond to increased competition, for example:

- Royal Mail could change its commercial strategy (i.e. pricing and terms). In particular, under the current regulatory regime Royal Mail has the ability to change the prices it charges access operators. This includes the ability to change how access prices are set for different geographic areas (currently the "zonal access pricing regime") to ensure they are reflective of relevant costs. This is particularly important given that in general an end-to-end competitor will still need to rely on access to Royal Mail's network to offer its customers full coverage of all addresses in the UK. Royal Mail's flexibility in setting zonal access prices can enable it to ensure that end-to-end competitors pay a cost reflective price for Royal Mail delivering mail in the areas where it has chosen not to enter (which may be the harder to reach, and hence less profitable parts of the UK). In this way, Royal Mail may be able to mitigate the impact on the universal service from an entrant 'cherry picking' by delivering in lower cost areas and handing over the rest of the mail to Royal Mail to deliver. In addition, Royal Mail has the flexibility to negotiate changes to its contracts both with its retail and access customers (subject to competition law and the existing ex ante regulatory conditions on access).
- Royal Mail could have a stronger ability and incentive to improve efficiency at a rate higher in the face of end-to-end competition, than would otherwise be the case. This in turn could serve to mitigate, to some extent, the direct impact on Royal Mail's financial position of losing revenue to competitors.

- 4.13 In addition, greater competition potentially implies more innovation, partly because the incentives on all operators to innovate are greater, but also because there are more operators exploring new ways of doing things. Increased innovation could also help counteract the rate of decline in overall letter volumes. This similarly has the potential to mitigate the direct effect of competition on Royal Mail's financial position.

- 4.14 However we recognise that there are likely to be limits on how far and how quickly Royal Mail would be able to implement significant changes. There will be the obvious constraints imposed by Royal Mail's universal service obligations. Moreover, even

allowing for these, there will be further constraints on how quickly Royal Mail can respond to competition. We would therefore need to take account of the pace of entry (i.e. how quickly the operations of the entrant(s) are expected to 'ramp up') in determining how quickly it is reasonable to expect Royal Mail to respond.

- 4.15 This aspect of the assessment is likely to be difficult to quantify with precision. One way to approach the issue would be to assess the conclusions from steps one and two in terms of the scale of risk to the universal service, and then form a judgment as to whether the indirect effects (those considered in the second bullet point above) were likely to be enough to offset that threat.

#### **Step four: testing whether the universal service is likely to be put at risk**

- 4.16 As noted above, any assessment of the impact of end-to-end competition on the provision of the universal service is necessarily forward looking. As such, it will inevitably be subject to an element of uncertainty. We would therefore subject the central findings of any assessment to sensitivity testing to enable us to form an overall judgment. This would allow us to consider the risks and potential likelihood that both Royal Mail and its competitors do not perform as assumed in our analysis. Importantly, this exercise would also help us determine how confident we could be that the forecasts developed in this process would allow us to reach reasonably robust conclusions on the likely impact of end-to-end on the universal service. This would also be an important input into any subsequent intervention.
- 4.17 This evaluation would include an assessment of the risks and sensitivities associated with the respective business plans of Royal Mail and its end-to-end competitors. Sensitivities that could have a substantial impact on the sustainability of the universal service might include (but are not limited to):
- Revenue risks associated with:
    - Aggregate demand for mail, for example as a result of electronic substitution or economic growth;
    - Changing product mix, such as between single piece and bulk mail, and letters and parcels/packets; and
    - Demand response to price changes (price elasticity).
  - Cost risks as a result of:
    - The extent to which Royal Mail is able to deliver a reasonable level of efficiency improvement; and
    - The extent to which Royal Mail is able to reduce costs as a result of reducing volumes (sometimes referred to as cost marginality).
- 4.18 In addition, we would also consider a range of sensitivities around end-to-end competitors' base case projections to form a view as to the potential impact on Royal Mail's finances if the competitors were more or less successful than the base case would imply.

## **Conclusion of the financial analysis**

- 4.19 The analysis described above would provide a detailed view of the likely impact of end-to-end competition on the financial position of Royal Mail, and therefore the provision of the universal service. The next step in the analysis would be to assess whether this analysis implies that there is a threat to the ongoing provision of the universal service, and whether any regulatory intervention is warranted to address that threat. This is discussed in the next section.

## Section 5

# The implications of the analysis of the impact of end-to-end competition

## Introduction

- 5.1 Section 4 set out the steps we would undertake to form a detailed view of the likely impact of end-to-end competition on Royal Mail's financial position and of its ability to provide the universal service in a financially sustainable way. This section outlines how we would assess the findings of this analysis to form a view as to whether the financial sustainability of the universal service is threatened as a result. It also sets out how we would aim to balance the need for regulatory intervention to be sufficiently timely to avoid irreparable harm to the universal service, with the need to be satisfied that action is necessary and proportionate in light of the risks we have identified, on the evidence before us at the time.
- 5.2 The first aspect we would consider in this respect is whether Royal Mail's profitability is expected to be below a level consistent with our view of financial sustainability. As this section sets out, we currently consider the appropriate indicative reference level to use for this assessment to be that which we set out in our March 2012 statement, namely a 5% to 10% EBIT/revenue margin. Additionally, we would also take into account the period over which profitability might fall below a level consistent with financial sustainability and whether it could subsequently be expected to return to a financially sustainable level within the plan period.
- 5.3 The second aspect relates to the potential presence and impact of perverse incentives. These could arise if it was believed that the regulator would intervene in relation to end-to-end competition if Royal Mail's profitability were to fall below a certain level, regardless of the circumstances. If this were the case, it might have an undesirable impact on Royal Mail's incentives to realise efficiency savings and could conflict with our duty to have regard to the need for the provision of the universal service to be efficient. We would also be concerned if this reduced Royal Mail's incentives to innovate in response to competition.
- 5.4 A number of factors might cause Royal Mail's profitability to fall below a level consistent with our view of financial sustainability. We would look in detail at each of these factors and Royal Mail's ability to control or respond to them. This would inform our assessment of whether it would be necessary to intervene in relation to end-to-end competition, take some other regulatory action, or whether it would be appropriate to rely on Royal Mail's ability to address the challenge posed by end-to-end competition through those factors which were within its control.
- 5.5 This section outlines:
- The basis for assessing the level of profitability consistent with our view of financial sustainability, including the need for a forward-looking approach and the timeframe over which we would make the assessment;
  - How our approach would aim to avoid distorting Royal Mail's incentives to respond effectively to competition, innovate and improve efficiency;

- The key risks to Royal Mail's future revenues, including volumes, product mix and commercial strategy and the level of Royal Mail's control over these factors; and
- The key risks to Royal Mail's future costs, including efficiency, volumes, product mix and the scope of the universal service, and the level of Royal Mail's control over these factors.

5.6 The analysis described in this section is challenging and would need to be robust. However, due to our monitoring programme we will already have most if not all of the information to carry out the analysis and have or will have developed the analytical methods we will use. Therefore, we are confident that the work can be accomplished as swiftly as necessary to protect the universal service.

## The basis for assessing financial sustainability

### A level of profitability consistent with financial sustainability

- 5.7 As discussed above, the impact of end-to-end competition on Royal Mail's profitability matters insofar as it may represent a risk to the continued provision of the universal service.
- 5.8 The March 2012 statement set out our approach to assessing the financial sustainability of the universal service. We described the scope of Royal Mail's business that we would include in any assessment and the reasonable level of commercial return we considered necessary to support a financially sustainable universal service.
- 5.9 We determined that any assessment of the sustainability of the universal service should take account of all the costs and revenues of both regulated and unregulated products that depend on the core universal service activities for their efficient provision. This includes all universal service products, retail bulk mail products and access products (we term this "the reported business").
- 5.10 In the March 2012 statement we also determined that financial sustainability should take into account not only the need for the universal service provider to be able to earn a reasonable commercial rate of return on any expenditure related to the provision of the universal service, as expressly required by the Act, but also the significant risks associated with providing the universal service based on our assessment of the risks within Royal Mail's restructuring plan.
- 5.11 In 2011, as part of our work on the new regulatory framework for the postal sector, Cambridge Economic Policy Associates ("CEPA") was asked to advise us on approaches to measuring financeability. CEPA proposed to express Royal Mail's required return as an EBIT<sup>19</sup> margin (a measure of return on sales), a metric used by rating agencies when assessing business risks. CEPA also considered the margins earned by international postal operators with private investment, other regulated companies and asset-light industries.
- 5.12 Based on an assessment of CEPA's work, the broader market evidence and regulatory precedent, we determined that an indicative EBIT range of 5% to 10%<sup>20</sup>

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<sup>19</sup> Earnings before interest and tax.

<sup>20</sup> Based on a return on sales, calculated on a pre-exceptional basis, although where exceptional items may be expected to recur each year, we will consider withholding these costs on a case-by-case basis.

was 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. We also determined that for the universal service to be financially sustainable in the long term it would need to have the opportunity to earn a reasonable commercial rate of return over the relevant period and on an ongoing basis.

- 5.13 We therefore consider that the appropriate basis for assessing the financial sustainability of the universal service, in relation to any assessment of the impact of end-to-end competition, would be to have regard to whether the expected EBIT margin for the reported business is likely to be within a range consistent with our view of financeability.
- 5.14 At present we consider that this level would be that set out in the March 2012 statement: an EBIT margin of 5% to 10%. However if we were to change this level as part of the broader regulatory regime, we would then apply the revised benchmark for the purposes of this guidance. We note that, although improving, the profitability of Royal Mail's Reported Business is currently below this range, with a 2.3% EBIT return for the financial year 2011-12.<sup>21</sup>

### **Timeframe of assessment**

- 5.15 We have discussed above that we would look at the potential impact of end-to-end competition on Royal Mail's financeability – looking at the range of returns that we consider to be consistent with financial sustainability. In the event Royal Mail's profitability was projected to be below the range we consider to be consistent with financial sustainability, we would also consider whether this was expected to be sustained for long enough to pose a threat to the future provision of the universal service.
- 5.16 A short term dip in profitability would not, in itself, be likely to be sufficient to justify intervention. The expected period of poor profitability would have to be of sufficient duration to mean that there was a real threat to the financial sustainability of the universal service. Transient low profitability would not be likely to threaten the provision of the universal service, in contrast with a situation in which returns were expected to be below a reasonable level for some time.
- 5.17 Similarly, whilst Ofcom might decide not to intervene based on a projection of low short term profitability, this does not mean that Ofcom would require Royal Mail to undergo a period of negative or low profitability before intervening. If Ofcom is satisfied that the threat to the universal service from end-to-end competition is likely to lead to an enduring problem in relation to the sustainability of the universal service such that intervention is necessary and appropriate, then it will be able to intervene before such a point.
- 5.18 We would therefore need to consider whether any low expected future returns were likely to be transient or more permanent in nature. In determining the length of this period, we would consider whether the factors driving the expected level of profitability were short term (or cyclical) in nature, as opposed to long term (or structural). Factors that are of a structural nature would clearly be of greater concern than cyclical factors, although the latter might still raise concern if the impact were over a sufficiently long period to threaten the universal service.

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<sup>21</sup> Royal Mail Group Limited, *Regulatory Financial Statements 2011-12*, "Total Mails before exceptional items".

- 5.19 The timeframe and permanency of profitability below a level consistent with financial sustainability may also be a relevant factor in the timing of any intervention. This is discussed further in Section 6.

## Sustaining the universal service while avoiding perverse incentives

- 5.20 The analysis described thus far should allow us to conclude whether, after taking account of the expected impact of end-to-end entry, the provision of the universal service is likely to be threatened. In itself, however, this may not automatically imply that intervention would be warranted.
- 5.21 It is important that the regulatory regime maintains the right incentives on Royal Mail. In particular, the regime should ensure that Royal Mail is sufficiently incentivised to improve efficiency and innovate. If Royal Mail were effectively guaranteed intervention whenever its performance fell below the level consistent with financial sustainability, then the incentives to improve efficiency and respond to competition more broadly, might be weakened. To the extent that this is the case, it could conflict with our duty to have regard to the need for the provision of the universal service to be efficient.
- 5.22 The regulatory approach to end-to-end competition should therefore have regard to the risk that incentives could be diluted. In other sectors, Ofcom has found the principle of the "fair bet" to be a useful way of approaching financial sustainability at the same time as ensuring that this potential risk is addressed.

## The opportunity to earn an appropriate return: the 'fair bet' principle

- 5.23 In other sectors which it regulates, Ofcom's approach to financial sustainability has been to consider whether the entity we are regulating has a sufficient *opportunity* to earn a certain return. It is not, however, *guaranteed* that return. If, for example, a firm subject to a charge control underperforms against expectations, and as a result earns a lower return, then that is not in and of itself a case for regulatory intervention to allow it to charge more. Similarly, if it out-performs expectations, and earns a higher return, then we would not seek to claw this back.
- 5.24 This approach is termed the 'fair bet' principle. We explained this concept in our consultation on the control on BT's wholesale broadband access charges in the following way:

"An investment is a 'fair bet' if, at the time of investment, expected return is equal to the cost of capital. This means that, in order to ensure that an investment is a fair bet, the firm should be allowed to enjoy some of the upside risk when demand turns out to be high (i.e. allow returns higher than the cost of capital) to balance the fact that the firm will earn returns below the cost of capital if demand turns out to be low. This issue is particularly important where there is significant uncertainty around demand (or other factors that affect returns)".<sup>22</sup>

- 5.25 A key part of this approach is that returns are judged on a forward looking basis. That is, we are concerned with expected returns in future, not actual returns that have

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<sup>22</sup> See Ofcom, *Proposals for WBA Charge Control – Consultation*, 20 January 2011, Annex 8, paragraph A8.27 available at: <http://stakeholders.ofcom.org.uk/consultations/wba-charge-control/>

occurred in the past, and we allow for the possibility of variations in returns from year to year, with the firm bearing the resultant risk.

- 5.26 The thinking behind the fair bet principle is also relevant in the context of postal regulation, because incentives for efficiency remain important. However, it needs to be adapted to take account of Ofcom's different duties in relation to postal services. In particular, Ofcom's duty to secure the provision of the universal service means that, in practice, not all of the risk of adverse outcomes will necessarily be borne by Royal Mail.
- 5.27 We also note that for the reasons set out in the March 2012 statement, we consider that a metric based on EBIT/sales rather than the cost of capital (as used in charge controls) is the more suitable basis for assessing Royal Mail's financeability. We consider that the 5% to 10% EBIT margin we set out in the March 2012 statement is consistent with Royal Mail bearing some downside risk, because the range was determined in the light of evidence on the returns earned by other regulated and unregulated comparator companies (and as such includes an amount to compensate shareholders for some degree of market risk). This is consistent with our approach to assessing the period over which profitability would need to be below a level consistent with financial sustainability, where we noted that transient low profitability would not threaten the provision of the universal service. If, however, the returns were expected to be below the level needed to finance the universal service in a sustainable manner, then there would be a case to consider regulatory intervention, including in relation to end-to-end competition. In such circumstances, Ofcom would assess this case in light of the range of factors we have described and would act as necessary and appropriate.

## Our approach

- 5.28 The approach we will take in assessing the case for regulatory intervention in response to end-to-end competition is, as far as possible, intended to preserve incentives for efficiency. Accordingly, we would review whether Royal Mail has sufficient opportunity to earn a reasonable commercial rate of return to secure the provision of the universal service. We would not, however, guarantee that Royal Mail earns that return, nor would we seek to claw-back earnings in excess of this return as a result of efficiency improvements.<sup>23</sup> This approach to assessing financeability is central to balancing the duty to support the universal service with the need to provide healthy incentives for Royal Mail to perform and compete effectively and efficiently, as discussed later in this section.
- 5.29 In applying this principle, we would need to establish the level of control that Royal Mail has over each of the factors identified as contributing to its poor financial performance. The central distinction would be between those factors that are largely within Royal Mail's control and those factors that are not. As a general rule, if Royal Mail's poor financial performance was primarily the result of factors that are within its own control, then there would be a substantially weaker case for intervention than if its performance was due to factors that are mainly outside of its control.
- 5.30 In undertaking this assessment we would be conscious that the control Royal Mail has over the risks to its finances is unlikely to be entirely clear cut and as a result there will inevitably be an element of judgment involved in making this assessment. This is because the majority of individual factors are unlikely to be wholly within or outside of Royal Mail's control. For example, while volumes are likely to be

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<sup>23</sup> Noting that we have a duty to ensure that universal services remain affordable.

influenced by prices set by Royal Mail (due to price elasticity of demand), both the wider economy and the trend towards electronic substitution (which are largely outside of Royal Mail's control) will also impact future volumes.

- 5.31 The outcome of this analysis should establish the cause of any potential threat to provision of the universal service, the level of control Royal Mail has over the identified factors and thus the type of action (if any) that we might consider taking. For example, this might include regulatory action specifically targeted to address problems caused by end-to-end competition, exercising our other powers in relation to post, or relying on Royal Mail to address the factors within its control.
- 5.32 The following subsections set out the factors we would be likely to consider and how we would form a judgement in relation to each. We have divided these factors into revenues and costs for presentational purposes, although there is the potential for factors to have both revenue and cost implications. The list below is, however, not expected to be exhaustive and there may be other factors that have a significant impact on Royal Mail's profitability, and as such would need to be considered as part of any review.

### **Key risks to Royal Mail's future revenues**

- 5.33 There are many uncertainties affecting Royal Mail's revenues, and in the future it could outperform or underperform its revenue expectations. Given that a case for regulatory intervention in response to end-to-end competition would be based on the potential threat to the universal service, we necessarily focus here on the downside risks, in particular:
- A worsening of demand conditions driving down mail volumes due to:
    - An acceleration in electronic substitution;
    - A deterioration of the economic climate (i.e. lower than expected GDP);
  - A change in the product mix; and
  - Royal Mail's commercial strategy.

### **Decline in mail volumes**

- 5.34 Mail volumes can have a significant impact on revenues and therefore Royal Mail's profitability. As discussed in Section 1, there has been a significant decline in addressed mail volumes over recent years as more customers switched to electronic alternatives. Total market addressed mail volumes decreased by over 25% between 2006 and 2011.<sup>24</sup>
- 5.35 There are two key factors that have caused this decline. The main factor is electronic substitution, a trend which Royal Mail expects will continue and has thus factored into its business plan. The second reason, which has had a compounding effect, has been the recent macroeconomic climate. Royal Mail's assumptions on the future level of economic growth are also built into its business plan.

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<sup>24</sup> Ofcom, *Communications Market Report*, July 2012, available at: <http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/cmr12/>

- 5.36 While it is to be expected that these will have been factored into Royal Mail's plan, they are difficult to predict accurately. Thus, if they were to diverge substantially (and unfavourably) from Royal Mail's assumptions, the threat to the universal service could be greater than originally expected.
- 5.37 Electronic substitution is primarily driven by a change in consumers' (including businesses') communication habits, which is largely out of Royal Mail's control, as are general economic conditions. It is possible however, that Royal Mail's commercial strategy may influence electronic substitution to some extent (due to the effect of price increases on demand, as discussed below).<sup>25</sup>
- 5.38 Given the importance of mail volumes to Royal Mail's financial performance, in assessing the case for intervention it would be important to have regard to the level of control Royal Mail has over these factors and therefore its current and expected future volumes and revenues. Lower than expected volumes would also be likely to have an impact on Royal Mail's costs which is discussed further below.

### **Change in product mix**

- 5.39 Changes in product mix also have an impact on Royal Mail's revenues. For example, between 2006 and 2010 there was a substantial shift towards lower cost products, particularly by business customers (such as switching from First Class to Second Class and from single piece to bulk mail products). This change in demand had a negative impact on Royal Mail's revenues.
- 5.40 In contrast, more recently, while traditional Letter volumes have been declining, packet volumes have been increasing due to the greater use of the internet for shopping. This has had a positive impact on revenues as these products are priced significantly higher than Letters and Large Letters.
- 5.41 A change in product mix due to declining Letter and increasing packet volumes is to a large extent outside Royal Mail's control as it is driven primarily by the growth in electronic substitution and commerce (as a result of customers buying more products online rather than from the high street). However, it is also possible that changes in product mix could, at least in part, be due to Royal Mail's commercial strategy, in particular the relative and absolute pricing of different products and changes in delivery and collection methods which may encourage consumers to transact online and have items delivered to their homes.

### **Royal Mail's commercial strategy**

- 5.42 As discussed in Section 1, the new regulatory framework set out in our March 2012 statement gives Royal Mail pricing freedom for the significant majority of its products. For example, Royal Mail has implemented significant price increases over the last two years, in particular for universal services.
- 5.43 Increases in the prices of individual services are likely to reduce demand for these services and Royal Mail has taken this into account in its business plan. Historically the price elasticity<sup>26</sup> of the majority of mail products and customers has been low. However it is possible that some future price rises may not be profitable in the longer term, if the price elasticity of demand increases sufficiently.

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<sup>25</sup> A number of large customers expressed this view in response to Postcomm's consultation on Royal Mail's price increase in 2011-12 (where some business mail prices were increased by 15-20%).

<sup>26</sup> The degree that demand for a product varies based on changes in its price.

## Key risks to Royal Mail's future costs

5.44 There are also a number of factors that may affect Royal Mail's future costs, including:

- Progress on efficiency improvements;
- Expected volumes / rate of volume decline;
- Product mix; and
- The scope of the universal service.

### Efficiency improvements

5.45 Given the size of Royal Mail's operating costs compared to its margins, relatively small percentage changes in its efficiency performance can have a significant impact on profitability. As noted above, in performing our primary duty in relation to the universal service, we must have regard to the need for its provision to become efficient after a reasonable period and thereafter remain efficient. For these reasons, it is important as part of any assessment that we consider the progress that Royal Mail has made, and is planning to make, towards becoming efficient over the period of its business plan.

### Level of Royal Mail's control over efficiency

- 5.46 The need to meet its obligations in respect of the universal service inevitably constrains Royal Mail's ability to vary costs in line with mail volumes. That said, Royal Mail also exercises considerable control over its cost structure and efficiency levels: this includes the extent to which it implements the enabling measures in its modernisation programme, the speed of implementation and level of actual cost reduction.
- 5.47 Changes in product mix are also likely to have an impact on the level of cost reduction that can be achieved. This is because different products involve different workloads. To the extent that product mix is the result of structural changes in demand (such as changes in consumer preferences), it will be beyond Royal Mail's control. We would note, however, that an increase in average unit costs due to changes in the overall mix of mail (reflecting the growth in packets and the decline in letters) should be offset to some extent by revenue increases. This is because while packets are more costly to process than letters they are also have higher average prices.
- 5.48 Royal Mail's costs are also susceptible to other factors that are mostly out of its control, such as fuel costs and inflation (putting pressure on wage negotiations and other input costs). On the other hand, as 65% of Royal Mail's costs are labour costs<sup>27</sup>, non-labour costs are less likely to have a significant impact on its overall costs. It would therefore be important to account for these factors when considering the level of efficiency Royal Mail has and will realistically be able to achieve.

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<sup>27</sup> *Royal Mail Group Limited*, Regulatory Financial Statements 2011-12. UKPIL people costs as a proportion of operating costs.

## Assessment of efficiency

- 5.49 As we have noted, efficiency is likely to be a key part of our assessment of whether regulatory intervention is necessary in response to end-to-end competition. Accordingly, the approach we take to determine what constitutes a reasonable level of efficiency performance by Royal Mail is an important factor not just for this exercise, but also in considering the success of the regulatory regime for post more broadly.
- 5.50 A reasonable rate of efficiency improvement would take account of not just the scope that Royal Mail has to improve efficiency, but also of the speed at which it can reasonably be expected to modernise its operations and reduce costs. We recognise that if end-to-end entry were to increase rapidly, Royal Mail may not, within a short timeframe, be able to implement the changes needed to reduce its costs to offset the decline in revenue. Equally, if Royal Mail were to attempt to reduce its costs too quickly, it could result in operational risks that may cause delays or additional costs, or reduce the quality of service (which could potentially trigger further migration from postal services or a faster rollout of an entrant's end-to-end network).
- 5.51 Royal Mail's efficiency performance is central to many regulatory issues, not just end-to-end competition. The granting of substantial pricing freedom to Royal Mail in March 2012 was contingent on Royal Mail using this flexibility to improve efficiency. In addition, as mentioned above, Ofcom has a duty in respect of the efficient provision of the universal service. It therefore follows that Ofcom would need to consider Royal Mail's efficiency irrespective of the position on end-to-end competition. This will likely include what we consider to be a reasonable level of efficiency saving, taking into account how quickly such savings might be realised over time.

## **Volumes / rate of decline**

- 5.52 As discussed above in relation to revenues, future volumes and the rate of volume decline are likely to have a significant impact on the financial sustainability of the universal service. However, the impact of volume decline is not just on revenues – it also has cost implications. It is therefore important to consider the extent to which Royal Mail volume reduction directly leads to a fall in costs (which is termed 'cost marginality').
- 5.53 Much of Royal Mail's costs, at least in the short term, are relatively fixed – particularly in relation to mail delivery. For example, the incremental cost reduction from delivering an average of two rather than three items per day to every household may be relatively small.<sup>28</sup>
- 5.54 Royal Mail is, however, likely to have a degree of control over its costs in relation to falling volumes. We will need to assess what a reasonable level of cost marginality would be and take this into account when measuring efficiency.

## **Changes in product mix**

- 5.55 The extent to which product mix can have a significant impact on Royal Mail's revenues is discussed above. Changes in product mix can also have an impact on its overall unit costs as the proportion of higher and lower cost products changes.

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<sup>28</sup> Similarly, if volumes increase this is unlikely to be matched by an increase in costs (i.e. the marginal cost of the volume increase is relatively low).

- 5.56 All other things being equal, the reduction in letters and increase in packets is likely to increase Royal Mail's overall unit costs. This is because the average cost of processing and delivery is higher for a packet than for a Letter. However, as long as the increase in cost results in at least a corresponding increase in unit revenues, then this is not likely to impact on Royal Mail's future profitability and/or cause an issue for the financial sustainability of the universal service.
- 5.57 Royal Mail may have some degree of control over the impact that changes in product mix have on its costs, particularly if there is a difference in the relative level of operational efficiency between different products. However, this is likely to be limited and it would therefore be important to take this into account when assessing Royal Mail's control over the factors that may lead to the provision of the universal service being under threat.

### Scope of the universal service

- 5.58 The financial sustainability of the universal service is dependent on the costs of its provision, and those costs are in turn determined, at least in part, by its scope. In legal terms, the universal service is made up of:
- Certain minimum universal service requirements as set out in the Act, in its simplest form such as the requirement to collect and deliver mail six days per week<sup>29</sup> at a uniform and affordable price, everywhere in the UK; and
  - Certain elements that go beyond the minimum requirements in the Act, and which Ofcom considers should be provided in the UK as a universal service. These elements are set out in an order made by Ofcom under the Act<sup>30</sup>, including the requirement to provide a priority next day delivery service and a standard service which targets delivery within three days as well as minimum quality of service targets.
- 5.59 The minimum requirements can only be changed by a direction from the Secretary of State or through modifications to primary legislation. The elements that go beyond the minimum requirements in the Act can be changed by Ofcom by amending the order.
- 5.60 Before Ofcom can modify that order, the Act requires Ofcom to carry out an assessment of the extent to which the market for the provision of postal services in the UK is meeting the reasonable needs of users of those services. Ofcom is currently carrying out such an assessment, which must be completed by April 2013 under the provisions of the Act. Ofcom also has the power to make similar assessments in the future.
- 5.61 In assessing the factors that may contribute to Royal Mail's profitability falling below a level consistent with financial sustainability, we would expect to assume that the universal service is specified at the appropriate level, in light of the latest review of users' needs undertaken by Ofcom at that time. On that basis we would not consider the scope of the universal service was likely to be a contributory factor if Royal Mail's financial performance was below the level needed to ensure its future sustainability.

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<sup>29</sup> Five days per week for packets.

<sup>30</sup> Universal service Order 2012, Annex 6 of Securing the Universal service – Decision on the new regulatory framework, 27 March 2012, available at <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>

- 5.62 However, if we had good reason to believe otherwise, for example if a proposed change to the scope of the universal service has yet to be implemented, then we would take this into account in our assessment.

## Section 6

# Options for regulatory intervention in relation to end-to-end competition

## Introduction

- 6.1 In Section 4 we set out the process by which we would assess the impact of end-to-end competition on the universal service and in Section 5 we looked at how we would take into account the outcome of this analysis in considering whether to intervene in relation to end-to-end competition.
- 6.2 We believe that the powers available to Ofcom should allow us to identify and act on potential risks to the sustainability of the universal service as a result of end-to-end competition in a timely manner: we will have advance warning of competitors' plans through the notification process and we also have access to detailed information on Royal Mail's operational and financial performance on a regular basis through the monitoring regime. Nonetheless, we will be keeping developments in the market under close review to ensure that if there is a need to consider the case for intervention, it is identified and acted on sufficiently early.
- 6.3 In this section we set out the main regulatory interventions that we might consider taking if we reached the view that intervention was necessary and appropriate.
- 6.4 The section is structured as follows:
- First we note the general legal requirements relevant to imposing regulatory conditions.
  - We then discuss factors we would consider in the timing of any intervention.
  - The main part of the section sets out the key regulatory tools available to Ofcom to secure its primary duty. These are:
    - The ability to impose certain regulatory conditions, in particular general universal service conditions ("GUSC");
    - The potential for a universal service compensation fund; and
    - Other policy options that might have an impact on the issues raised by end-to-end competition.
  - We then end by setting out the factors we are likely to need to take into account when considering the most appropriate type of intervention.

## General legal requirements relevant to imposing regulatory conditions

- 6.5 A number of the options considered below have specific statutory tests provided for in the Act, which must be met before they can lawfully be adopted. We address these under the relevant headings below.

- 6.6 In addition, Schedule 6 of the Act provides that any regulatory condition that Ofcom considers imposing must be objectively justified, not unduly discriminatory, proportionate and transparent.
- 6.7 In order for any intervention to be proportionate, Ofcom would need to:
- Identify the threat to the provision of the universal service;
  - Identify the range of options that would be capable of addressing that threat; and
  - Choose the option within that range that addressed the threat in the least onerous way.
- 6.8 In carrying out this assessment, Ofcom would need to consider whether the threat to the provision of the universal service was caused by a single factor (such as end-to-end competition on its own), or a combination of factors. In the latter case, we would need to take a view on the relative contribution of those factors in deciding what regulatory intervention, if any, was appropriate.

## Timing of intervention

- 6.9 Ofcom has the powers to intervene in relation to end-to-end competition at any point, subject to following due process. A key consideration in determining the most appropriate form of intervention would therefore be the timing of the threat to the universal service. If the threat is sufficiently imminent then an intervention that is able to be applied in a commensurate timeframe would be necessary. If the threat is in the medium to long term, then there may be more flexibility in the types of regulatory intervention that could effectively be adopted.
- 6.10 Any decision to intervene at a particular point in time would need to take account of, amongst others: (i) the need to have sufficient confidence that the future financeability of the universal service is in doubt, so as to be able to meet the legal tests for intervention (which in general implies waiting longer before intervening); and (ii) the need to put in place any measures necessary in good time to offset that risk (which may imply earlier intervention). As well as our statutory duties in relation to post, any such judgment would take into account, among other things:
- The assessment of the expected short and long term impacts of end-to-end competition;
  - An assessment (possibly qualitative) of the underlying forecasts and assumptions that make up our assessment of the long term impacts and the uncertainty associated with these assumptions;
  - The expected time it will take to implement each intervention and for each intervention to take effect (discussed further in relation to each of the potential options below); and
  - The fact that we have the ability to intervene at any point in time, should our assessment reveal that intervention is necessary (e.g. through the monitoring regime).

## Main options for exercising our regulatory powers in relation to end-to-end competition

- 6.11 In the event that Ofcom has identified a threat to the provision of the universal service from end-to-end competition, and it is appropriate to take action against that threat, we consider that there are a number of potential options that Ofcom could consider.
- 6.12 The two key options are the imposition of GUSCs, and the setting up of a universal service compensation fund to which, for example, operators that meet certain criteria would be required to contribute. We address these below, noting at the outset that setting up a universal service fund would require action not only by Ofcom but also by the Secretary of State.

### General universal service conditions

- 6.13 Under section 42 of the Act, Ofcom has the power to impose a GUSC on postal operators that provide services (or a specified description of services) within the scope of the universal service. Section 40 of the Act defines which services fall within the scope of the universal service. GUSCs would apply to every postal operator providing such a service. However, GUSCs could potentially be designed to only apply to operators that have reached a minimum scale or provide a specific type of service.
- 6.14 Before Ofcom may impose a GUSC, it must be satisfied that it has met the relevant legal test for doing so. Section 42 of the Act provides that a GUSC may contain such obligations as Ofcom considers *necessary* to impose for, or in connection with, securing the provision of a universal service in accordance with the standards set out in the universal service order. The necessity test in the Act derives from Article 9 of the Directive, which is implemented by (among others) section 42 of the Act. The Act limits the scope of a GUSC, by providing that a GUSC may *not* require a person to:
- Deliver or collect letters six days a week, or other postal packets five days a week;
  - Provide a service throughout the UK; or
  - Provide a service at an affordable price which is uniform throughout the UK.
- 6.15 Subject to the above statutory limitation, a GUSC could take a wide range of forms provided Ofcom was satisfied that it met the general requirements of Schedule 6 of the Act as to proportionality, objective justification, discrimination, and transparency.
- 6.16 It could, for example, require postal operators<sup>31</sup> to deliver to a certain specification, such as a minimum number of days per week or a specified geographic area.
- 6.17 At the time of writing, there are a number of EU countries where requirements broadly similar to GUSCs have been placed on postal operators or potential entrants who are in competition with the universal service provider. These include specific requirements on the number of delivery days per week and the minimum geographic areas entrants must deliver to (for example, both are in place in Belgium and Finland).

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<sup>31</sup> That meet a specified criteria.

### How could GUSCs address a risk to the provision of the universal service?

- 6.18 As set out above, a GUSC may only contain obligations that Ofcom considers are necessary to impose for or in connection with the provision of a universal service. As a result, in order to impose a GUSC, Ofcom needs to have identified a risk to the provision of the universal service, at which the obligation(s) in the GUSC is/are targeted.
- 6.19 As discussed above, as the universal service provider, Royal Mail is subject to a number of regulatory requirements that impact the scale and scope of its operations and therefore the cost of the provision of its services. This includes the number of days it is required to collect and deliver to addresses throughout the UK (including the high cost rural areas). End-to-end entrants on the other hand are subject to fewer regulatory requirements that will impact the scale and scope of their operations. GUSCs could potentially, if necessary and proportionate, be used to rebalance the position of Royal Mail and potential entrants in this regard. In particular, this may be an appropriate intervention where entrants try to undercut Royal Mail, not by being more efficient, but by being able to operate as a lower cost provider solely as a result of not having the same regulatory obligations, and hence costs.
- 6.20 In light of the statutory test for imposing a GUSC, Ofcom could not impose a GUSC solely to level the playing field in regulatory terms between the universal service provider and the entrant, if it was not necessary to do so (as set out above).

### Obligations that a GUSC could impose

- 6.21 There is a wide range of obligations that could potentially be imposed through a GUSC. Given the central characteristics of the universal service obligations, they are, in our view, most likely to fall into the following two classes of obligations in relation to delivery:
- Minimum number of delivery days per week to each address (within the area entered); and
  - Minimum geographic coverage (potentially extending the area covered by the entrant).

#### *Days per week requirement*

- 6.22 A minimum requirement of the universal service, as set out in the Act, is for the universal service provider to collect and deliver mail six days per week. For a given volume, end-to-end operators that deliver less than six days per week are likely to have lower unit costs and will therefore be able to charge lower prices.<sup>32</sup> This in turn could result in the entrant taking volumes from the universal service provider that will still have to deliver six days per week. An obligation requiring operators to deliver on a minimum number of days to each delivery point or address in its coverage area could potentially address this situation, provided that it was necessary and proportionate for or in connection with the provision of the universal service.<sup>33</sup> As discussed above, any GUSC in relation to delivery days could not require an entrant to deliver letters more than five days per week.

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<sup>32</sup> They may also have lower unit costs, even with lower volumes, if they have lower fixed costs than Royal Mail.

<sup>33</sup> It may or may not be coupled with a requirement around the number of days after posting the item must be delivered i.e. D+X, i.e. a quality of service condition.

### *Geographic coverage requirement*

- 6.23 Royal Mail is required to deliver to each address (delivery point) in the UK. In principle, therefore, end-to-end operators should be able to operate a lower cost network if they only deliver in lower cost areas and rely on Royal Mail to deliver their mail in higher cost areas (through the access regime). A GUSC could seek to equalise this cost differential by requiring postal operators to deliver to a specified percentage (up to but less than 100%) of delivery points within a certain area of the UK. In addition, it could require an entrant to deliver to a nationally representative proportion of the population (i.e. deliver to the same proportion of urban, suburban and rural addresses as Royal Mail). Any reduction in delivery volumes would clearly result in less revenue for Royal Mail; where those volumes are lost in lower cost areas, it would also be likely to increase its average unit costs.
- 6.24 The specific form of geographic requirement would need to be targeted to the particular circumstances at the time we were considering exercising our regulatory powers. However, options might include requiring entrants to deliver to a certain percentage of the UK or to particular regions or zones. Alternatively, where an operator chooses to deliver to a city, it could also be obliged to cover a certain percentage of the surrounding suburban and rural areas.
- 6.25 It is important to note that, as discussed in Section 5, Royal Mail has pricing freedom to set its access prices (as long as they are fair and reasonable). It therefore should be able to address any issue of an imbalance in relation to geographic pricing and ensure that an end-to-end operator pays it fairly for delivering its items in the areas it has chosen not to enter (subject to competition law and the existing ex ante regulatory conditions to provide access on fair and reasonable terms, which apply to it).

### **Universal service compensation fund**

- 6.26 A universal service compensation fund would compensate the universal service provider for any unfair financial burden arising from having to provide the universal service. The setting up of such a fund is clearly envisaged in both the Directive and the Act as a mechanism for dealing with a threat to the provision of the universal service. There are a range of potential sources of funding which we discuss below.
- 6.27 At the time of writing, provision has been made for universal service compensation funds in a number of EU countries (such as Belgium, Estonia, France, Germany and Portugal). However, only in Italy has a fund actually been activated, although we note that PostNL recently submitted a request to the Dutch regulator, OPTA, for compensation of the net costs of the universal service.<sup>34</sup>
- 6.28 There are a number of steps involved in establishing a universal service compensation fund in the UK:
- First, prior to October 2016, the Secretary of State would need to direct Ofcom to review the net cost of the universal service (after this time, we could choose to undertake a review at our discretion);
  - Second, Ofcom would need to review the net cost of the universal service;

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<sup>34</sup> [http://www.postnl.com/Images/201209-postnl-pa-newsletter-nr-14-september-2012\\_tcm216-616055.pdf](http://www.postnl.com/Images/201209-postnl-pa-newsletter-nr-14-september-2012_tcm216-616055.pdf)

- Third, if that review established that complying with its universal service obligations imposes a financial burden on Royal Mail, Ofcom would have to determine whether it considered that financial burden to be unfair, and if so, to what extent it was unfair;
- Fourth, if Ofcom did determine that the universal service imposed an unfair financial burden on Royal Mail, it would have to report to the Secretary of State setting out recommendations as to the action, if any, that Ofcom consider should be taken to deal with the burden;
- Fifth, the Secretary of State would have to direct Ofcom to set up a fund; and
- Finally, Ofcom would have to design, consult and then establish the fund.

6.29 The following section sets out some of the key steps in further detail.

### Steps involved in establishing a universal service compensation fund

#### *Establishing the net cost of the universal service*

6.30 The purpose of a review of the net cost of providing the universal service would be to ascertain whether the costs of the universal service obligations are greater than the market benefits derived from being the provider of the universal service. This would determine whether the universal service obligations result in a net burden to Royal Mail. In assessing the costs, we would be required to take a view on Royal Mail's efficiency, as the Act expressly provides that Ofcom must consider the extent to which, in their opinion, the universal service provider is complying with its universal service obligations in a cost-efficient manner.

6.31 Should the review find there is a burden on Royal Mail in providing the universal service, we would then be required to ascertain whether that burden is unfair. This term is not defined in the Act or the Directive and Ofcom therefore has discretion to determine what this means as part of any such review.

#### *Design and implementation of a fund*

6.32 If directed to establish a fund, Ofcom would have to design and consult on its establishment. Depending on the detail of the direction from the Secretary of State, Ofcom might also have to decide on the level of the fund, including whether contributions should be made for meeting some or all of the burden concerned.

6.33 A key question would be the method of raising funds. This would need to address a number of issues:

- The contributors to the fund, e.g. postal operators or customers directly.
- The basis on which the contribution would be calculated. Where postal operators were required to contribute, it would be necessary to determine whether it was calculated, for example, on their mail volumes or revenues. In the case of a contribution by customers directly, this could be a surcharge on postal products.
- Which volumes/revenues were to be included, e.g. only universal service products or also non-universal service products.
- The level of the contributions required to match the sum of the fund.

## Other available regulatory powers

- 6.34 There are a number of other possible regulatory options that impact on how end-to-end competition affects the provision and financeability of the universal service. However, the nature of these options is such that they would generally require that a certain level of end-to-end competition has developed before they could potentially be effective.

### Modification to Royal Mail's requirement to offer access to its delivery network

- 6.35 End-to-end operators are unlikely to be willing or able to provide a service where they themselves can deliver to addresses across the entire UK. If they are to avoid requiring their customers to have separate contracts for delivering their mail between areas that the operator covers and those destined for other areas, then they will need to rely on access to Royal Mail's network for delivery of out of area items.
- 6.36 Although Royal Mail has substantially greater commercial freedom now (compared to the previous regulatory regime) it still has an obligation to provide access to its Inward Mail Centres in respect of letters so that other postal operators have the opportunity to collect and sort mail which is then handed over to Royal Mail for delivery. In addition, Royal Mail is subject to an ex ante margin squeeze test to protect upstream competition and operators are able to bring formal disputes for resolution by Ofcom in respect of the terms and conditions of access.<sup>35</sup>
- 6.37 As end-to-end competition develops, it might be appropriate to review the existing access obligations which apply to Royal Mail, specifically to consider whether it should continue (as is presently the case) to be required by ex ante regulatory conditions to offer access to its network to all third party postal operators, including those who compete with Royal Mail on an end-to-end basis. This could be the case where there is a material amount of end-to-end competition in certain areas.
- 6.38 Ofcom would have to consider the impact on the wider access market before adopting any changes to the access regime. Changing the conditions of access to Royal Mail's network would also impact on other access providers, not just those that are also providing end-to-end services. This impact would need to be taken into account in assessing the appropriateness of such a measure, recognising the benefits from access competition to the overall postal market (as discussed in our March 2012 statement).

### Requiring end-to-end operator(s) to offer access to their own delivery network

- 6.39 Instead of removing access obligations from Royal Mail in certain areas (as discussed above), an alternative might be to apply them to end-to-end operators, for example, when they reach a certain market share nationally, or in a particular area. Ofcom has powers to impose general access conditions, under section 50 of the Act.
- 6.40 The purpose of doing so would be similar to the imposition of a GUSC, i.e. as a potential way of addressing any imbalance between Royal Mail (which as the universal service provider, is currently required to offer access to its network) and other postal operators who do not have this requirement.

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<sup>35</sup> As set out from page 155 of our March 2012 statement.

## Competitive tendering of the universal service

- 6.41 The Act allows for the possibility of the universal service being competitively tendered. That is, it would be possible effectively to franchise out the provision of the universal service in certain areas according to a process of competitive bids. In theory this might provide a means of reducing the overall cost of providing the universal service. This in turn may mean it is possible to accommodate a greater amount of competition without a threat to the provision of a universal service.
- 6.42 The Act, however precludes exercising this power for the first ten years of its operation (i.e. not before 2021), unless Royal Mail consents to it. As with the universal service compensation fund, competitive tendering could only be introduced following a review of the burden of providing the universal service. Such a review would need to find that a postal operator could provide a universal service at a lower net financial burden (or potentially with a net financial benefit) than was currently the case. As with the universal service compensation fund the Secretary of State would have to direct Ofcom in this regard.

## Factors Ofcom would likely need to take into account when considering an intervention

### Timeliness

- 6.43 As set out at the beginning of this section, a key consideration in determining the most appropriate form of intervention is the timing of the threat to the universal service.
- 6.44 Of the options identified above, a GUSC is likely to be the intervention that could be applied most quickly. Ofcom already has the necessary powers to impose a GUSC and could exercise those powers in accordance with the requirements of the Act. A GUSC might therefore be a particularly appropriate option where there is a short term/immediate threat to the provision of the universal service. We estimate that, subject to the necessary level of analysis and consultation, a condition could be put in place within 6-9 months. GUSCs can therefore be imposed at relatively short notice and can remain in place for as long as Ofcom considers them to be necessary.
- 6.45 By contrast, implementing a compensation fund, including the complex task of quantifying the net financial burden, would likely require a significant amount of time given the steps that need to be taken pursuant to the Act. This could mean it is less likely to be appropriate to address the short term risks to the universal service, at least from the current starting point where the process of setting up a universal service fund has yet to commence.
- 6.46 As noted above, the other three options covered in this section would generally require a significant degree of end-to-end competition to be in place and as such are more appropriate as medium to longer term options. However, assuming such a level of end-to-end competition did exist, both options relating to access arrangements could potentially be put in place in a similar timeframe to GUSCs. At this point, competitive tendering is likely to be the longest term option, given the current restrictions in the Act and the likelihood of the need for there to be a suitable alternative operator that could deliver all or part of the universal service.

## Potential to address the specific threat

- 6.47 A key factor that Ofcom would have to take into account when determining the type of intervention is the potential for that intervention to address the specific threat to the universal service that had been identified.
- 6.48 To the extent that the risk to the universal service was a threat to its financial sustainability as a result of other operators exploiting the greater regulatory freedoms they have compared to the universal service provider, a GUSC may be able to target the source of the distortion that gives rise to that risk.
- 6.49 However, as the mechanism by which GUSCs might work to address the risk to the universal service is indirect (that is they would impact on the operations of other postal operators rather than directly on the universal service provider itself) it may be difficult to assess, with a high level of accuracy, the effect of a specific form of condition on addressing the threat to the universal service. (This also applies in amending Royal Mail's access obligations or applying access obligations to an end-to-end entrant.) This could mean that ongoing monitoring would be required to determine whether the conditions were addressing the threat identified from end-to-end competition, and remained proportional to the size of that threat (and if they were not, whether they should be changed).
- 6.50 A universal service compensation fund might also be able to address a specific threat to the universal service, given it would be intended to address (in whole or in part) the net financial burden of the universal service (regardless of the extent to which this was caused by end-to-end competition). Competitively tendering the universal service might also have a similar effect to a fund in terms of reducing or removing the net financial burden.
- 6.51 However, the fund might be limited in how far it could address the threat, in a situation where contributions were based on the operator's share of revenues or volumes. For example, if Royal Mail had 90% of the market, it might only receive enough funding from the operator(s) that held the remainder, to target 10% of the problem.

## Regulatory risk

- 6.52 Any action in relation to end-to-end competition is a form of regulatory intervention and as such carries regulatory risks. Ofcom would need to take these factors into account when considering intervention to ensure it was as effective as possible and carried out in a way which imposed the lowest overall net cost.
- 6.53 One such risk, is the potential for an intervention to deter entry altogether when that entry might be compatible with the sustainable provision of the universal service and beneficial for postal users. This could potentially risk losing the opportunity that competition may provide efficiency incentives to reduce the long term cost of providing the universal service.
- 6.54 There is also a risk of unintended consequences. These could, for example, apply where requirements are placed on operators to do more than they would otherwise have done, for example, to deliver to a wider geographical area than planned or to offer access to their network to others. It may be necessary to consider the consequences of such requirements causing more volumes switching to an alternative operator – potentially further damaging the financial sustainability of the universal service.