



End-to-end competition in the postal sector

Ofcom's assessment of the responses to the draft guidance on end-to-end competition

Statement

Publication date: 27 March 2013

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Section 1

Background

Introduction

- 1.1 Historically certain parts of the postal sector have been reserved for the incumbent postal operator. However, the Third Postal Directive required the abolition of such reserved areas by 31 December 2010 in most Member States, with a further two years allowed for the remaining 11 Member States. In the UK the market was fully opened to competition in 2006.
- 1.2 In October 2011, the Postal Services Act 2011 ("the Act") came into force and Ofcom gained the responsibility and powers to regulate postal services. Our principal duty under the Act is to secure the provision of a universal postal service. In our statement of 27 March 2012 ("the March 2012 Statement"¹) Ofcom put in place a new regulatory framework which proposed to grant Royal Mail pricing freedom coupled with key safeguards to ensure that it would have strong incentives to improve efficiency and to protect vulnerable consumers. One of these safeguards was the existence of competition, in the form of both access competition and end-to-end competition. In this regard we noted that while end-to-end competition could potentially provide powerful incentives on Royal Mail to reduce its costs across the full length of the value chain, it also posed a greater threat to the sustainability of the universal service than access competition, in that it would remove proportionately greater amounts of revenue from Royal Mail.
- 1.3 In April 2012, TNT Post began a trial of end-to-end delivery services in the west London area in competition with Royal Mail. Given this significant development, in July 2012 Ofcom published an update on end-to-end competition.² This was intended to provide greater certainty and clarity on the position we had set out in the March 2012 statement on the new regulatory framework for post. In this July update, 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.
- 1.4 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. This led to us publishing the draft guidance on 31 October 2012 (the "Draft Guidance").³
- 1.5 Two subsequent announcements suggest to us that the decision we took in July 2012 was appropriate.
- 1.6 First, on 13 November 2012, Royal Mail published its interim financial report for the first half of 2012-13. Royal Mail's results were its best for several years; with its division UKPIL (UK Parcels, International and Letters) reporting an operating profit

¹ 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/>

² Update on Ofcom's position on end-to-end competition in the postal sector, 25 July 2012, <http://stakeholders.ofcom.org.uk/binaries/post/update.pdf>.

³ The Draft Guidance and the non-confidential versions of the responses are available here: <http://stakeholders.ofcom.org.uk/consultations/end-to-end-guidance/>.

(after exceptions) of £99 million (compared to an operating loss of £41 million for the first half of 2011/12). However, although Royal Mail's performance is now on an improving trend, its profitability is still below the target range we have identified as being consistent with the financial sustainability of the universal service (5% to 10% EBIT margin).

- 1.7 Second, on 25 February 2013, PostNL – TNT Post's owner – published its Q4 and full-year 2012 results. In these results and related presentations, PostNL published information on the current scale of its end-to-end operations in London and its intentions. In particular, it said that as of December 2012 TNT Post was delivering 345,000 letters per week as part of the London operations. This is about 0.13% of the relevant market (by volume). PostNL also said that due to its cash constraints it was looking for €50 to €80 million of external investment to complete a full rollout of end-to-end services in the UK.⁴
- 1.8 We received 15 responses to our consultation on the Draft Guidance from:⁵
 - Royal Mail;
 - Five other postal operators (both access and end-to-end operators) including TNT Post;
 - Three consumer groups (Consumer Focus, the Citizens Advice Bureau (CAB) and the Ofcom Advisory Committee for Wales (ACW));
 - Three associations (the Mail Competition Forum (MCF), Mail Users' Association (MUA) and Intellect);
 - Two unions (Communication Workers Union (CWU) and Unite); and
 - Alan Reid MP.
- 1.9 Ofcom's final Guidance on this matter has been published separately today.⁶ This statement sets out stakeholders' responses on the issues raised in the Draft Guidance and provides our response on these issues. We have set out those areas where the final Guidance differs from the Draft Guidance to take into account consultation responses. The structure of this statement is as follows:
 - *Section 2 – The circumstances under which we would undertake a review of the need for intervention* – this section covers responses to Section 4 of the Draft Guidance.
 - *Section 3 – Assessing the potential financial impact of end-to-end competition on the universal service* – this section covers responses to Section 5 of the Draft Guidance, namely the steps that we would take to form a detailed view of the

⁴ PostNL Q4 and 2012 full year results press release (http://www.postnl.com/Images/20130225-postnl-2012-q4-press-release_tcm216-666131.pdf); PostNL Analyst presentation (http://www.postnl.com/Images/20130225-postnl-2012-q4-analyst-presentation_tcm216-666158.pdf); and transcript of the analyst presentation (http://www.postnl.com/Images/20130304-postnl-2012-q4-analyst-presentation-transcript_tcm216-666855.pdf).

⁵ The full list is contained in Annex 1.

⁶ *End-to-end competition in the postal sector: Final guidance on Ofcom's approach to assessing the impact on the universal postal service* <http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E-Guidance.pdf>

likely impact of end-to-end competition on Royal Mail's financial position and its ability to provide the universal service in a financially sustainable way.

- *Section 4 – The implications of the analysis of the impact of end-to-end competition* – this section covers responses to Section 6 of the Draft Guidance, where we set out how we would assess the findings of our analysis to form a view as to whether the financial sustainability of the universal service is threatened as a result.
- *Section 5 – Options for regulatory intervention in relation to end-to-end competition* – this section covers responses to Section 7 of the Draft Guidance, which set out the main regulatory interventions that we might consider taking if we reached the view that intervention was necessary and appropriate.

- 1.10 Comments from stakeholders relating to the other sections of the Draft Guidance (including Section 3 on the legal framework) are addressed where relevant in the above sections.
- 1.11 As a result of stakeholder responses and our analysis, we have decided to make three substantive changes to the final Guidance. We have:
- made a change to be clearer about the circumstances under which we would initiate a review;⁷
 - made a clarification in relation to the issue of the treatment of exceptional items;⁸
 - removed reference to the current work Ofcom is doing to understand the appropriateness of different methodologies for assessing efficiency. We have instead included an update on the efficiency work in this statement.⁹
- 1.12 We have also made other minor modifications to reflect the change in status of the Guidance from draft to final,¹⁰ include a summary of our approach to securing the provision of the universal service in the presence of end-to-end competition¹¹, add a paragraph to the introduction to Section 5¹² and to improve clarity in relation to a comment on the universal service compensation fund and competitive tendering.¹³

General comments on end-to-end competition

- 1.13 In the consultation on the Draft Guidance, we sought views on the approach proposed by Ofcom to the assessment of the impact of end-to-end competition on the universal service. However, a number of respondents provided their views on

⁷ At paragraph 3.26 of the final Guidance (paragraph 4.26 of the Draft Guidance) a bracketed sentence has been added to the first bullet point and an additional bullet point to the end.

⁸ A bracketed sentence has been added to the footnote in paragraph 3.5 of the final Guidance and paragraph 3.7 omits the specific reference to the 2011-12 profit and recent cashflow of Royal Mail's universal service business that was referred to in paragraph 4.7 of the Draft Guidance, along with the associated footnote.

⁹ Paragraphs 6.50-6.52 of the Draft Guidance have been consolidated into Paragraph 5.51 of the final Guidance.

¹⁰ Including removal of the Covering Note and the Annexes on our consultation process.

¹¹ At paragraphs 1.4-1.11 of the final Guidance, this includes the introduction section from the Draft Guidance.

¹² Paragraph 5.6.

¹³ Paragraphs 6.50-6.51 of the Guidance, formerly paragraphs 7.50-7.51 of the Draft Guidance.

end-to-end competition in general or raised wider points in relation to the type of entry and the impact this may have on Royal Mail.

- 1.14 Below, we very briefly summarise these points. However, given the scope of the consultation we do not provide a point-by-point response on these issues. The consultation was on how we would approach an assessment of the impact of end-to-end competition on the universal service rather than a consultation on the advantages and disadvantages of end-to-end competition in the postal sector.
- 1.15 Roughly half of respondents expressed some concern about the impact of end-to-end competition on the universal service. A number of other respondents (including TNT Post, the MUA and Consumer Focus) pointed out the potential benefits to customers and consumers that could result in increased choice, innovation and improved efficiency. Conversely, Royal Mail and Unite both stated that end-to-end competition was unlikely to significantly strengthen Royal Mail's efficiency incentives. Royal Mail considered it already faced strong efficiency incentives and if extra cost cutting was required there would be significant execution risk to its transformation programme. The CWU was also concerned that end-to-end competitors may rely on low wages and precarious employment terms in providing their services.
- 1.16 The MUA, TNT Post, the MCF, ONEPOST and DX all expressed concern that, by Ofcom proposing possible interventions, perverse incentives are created for Royal Mail. The MCF stated its view that there could be no greater incentive for delivering efficiency than exposing Royal Mail to end-to-end competition.
- 1.17 Intellect, the CWU, the CAB, Unite, Royal Mail, the ACW and Alan Reid MP all highlighted concerns regarding competition based on cherry picking, whereby a new entrant could target high density areas and undercut Royal Mail's prices – not as a result of a more efficient service but because the entrant would not have universal service obligations.

Section 2

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

Consultation responses

- 2.1 Royal Mail and TNT Post both asked for additional regulatory certainty over the circumstances under which we would initiate a review. Royal Mail considered that certainty would be provided if Ofcom set out a threshold at which we would commence a review, but that we should not be restricted to initiating a review only in these circumstances. Royal Mail believed that this threshold should be when end-to-end competitors reach 2% market share of volume (equating to approximately a 1% reduction in Royal Mail's revenue) as this would have a material impact on the financial sustainability of the universal service. Royal Mail considered an early review was essential given the potential speed of rollout by competitors.
- 2.2 TNT Post argued it was essential that the circumstances under which we would initiate a review were objective and transparent and based on measurable criteria. It noted that end-to-end competitors would need to make significant investment decisions at different points in the rollout of their delivery operations and it would therefore be crucial that any review is signalled far enough in advance to ensure that an informed investment decision is made. TNT Post also wanted clarity about what was meant by a "material" increase in the level of competition and, in particular, whether this was in relation to a competitor's current delivery operations or its planned rollout that it had previously provided to Ofcom.

Our assessment

- 2.3 The Draft Guidance (paragraphs 4.25-4.26) set out that we would commence a review of the need for intervention in relation to the provision of the universal service if there is a potential material threat to that provision resulting from end-to-end competition. We continue to consider that the monitoring regime is the most appropriate and comprehensive way of determining when to review the impact of end-to-end competition on the universal service. Moreover, we consider that it is not necessary to undertake a detailed review every time an end-to-end operator notifies Ofcom of its intention to expand its delivery operations if this expansion is consistent with what Ofcom has previously taken account of.
- 2.4 We would however be likely to undertake a review if the expansion was a material change to previously notified plans or it was a new competitor of a significant scale entering the market. It may also be necessary to review the need for intervention if there has been a material change in the financial sustainability of the universal service – for example due to a change in the expected level of revenues or costs.

- 2.5 We have made two changes to the proposals in the Draft Guidance to reflect TNT Post's comments.¹⁴ First, regarding TNT Post's view that it was unclear in the Draft Guidance whether the material change to the level of competition would be based on the current level of competition or a material change to business plans previously provided to Ofcom.¹⁵ Second, to provide greater clarity to stakeholders we have explicitly set out the circumstance where end-to-end competition has developed to a level that we had previously identified might signal the potential of a threat to the universal service.¹⁶
- 2.6 We recognise that Royal Mail is concerned – particularly given its likely lack of information about its competitors' plans – that the circumstances under which a review is triggered are sufficiently robust such that any threat to its future provision of the universal service is identified and acted on sufficiently far enough in advance. On the other hand entrants will be concerned about the potential impact of any regulatory decision to intervene on their current and future investment decisions.
- 2.7 A threshold based on an entrant's market share would be objective and transparent and likely to provide Royal Mail greater certainty over the circumstances under which we would undertake a review. However, the market share of end-to-end operators is only one of a number of factors that may affect Royal Mail's ability to continue to provide the universal service. In addition, once any market share has been reached (and a review undertaken), it will become obsolete. We also consider that it would be difficult to set the level of any market share threshold given the uncertainty associated with future forecasts. As such, what could be an arbitrary threshold could also become a focal point for the industry and be misinterpreted as the market share at which regulatory intervention would be likely to occur.
- 2.8 We do, however, consider there is merit in Ofcom committing to carry out an assessment of the impact of end-to-end competition on the provision of the universal service at some defined point in the future. This would allow us to review the actual and potential impact of end-to-end competition once we have a better understanding of how the market is developing given the uncertainty over many of the key assumptions in any forward looking assessment. In particular, it would provide us with the opportunity to take account of how end-to-end competition has actually developed in the UK market for a period, including how successful entrants have been in achieving their business plans which, in turn, would allow us to develop a better informed view of the potential long term prospects for competition in delivery. We would also be able to observe Royal Mail's response to the challenge from end-to-end competition and how effective these measures have been.
- 2.9 Committing to initiate a review at a certain point in time would provide many of the benefits of a market share threshold without the difficulties associated with determining the appropriate level of the threshold. It would allow us to undertake a review at a particular point in time rather than relying on only one of the factors that influence whether the universal service is financially sustainable. It may also give some additional certainty to potential entrants to enable them to make more informed investment decisions. However, consistent with Ofcom's legal duties in the postal sector, we would still initiate a review earlier if we considered there was a material threat to the provision of the universal service. As such, there is an inherent limit in the level of clarity and regulatory certainty that can be given to stakeholders regarding future developments in the market.

¹⁴ At paragraph 3.26 of the final Guidance (paragraph 4.26 of the Draft Guidance).

¹⁵ A bracketed sentence has been added to the first bullet point.

¹⁶ An additional bullet point has been added at the end.

- 2.10 Therefore, if our monitoring of market developments has not already led to a full review, we will initiate a review into the impact of end-to-end competition on the universal service towards the end of 2015. This will coincide with the mid-point of the seven year period established for the current regulatory regime for postal services set out in our statement published in March 2012. In the event, however, that circumstances change and lead us to the conclusion that the sustainability of the universal services may be at risk as a result of end-to-end competition, we will initiate a review at the point we make that determination. However, as noted in Section 1, the evidence available to us does not suggest there is a case for initiating a review now or in the immediate future given our current understanding of competitors' plans.

Section 3

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

Consultation responses

- 3.1 At Section 5 of the Draft Guidance we proposed a four step approach to how we would assess the financial impact of end-to-end competition on the universal service.
- 3.2 Royal Mail agreed that the assessment of the financial sustainability of the universal service should be based on its reported business. Royal Mail also welcomed the approach for assessing the impact of end-to-end competition on its financial projections (set out in step one). However, it stated that, since markets are subject to many inter-related dynamics, it would be impossible to isolate the effect of end-to-end competition on the sustainability of the universal service. Royal Mail argued that Ofcom should adopt a probabilistic approach to assess the causal relationship between end-to-end competition and the financial sustainability of the universal service. It noted that this would enable various factors to be assessed using a range of sensitivities rather than having to generate a narrow range of scenarios. Royal Mail also noted it was important that Ofcom does not set the standard of proof too high.
- 3.3 TNT Post commented on Ofcom's four steps to assess the financial impact of end-to-end competition on the universal service. It considered that:
 - Royal Mail's business plan would only be a sensible starting point if it takes realistic account of the degree of competition and the measures Royal Mail intends to take to respond to this, including its planned commercial strategy, cost reductions and efficiency gains.
 - It is unlikely that competitors will underestimate their expected success to forestall regulatory intervention, because (a) the quarterly notifications will quickly reveal disparities and (b) it would struggle to justify to its shareholders a "head in the sand" approach of making significant investment in machinery and recruitment of employees, and then running the risk of subsequently being forced to make staff redundant or materially write down the value of its assets.
 - The speed of Royal Mail's response should not be a relevant consideration. It argued Royal Mail has the scale, scope and financial power to withstand transitory inefficiency, but it needs competitive pressure to ensure it addresses its inefficiency. TNT Post stated that the only relevant consideration is Royal Mail's ability to provide the universal service, not its financial position generally or a minimum level of profitability. TNT Post also believed that Ofcom should consider the effect of Royal Mail's continued provision of loss-making services (such as international bulk mail services and Relay).
 - TNT Post also argued that it was not clear how Ofcom could assess the impact of end-to-end competition on the universal service without determining the net cost of the universal service. TNT Post argued that in assessing the impact of end-to-

end competition, if the extent of the universal service is set at a level wider than it needs to be, there can be no defensible argument that competition should be constrained. (This point about the scope of the universal service is addressed in Section 4.)

- 3.4 The CWU considered there was inherently a high level of risk involved in Ofcom's assessment and called for Ofcom to begin to monitor far more closely the commercial activities of end-to-end competitors. It believed that there were incentives for both Royal Mail and end-to-end entrants to present commercial information in a way which may influence the regulator. In addition, the CWU considered that difficult judgements needed to be made throughout the proposed process and these carry high levels of uncertainty. This included whether Royal Mail's business plan was an accurate predictor of future performance. The CWU also noted that competitors' business plans would be likely to be untested and that there is a great deal of uncertainty over Royal Mail's potential commercial responses.
- 3.5 ONEPOST believed that Ofcom needed to consider whether Royal Mail's business plan was realistic in light of its current performance and in comparison with other European operators. CFH considered that Ofcom's general approach made sense in theory, but that the analysis would be subject to great uncertainty due to the large number of variables. Given these uncertainties, it believed that Ofcom should not propose a regulatory regime that would pre-emptively take action against a competitor, but that any regulatory action should only be taken once competition has developed.

Our assessment

- 3.6 We have considered the responses to our proposed four step approach in assessing the financial impact of end-to-end competition on the universal service and have decided it is not necessary to change the Guidance in this area.
- 3.7 In considering the expected impact of end-to-end competition, we will use whatever techniques or approaches are appropriate in light of the specific data and issues. In particular, we would consider various scenarios, based on all key relevant variables, which span the range of likely outcomes. We would also consider the likelihood of these scenarios occurring. In practice we think there may be little if any significant difference between the probabilistic approach Royal Mail proposes and the approach we have described.
- 3.8 While we agree with TNT Post that it is unlikely competitors will underestimate their expected success to forestall regulatory intervention, we need to take into account the risk of longer term forecasts being less accurate than short term forecasts. As explained above, we would address this risk by considering the range of likely outcomes as part of the sensitivity analysis. We would take the speed of Royal Mail's response into account in circumstances where we thought that the universal service was likely to be unsustainable on a non-transitory basis.
- 3.9 As we explained in our March 2012 Statement, a 5% to 10% EBIT margin is indicative of returns consistent with the financial sustainability of the universal service. We do not intend this range to guarantee a minimum or a maximum profitability, which seems to be TNT Post's concern. This is further discussed in the following section under the heading "the basis for assessing financial sustainability".
- 3.10 As raised by TNT, we would expect to consider any loss making services that are being offered by Royal Mail as part of any assessment of Royal Mail's potential

commercial response. In this respect, we note that services that share the universal service network could be positively contributing to the universal service as long as they recover at least their incremental costs, and there may therefore be a case to continue these services even if they appear to be loss making on a fully allocated cost basis.

- 3.11 We note the concern expressed by the CWU about the level of risk associated with the process we have set out for assessing the potential financial impact of end-to-end competition on the universal service. However, regardless of the outcome of any assessment on the need for intervention in relation to end-to-end competition, we already monitor the market closely and will continue to do so. We receive detailed monthly and quarterly data from Royal Mail, in particular on its financial performance. We also receive data quarterly from both access and end-to-end competitors on their volumes and revenues. Moreover end-to-end operators are required to notify us three months in advance of any expansion in their delivery operations over a certain threshold (currently 2.5 million items per quarter). We therefore consider that we will have sufficient information to determine at an early stage if the financial position of the universal service is worsening and we can, if necessary, initiate or re-open a review.
- 3.12 We agree with ONEPOST that we should assess whether Royal Mail's business plan is realistic in light of its ongoing performance. This would form part of "reviewing the assumptions to test whether they are plausible and reasonable" under step one. One way of doing this assessment could be to compare Royal Mail with other European operators. However, we note that drawing conclusions from such comparisons would be done with a degree of caution, taking into account the differences as well as the similarities between the countries, markets, operations, competition and other relevant factors.
- 3.13 We disagree with CFH's response that the uncertainties mean we should wait until end-to-end competition has developed before we conduct an analysis of the impact. As we explain in step four of our assessment process, in testing whether the universal service is likely to be put at risk, we will allow for the uncertainties associated with the projections of the relevant businesses. We state in the Guidance, if we are satisfied that the threat to the universal service is likely to lead to an enduring problem in the sustainability of the universal service – such that intervention is necessary and appropriate – then we may need to intervene before such a point is reached. The timing of any potential intervention (including the need for the threat to be sufficiently imminent) is addressed in Section 6 of the Guidance.

Section 4

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

The basis for assessing financial sustainability

- 4.1 Section 6 of the Draft Guidance outlined how we would consider whether the sustainability of the universal service was likely to be under threat from end-to-end competition. It also set out how this would potentially affect the type of intervention that was appropriate, taking account of the factors contributing to Royal Mail's financial performance and the extent to which they were, or were not, largely within Royal Mail's control.

Consultation responses

- 4.2 The Draft Guidance reiterated our approach to assessing the financial sustainability of the universal service as set out in the March 2012 Statement. Royal Mail supported the proposal to assess financial sustainability with reference to the reported business and in terms of its ability to earn a reasonable commercial rate of return measured as the EBIT margin on the reported business. Royal Mail also stated it did not disagree that financial sustainability should take into account both the need to make a reasonable commercial rate of return and the level of risk associated with providing the universal service.
- 4.3 However, Royal Mail considered that the lower end of the EBIT range is not consistent with a reasonable commercial rate of return for a company with its risk profile. Royal Mail reiterated its arguments put forward in response to the October 2011 consultation¹⁷ that the EBIT margin should be heavily influenced by the return achieved by other major privatised European universal service providers, namely Deutsche Post, Austrian Post and Post NL. It considered that Ofcom should set a point estimate in line with established best practice for determining the allowed cost of capital when setting regulated price controls, and that this should be at the top end of the proposed range (i.e. 8% to 10% EBIT margin), if not above. In its view, the risks of setting a rate of return that is too low far outweigh the risks associated with setting it too high.
- 4.4 Royal Mail also believed that further clarity was required as to the intended treatment of exceptional items as the Draft Guidance may lead to ambiguity on how transformation costs will be treated by Ofcom. It considered that the right approach was the one set out in the March 2012 statement that Ofcom would not expect restructuring or redundancy costs recurring year on year to be included in exceptional items.
- 4.5 TNT Post argued that the UK legislation went beyond the requirements of the Third Postal Directive (2008/06/EC) (the Directive) in requiring that the regulator has regard to the need for the universal service to make a reasonable commercial rate of return. It considered that the relevant level of profitability should be set at the lowest

¹⁷ Securing the Universal service – Consultation, 20 October 2011, available at <http://stakeholders.ofcom.org.uk/consultations/securing-the-postal-service/>

acceptable rate, taking into account permissible reductions in the scope of the universal service.

- 4.6 While Consumer Focus agreed that other postal operators have earned returns similar to the 5% to 10% EBIT margin and that it may be appropriate to set such a target (e.g. in the context of a price control), it considered that Ofcom should not set a return for Royal Mail that would be a regulatory target for intervention in relation to end-to-end competition. It was of the view that successful end-to-end entry may legitimately reduce Royal Mail's margins and noted that the target margins set out in the Draft Guidance exceeded those that were being achieved by competitors in the growing e-commerce market.

Our assessment

- 4.7 We continue to consider that in any assessment of the impact of end-to-end competition on the provision of the universal service it is appropriate to determine whether the EBIT margin for the reported business is, on a forward looking basis, within the range we consider consistent with the financial sustainability of the universal service (i.e. the EBIT margin range used in the monitoring regime). We therefore consider that transient low profitability would not be likely to threaten the provision of the universal service. As discussed further below, this does not guarantee a return to Royal Mail within the 5% to 10% EBIT margin.
- 4.8 When putting the regulatory framework for the postal market in place in March 2012, we undertook a considerable amount of work to understand the level of profit that would be required, and how it should be measured, in order to ensure the financial sustainability of the universal service. We considered the indicative 5% to 10% EBIT margin was commensurate with the level of risk within the business based on market evidence, analysis undertaken by consultants at Ofcom's request,¹⁸ and regulatory precedent. In essence, we presently consider that an EBIT margin of less than 5% would not be consistent with ensuring financial sustainability. In addition, as we have not put a traditional price control in place we do not consider it is necessary or appropriate to set a point estimate target for the EBIT margin for the reported business (as suggested by Royal Mail).
- 4.9 No stakeholder provided any new evidence in response to this consultation to show that the indicative 5% to 10% EBIT margin is inappropriate in securing the provision of the universal service. Royal Mail's arguments about the return achieved by other major privatised European universal service providers were considered in making our decision on the new regulatory framework.¹⁹
- 4.10 We consider that, given our analysis (on the level of profitability consistent with financial sustainability) was undertaken relatively recently and the absence of any new evidence suggesting a different range, it is not necessary at this stage to review the indicative EBIT range for the monitoring regime and/or in the finalised guidance.
- 4.11 In relation to Royal Mail's call for clarity on our approach to exceptional items, our position remains as set out in the March 2012 statement. The reference in the Draft Guidance to EBIT before exceptional items was simply to illustrate Royal Mail's improving financial position in general terms and was not intended to reflect a change

¹⁸ Report by CEPA on the margins earned by international postal operators with private investment, other regulated companies and asset-light industries. <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/annexes/financeability.pdf>

¹⁹ We explicitly took into account the 2011 EBIT margins which Royal Mail quotes in its submission.

in position with respect to the treatment of recurring restructuring or redundancy costs in any assessment of financial sustainability. For clarity, we have removed the reference from the finalised Guidance.²⁰

Sustaining the universal service while avoiding perverse incentives

Consultation responses

- 4.12 In the Draft Guidance, we set out the importance of the regulatory regime maintaining the right incentives on Royal Mail and, in particular, of ensuring that Royal Mail is sufficiently incentivised to improve efficiency and innovate. We recognised that the potential for future intervention (in particular, if this was guaranteed whenever Royal Mail's performance fell below the level consistent with financial sustainability²¹) may create perverse incentives in relation to efficiency. We considered that an appropriate application of the "fair bet" principle (used in our regulation of telecoms) was a useful way to approach financeability while addressing that risk.
- 4.13 Royal Mail agreed that the 'fair bet' principle may have a role to play in the design of the regulatory framework for Royal Mail, as it does in other utility sectors in the UK. It understood the principle that it cannot be guaranteed a certain return and recognised the strong incentive properties of this approach in regulated industries.
- 4.14 Royal Mail welcomed Ofcom's acknowledgement of the need for the fair bet principle to be adapted to take into account our duties in relation to post and that, in practice, not all of the adverse outcomes will necessarily be borne by Royal Mail. However, it considered it was not clear how the 5% to 10% EBIT margin and the fair bet principle would be factored into any decision to take regulatory action and argued that this needed to be clarified in the Guidance. It was concerned that Ofcom's intended approach would amount to double counting of the fair bet principle – once in setting the EBIT margin range which we recognised in the Draft Guidance was consistent with Royal Mail bearing some of the downside risks, and secondly in the refusal to intervene if returns fell below the lower end of that range. If this was Ofcom's intention, Royal Mail considered it was inconsistent with the March 2012 Statement where we noted the potential need to reconsider the regulatory framework if returns fell below the 5% to 10% EBIT margin, and our primary duty to secure the provision of a universal service.
- 4.15 Royal Mail considered that it already faces strong efficiency incentives and that there is no evidence that end-to-end competition or the prospect of intervention would affect these incentives. It believed that it was very important not to overstate the importance of end-to-end competition as a driver for its efficiency. Unite also considered that Royal Mail is already heavily committed to change and cost reduction.

²⁰ Paragraph 3.7 omits the specific reference to the 2011-12 profit and recent cashflow of Royal Mail's universal service business that was referred to in paragraph 4.7 of the Draft Guidance, along with the associated footnote.

²¹ We set out that if the potential impact of end-to-end competition was such that Royal Mail's profitability was projected to be below the range we consider to be consistent with financial sustainability, we would need to consider whether this low expected future return was likely to be transient or more permanent in nature. We noted that transient low profitability would not be likely to threaten the provision of the universal service and that 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.

4.16 Consumer Focus, DX, MCF, MUA, ONEPOST and TNT Post highlighted the importance of Royal Mail improving its efficiency and considered that incentives needed to be provided to ensure this is the case. Consumer Focus, the MCF and TNT Post argued that these incentives are best provided by competition. A number of these stakeholders also expressed concern that the potential for intervention would create perverse efficiency incentives for Royal Mail. For instance, the MCF believed that any proposal to regulate or restrict delivery competition provides, to varying degrees, a perverse incentive for Royal Mail not to strive for efficiency. It believed that the Guidance should make it clear that the presumption will be against any form of regulation in accordance with Ofcom's duty to promote competition.

Our assessment

- 4.17 In performing our duty to secure the provision of a universal service, we are required to have regard to both the financial sustainability and efficiency of the universal service. Accordingly, we must balance the need for the universal service to make a reasonable commercial rate of return with incentives for Royal Mail to provide the universal service efficiently. Our approach is central to balancing these two objectives.
- 4.18 Ofcom considers that the approach set out in the Guidance would not lead to Royal Mail bearing too much risk of an adverse outcome. As discussed above we consider the indicative 5% to 10% EBIT margin is commensurate with the level of risk to which Royal Mail's business is subject.
- 4.19 As set out in the Guidance, we agree that any application of the fair bet principle would need to be adapted to take account of our duty in relation to the universal service. The important point in this context is that returns are to be assessed on a forward looking basis and over a sufficiently long period of time for sustainability to be judged and that the assessment needs to take into account the incentive properties of the regulatory regime to avoid perverse incentives. Royal Mail has accepted these points.
- 4.20 In summary, if we anticipate that Royal Mail's returns will fall below the 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. We consider that the Draft Guidance provided sufficient clarity on this issue and we have therefore decided it is not necessary to amend the Guidance in relation to these issues.

Key risks to Royal Mail's future revenues and costs

- 4.21 In the Draft Guidance, we noted that, in considering the case for intervention, we would assess a range of factors, which we identified as having a significant impact on Royal Mail's financial performance, to determine the level of control Royal Mail had over these factors. The following sets out the consultation responses and our assessment in relation to each:
- Mail volumes, product mix and Royal Mail's commercial strategy;
 - Efficiency improvements; and
 - The scope of the universal service and the assessment of the net costs of its provision.

Mail volumes, product mix and Royal Mail's commercial strategy

Consultation responses

- 4.22 TNT Post stated that a structural decline in mail volumes could not justify restraints being imposed on delivery competition. TNT Post believed that Royal Mail would need to review its business plan if it has been overly optimistic in its volume and revenue projections. TNT Post also considered that product mix is likely to be largely shaped by Royal Mail's pricing structure and so should be seen as a matter that is largely within Royal Mail's control.
- 4.23 CFH argued that the Draft Guidance underestimated the impact of Royal Mail's commercial strategy on the rate of decline in mail volumes. It commented that, whilst e-substitution was an important factor, historically Royal Mail's actions (CFH cited strikes, extensive price rises and poor service to business customers) have been a key driver for customers (particularly business customers) moving away from post in recent years. CFH also believed that Royal Mail was currently deliberately making itself less profitable by making contractual access proposals that offer reduced 'national pricing' for volume commitment and it questioned whether such a strategy would be taken into account when carrying out an assessment of the commercial responses of Royal Mail to end-to-end competition. TNT Post also argued that where Royal Mail adopts a commercial strategy of discounting, this should be considered a matter within its control.
- 4.24 CFH further suggested that one of the key factors to take into account when considering intervention is whether the competitor(s) are offering a service that is not available through Royal Mail. It considered that competitors should not be penalised in order to support Royal Mail's ability to provide the universal service if Royal Mail was losing market share because the entrants were offering new and innovative solutions to the market.
- 4.25 ONEPOST noted that with so many factors judged to be outside of Royal Mail's control, there was a danger that any end-to-end competition could be assessed as detrimental despite evidence in other markets indicating that the opposite is true.

Our assessment

- 4.26 There are a number of factors that are likely to have a significant impact on the future financial sustainability of the universal service and the degree of control that Royal Mail has over these different factors is likely to vary significantly. For example, it has control over its commercial strategy and therefore to some extent the impact this has on volume decline (price elasticity) but it is likely to have less control on e-substitution (although we note that price changes and in particular significant one-off increases could incentivise customers to bring forward the investment work needed for electronic platforms). Therefore as we note in the Guidance, the control that Royal Mail has over the risks to its finances is unlikely to be clear cut and there would inevitably need to be an element of judgement in our assessment.
- 4.27 In recent years there has been a significant trend towards volume decline in the vast majority of postal markets in developed countries as customers switch to electronic alternatives. We therefore consider it is reasonable to assume that a significant amount of volume decline would be outside of Royal Mail's control. In addition, while we would expect Royal Mail to factor a reasonable level of volume decline into its plans (both from ongoing e-substitution and end-to-end competition), we recognise the difficulty in predicting these accurately. However, we would expect Royal Mail to

regularly update its plans to take account of areas where actual performance has significantly differed from its plan.

- 4.28 We note the comments by CFH on Royal Mail's current incentives to become financially sustainable and the impact this may have on its commercial strategy. While we consider that Royal Mail is likely to have inherent efficiency incentives (as set out in the March 2012 statement), as part of any assessment of the need for intervention in relation to end-to-end competition, we will review if relevant its commercial strategy and the impact this has had on its finances. While this exercise may be complex, given the understanding we have of Royal Mail's business as a result of our monitoring programme, we are confident it can be completed in a timely manner so as to not delay our considerations.
- 4.29 In response to ONEPOST's argument about the number of factors judged outside of Royal Mail's control, the different factors we identify in the Guidance do not mean to imply that our analysis will be weighted in any particular way.
- 4.30 We consider the Guidance appropriately deals with the issues raised by stakeholders through the approach which assesses a range of possible contributory factors including whether these are within or outside of Royal Mail's control. We therefore consider there is no requirement for the Guidance to be modified in this area.

Efficiency improvement

Consultation responses

- 4.31 Royal Mail recognised that Ofcom is required to have regard to the need for the provision of a universal postal service to be efficient before the end of a reasonable period and for its provision to continue to be efficient at all subsequent times. It therefore accepted the need for Ofcom to review its progress towards achieving a reasonable level of efficiency as set out in its strategic plan.
- 4.32 Royal Mail considered, however, that there is no need for Ofcom to commit to a major or lengthy review of its cost reduction forecasts. In its view, it already faces powerful incentives to improve efficiency due to:
- upstream competition in letters;
 - the level of competition in the parcels market;
 - e-substitution; and
 - the need to attract private capital.
- 4.33 Royal Mail therefore believed that the incremental incentives to become more efficient arising from end-to-end competition are likely to be marginal. It noted that it is already engaged in an extensive transformation program aimed at making the business more efficient and has a track record of delivering cost savings. Royal Mail also highlighted that its business plans have been reviewed by senior executives and been subject to significant external validation and urged Ofcom to quickly conclude its own efficiency review of Royal Mail's cost forecasts ("in the early part of 2013"), and thus remove this as an obstacle to regulatory action.
- 4.34 The CWU welcomed our efficiency review noting that a thorough and independent assessment of Royal Mail's performance and relative efficiency is needed. It argued

that discussions of Royal Mail's efficiency should be based on a clear understanding of the objectives and how progress towards these objectives will be measured. The CWU believed that Royal Mail's employees are working hard to implement changes but that Ofcom should be realistic about what can be achieved and ensure the targets are valid.

- 4.35 TNT Post agreed with Ofcom's view on the critical importance of Royal Mail becoming more efficient and noted our statutory duty to have regard to the need for the provision of the universal service to be efficient. TNT Post expressed concern about our current review of Royal Mail's efficiency, saying that if the review set a reasonable rate of efficiency improvement that is too low, it could result in competitors not investing (due to the risk of regulatory intervention on end-to-end competitors) and may become a self-fulfilling prophecy. TNT Post also considered that the speed of Royal Mail's response should not be a relevant consideration (including in relation to addressing inefficiency) – we have addressed this issue in Section 3 above.
- 4.36 The MCF considered that Ofcom must make it clear in the Guidance that measures will not be implemented unless Royal Mail has demonstrated it has undertaken all reasonable steps to optimise its efficiency and that the presumption should always be against any form of regulation.
- 4.37 Some stakeholders also made comments in relation to labour. Specifically, TNT Post argued that wages and other employment conditions are within Royal Mail's control and, as such, it did not accept the presumption that Royal Mail's costs are relatively fixed. It believed Royal Mail's current business model would represent an inappropriate baseline if it was not forward looking and it should be based on alternative employment models, more akin to those of its competitors. TNT Post considered that Royal Mail will only deliver the most efficient and flexible cost structure when it is exposed to competition. On the contrary, the CWU expressed concerns about competition based on the erosion of terms and conditions. Consumer Focus believed that Ofcom's analysis should consider the issue of labour cost restraint at Royal Mail, perhaps through a benchmarking of labour costs between operators and across relevant comparators.

Our assessment

- 4.38 Ofcom's current work in relation to efficiency is a preliminary exercise looking at how we might assess what constitutes a reasonable rate of efficiency improvement by Royal Mail (rather than undertaking an actual review of Royal Mail's current and expected progress to determine whether it is reasonable). We are running this work separately from the work on end-to-end competition in recognition of its wider relevance. It will consider the most relevant methodologies for assessing Royal Mail's efficiency, should the need for any such review occur in the future. It will include an independent report on the pros and cons of various methodologies as well as background work on measures taken by other comparable European postal operators in light of changes in the market environment (e.g. fall in volumes, end-to-end competition). We expect to complete our review of the different methodologies for assessing efficiency during the summer of 2013. This work is likely to feed into any future formal review of Royal Mail's efficiency progress (e.g. as part of an assessment of the impact of end-to-end competition). We also consider that completing this work now, will allow any later review to run more swiftly and smoothly.

- 4.39 TNT Post was concerned that if the target level of efficiency improvement was too low, this would negatively impact investment decisions for end-to-end competitors. As this work will not be setting a target for Royal Mail's efficiency improvement, we do not consider this will be the case.
- 4.40 While Royal Mail may already face incentives to become more efficient from a number of sources, we consider that end-to-end competition is likely to provide additional incentives for efficiency. Royal Mail already faces competition in the mail market but, until recently, this was limited to the upstream segment of the market. Upstream competition is unlikely to provide strong incentives for efficiency improvement in other parts of the pipeline – in particular in delivery offices as upstream competitors rely on Royal Mail's network to deliver their mail to the final recipients.
- 4.41 We note the MCF's view that the Guidance should clearly state that we would not intervene in relation to end-to-end competition unless Royal Mail has demonstrated that it has undertaken all reasonable steps to become more efficient and that there should always be a bias against intervention. In considering any potential intervention, we intend to review Royal Mail's efficiency. In particular, we would take a view on whether Royal Mail has made (or is expecting to make) reasonable progress on efficiency and would take this into account in any decision on the need for intervention. As set out in the Guidance, intervention in relation to end-to-end competition can be justified only to the extent that it has been determined to be necessary to secure the provision of a universal service.
- 4.42 We consider that wage and employment conditions cannot be analysed in isolation. We would need to take into account a number of factors, including the legal employment framework in the UK, the speed at which Royal Mail can reasonably be expected to implement initiatives which aim at reducing costs, Royal Mail's commercial strategy and the impact of any potential changes on quality of service. We expect that any future assessment of efficiency will consider the extent to which Royal Mail's costs (including labour costs) and its business model more generally is efficient or expected to be so within a reasonable time. Should this report and any future work on efficiency suggest that benchmarking Royal Mail's costs (including labour costs) is an appropriate way to assess Royal Mail's efficiency, Ofcom would take this into account in any potential future efficiency assessments in relation to end-to-end competition.
- 4.43 We have therefore not amended the Guidance in relation to the major points discussed above. However, we have removed the reference to the specific piece of work we are undertaking in relation to efficiency.²² This is to ensure that the Guidance remains relevant in the future. It should be noted that this in no way changes our position on this work, the details of which are set out above instead.

Scope of the universal service and assessment of the net costs of its provision

Consultation responses

- 4.44 TNT Post considered that any potential changes to the universal service must be taken into account when assessing the impact of end-to-end competition on its provision. It did not believe there was a defensible argument for imposing regulatory conditions on end-to-end entrants if the scope of the universal service was set wider

²² Paragraphs 6.50-6.52 of the Draft Guidance have been consolidated into Paragraph 5.51 of the final Guidance.

than it needs to be from a consumer or EU legislation perspective. This view was shared by the MCF and an access operator (ONEPOST). The MUA and DX also noted that the universal service needed to be properly scoped before regulatory intervention in relation to end-to-end competition should be considered.

- 4.45 In addition, TNT Post believed it was not clear how an assessment of the impact of end-to-end competition could be undertaken in the absence of a full analysis of the net cost of providing the universal service. Consumer Focus also considered that an assessment of the net cost of the universal service should be undertaken following the conclusion of the review of user needs and, if there is a net cost, we should consider whether it may be appropriate to consider using remedies such as state aid to assist Royal Mail in meeting those net costs.

Our assessment

- 4.46 In undertaking any assessment in relation to end-to-end competition, we stated that we would expect to assume the universal service is specified at the appropriate level, in light of the latest review of users' needs at the time.²³ We also stated that if we had good reason to believe the universal service was not specified at the appropriate level, we would take this into account in our assessment. In doing so, we would take into account (a) the need to consider when the definition of the universal service would be changed and (b) a reasonable period for the change to be implemented by the incumbent.
- 4.47 However, we consider that it will be necessary to undertake any review on the basis of the universal service that is in place at the time of the assessment. It will not be possible to predict what the future changes will be in the absence of an evaluation of the impact on users and the potential changes in Royal Mail's cost basis as a result. In addition, any changes to the minimum requirements set out in the Act will be a matter for Government and Parliament, not Ofcom.
- 4.48 We do not agree with TNT Post and Consumer Focus that it is necessary to undertake an assessment of the net cost of the universal service as part of all assessments of the impact of end-to-end competition on the universal service. The requirement in the Act to conduct a net cost assessment specifically relates to the process for establishing a universal service fund. It does not apply, for instance, when considering the imposition of General Universal Service Conditions.
- 4.49 We therefore consider that the Draft Guidance appropriately reflects our legal obligations to secure the provision of a universal service as it is specified in the universal postal service order (UPSO) at the time of making an assessment and have not made any changes to this section of the Guidance.

²³ We note that we published our *Review of postal users' needs* simultaneously with the finalised guidance, which can be found at <http://stakeholders.ofcom.org.uk/consultations/review-of-user-needs/statement/>.

Section 5

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

General Universal Service Conditions (GUSC)

Consultation responses

- 5.1 In Section 7 of the Draft Guidance we set out an overview of the main forms of regulatory intervention that we may consider to be necessary and appropriate.
- 5.2 TNT Post was concerned that the Draft Guidance did not provide sufficient regulatory certainty on what, if any, regulation might be imposed and what the financial impact might be. DX argued that the measures proposed had the effect of making entry into the end-to-end segment more uncertain for new operators.
- 5.3 Royal Mail argued that further clarity is required, including on the type of regulatory interventions Ofcom would take in certain predefined circumstances. The MCF felt that the suggestion of the possible imposition of regulatory interventions created an unwelcome and unnecessary level of uncertainty. It urged Ofcom to consider if any of the proposals in the consultation could be removed, due to what it considered were unintended consequences.
- 5.4 TNT Post and the MCF argued that it would not be appropriate or legally permissible to impose conditions that limited competition. In addition, TNT Post and Consumer Focus argued that GUSCs would or could be inconsistent with the Directive. Consumer Focus argued that the power to licence postal operators only applied to the universal service provider.
- 5.5 TNT Post, MCF and ONEPOST considered that certain GUSCs had the potential to divert greater volumes away from Royal Mail to its end-to-end competitors. TNT Post argued that justifying measures that could render an otherwise viable competing business model loss-making could be extremely difficult and probably impossible.
- 5.6 Royal Mail argued that Ofcom must immediately impose conditions on end-to-end operators to require them to publish performance information and demonstrate that their services are not cross subsidised from other operations within a reasonable period of time (it suggested two years). Royal Mail also considered that the types of regulatory interventions that may be considered necessary to impose on end-to-end operators included requiring entrants to provide delivery services four days per week (it also argued we should provide further clarity on the likely minimum number of days we would require), covering rural and urban areas and reaching 80% coverage within five years as well as further quality of service and publication obligations (in addition to those it argued should be imposed immediately). The CWU similarly supported minimum number of days per week and coverage obligations including delivering to a representative proportion of the population.
- 5.7 Unite considered that there should be a minimum requirement on price and quality of service as well as a minimum wage for the postal sector in the UK. It also argued for a more level playing field such that all operators should be required to operate to the

same service standards and delivery requirements, including the number of days per week.

Our assessment

- 5.8 The purpose of this section of the Guidance is to set out the types of conditions that Ofcom could impose, if necessary and proportionate in the circumstances. Given the significant uncertainty about the type and extent of end-to-end competition it is not possible to be more precise about the exact nature of any regulatory conditions that might be appropriate. It would also not be prudent for Ofcom to pre-commit to any particular form of condition given these uncertainties. The discussion of the factors we would take into account when considering an intervention is aimed at providing stakeholders with as much clarity as possible on the consideration we would give to the types of interventions that would be appropriate to different circumstances.
- 5.9 As regards the lawfulness of GUSCs, they are provided for by section 42 of the Postal Services Act 2011 and may be imposed in accordance with the conditions of the Act. In particular, GUSCs can only be imposed in the circumstances envisaged in section 42 and where their imposition is objectively justified, proportionate and non-discriminatory. The provisions of the Directive are not limited to a universal service compensation fund but expressly include a power, for services falling within the scope of the universal service, to introduce authorisation procedures to the extent necessary in order to ensure the provision of the universal service. These requirements may include "if necessary and justified ... requirements concerning the quality, availability and performance of the relevant services".²⁴
- 5.10 We also recognised in the Guidance that there could be unintended consequences similar to those described by stakeholders. In practice, we would undertake modelling of the likely net impact of the condition in terms of universal service volumes and revenues when designing any GUSC in order to ensure that it was necessary to address the threat to the universal service.
- 5.11 At present, we do not consider that the tests required to impose conditions under section 42 of the Act have been met (that obligations are necessary to secure the provision of the universal service) and thus it is not appropriate to put in place GUSCs now. We note that Royal Mail is not required to publish quality of service data for its non-universal service products (which other operators are competing against), and as such we do not consider it would be appropriate to impose such conditions on those competitors at this time.
- 5.12 We therefore consider that it is not necessary to provide more specific guidance on the types and nature of interventions for specific circumstances as this will depend on the individual circumstances of the case. We also consider it would be inappropriate to rule out interventions at this point that remain potentially available. In addition, we do not consider it is appropriate to impose conditions on end-to-end operators now along the lines of what Royal Mail has proposed.

²⁴ Article 9, the Third Postal Service is available at:
http://ec.europa.eu/internal_market/post/doc/legislation/2008-06_en.pdf.

Universal Service Compensation Fund

Consultation responses

- 5.13 Several stakeholders including Unite, TNT Post, ONEPOST, the MCF and Intellect commented on different aspects of the Draft Guidance relating to a universal compensation fund. In particular:
- Unite argued that such a fund would be cumbersome to create and bureaucratic to administer with limited positive benefit. Similarly, Intellect suggested that the fund would take too long to set up and would not effectively mitigate the threat to the universal service. However it encouraged Ofcom to monitor experiences of mail operators in other countries.
 - Whilst ONEPOST said a compensation fund sounded like a good idea, it warned against the fund being used as a subsidy to compensate for inefficiency or paying above market rates for labour.
 - TNT Post argued that the Draft Guidance also failed to take into account that state aid (which it interpreted would include a compensation fund set up by a state measure) may not be possible in the case of Royal Mail, on the basis that the state aid recently granted was on a “one time, last time” basis. The MCF also called for clarification on this point. In addition, TNT Post considered that the Guidance should clarify the way in which Royal Mail would contribute to the fund.
- 5.14 In terms of implementation, Alan Reid MP argued that Ofcom should carry out preparatory work on the fund now as it is likely to be required at some point in the future. The CWU argued that it should be made clear in the Guidance that we would welcome a direction from the Secretary of State to establish the fund, in order to begin the assessment of the net costs of the universal service.

Our assessment

- 5.15 As we acknowledged in the Draft Guidance, implementing a compensation fund would be likely to require a significant amount of time given the steps that need to be taken under the Act, including quantifying the net financial burden. We also noted that a universal service compensation fund might 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).
- 5.16 In the Draft Guidance, we discussed that one of the issues to be addressed in the design and implementation of a fund would be who would contribute to this fund. We consider that it is best to address the question of whether consumers or postal operators (including whether that includes Royal Mail) pay into the fund at that time. This will allow us to take into account the specific circumstances, rather than definitively ruling in or out certain forms of funding or contributions to the fund at this time.
- 5.17 We note in response to ONEPOST’s concern, the assessment of the costs of providing the universal service expressly includes the extent to which Royal Mail is complying with its universal service obligations in a cost efficient manner, with this assessment forming a direct input into the quantum of any fund.

- 5.18 On the question of whether a universal service compensation fund is ruled out on the basis that state aid was granted to Royal Mail in 2012 with certain conditions, we note that compatibility with state aid criteria is something that would need to be taken into account at the time of the establishment of any fund. However we also note that a universal service compensation fund is one of the key mechanisms set out in the Directive.
- 5.19 We have therefore decided not to amend this aspect of the Guidance as we consider that the above issues are already dealt with sufficiently in the Guidance (including where the specific issues raised by stakeholders would be considered at the time any compensation fund was being developed). However, we have made one minor change in relation to a comment on the universal service compensation fund and competitive tendering, in order to improve clarity.²⁵

Other policy options

Consultation responses

- 5.20 Consumer Focus argued that it would be best to follow European legislation in the types of interventions, namely tendering, state aid and a universal service compensation fund, but that Ofcom was precluded from immediately implementing the tendering or compensation fund options.
- 5.21 Alan Reid MP argued that similar obligations should be placed on competitors as those facing Royal Mail, including publishing data on quality of service, as well as delivering to the rural areas surrounding the urban areas they choose to deliver in. He believed that Royal Mail should also not have to offer end-to-end operators access to its network and end-to-end operators should have to provide access to their networks.
- 5.22 CFH argued that it would be unreasonable to require competitors to deliver over a similar area to Royal Mail if they only had a proportion of its volume, but where there were similar volumes, geographic coverage and delivery day requirements would be reasonable. Yellow Jersey argued that if any measures were introduced, they should be proportional to the size of the operator but that no interventions should be required with respect to small end-to-end operators as the threat from them to the universal service would be minimal.

Our assessment

- 5.23 We note stakeholders' comments on the various interventions and that we would take into account the appropriate interventions if and when we considered that it was necessary to take action to secure provision of the universal service.
- 5.24 We note in response to Yellow Jersey's argument that the Guidance does specifically state that GUSCs could potentially be designed to only apply to operators that have reached a minimum scale or provide a specific type of service. This is something that we would take into account when designing any GUSC.
- 5.25 While we note stakeholders' comments on the various types of intervention, we do not believe these give rise to any need to change the Guidance. We also consider that concerns about GUSCs and the minimum scale of the operators to which they might apply are already appropriately set out in the Guidance.

²⁵ Paragraphs 6.50-6.51 of the Guidance, formerly paragraphs 7.50-7.51 of the Draft Guidance.

Annex 1

List of respondents to our consultation

A1.1 We received 15 responses to our consultation *End-to-end competition in the postal sector: Draft guidance on Ofcom's approach* from:

- Alan Reid MP
- Ofcom Advisory Committee for Wales (ACW)
- CFH
- Citizens Advice Bureau (CAB)
- Consumer Focus
- Communication Workers Union (CWU)
- DX
- Intellect
- Mail Competition Forum (MCF)
- Mail Users' Association (MUA)
- ONEPOST
- Royal Mail
- TNT Post
- Unite
- Yellow Jersey Delivery Ltd