

OFCOM discussion paper: Review of the regulation of Royal Mail Response of CFH Docmail Limited (CFH)

Executive summary

Targeted regulation to benefit smaller volume customers

- Delivery competition in letter mail has been eliminated in all but the small volume sector, in which CFH Docmail (Velopost division) continues to be active, and this remaining competition needs to be protected
- Regulation is needed to enable smaller volume customers to benefit from choice of postal supplier
 - There should be no discrimination between different access contract holders
 - Reduce the price differential between single item services paid for by stamps compared with those paid for by franking machines to reflect Royal Mail's avoided costs associated with processing meter mail
 - Remove metered mail from the universal service obligation
 - Review the barriers and restrictions imposed by Royal Mail which prevent the use by other postal operators of franking machines as a payment channel
 - Remove the Royal Mail restriction which prevents competitor access to the state-owned Post Office network

Effective protection for competition and customer choice

- Promote and protect customer choice for single-item and small-volume mailings by ensuring there is an effective price squeeze protection in place between meter and access prices

Separation of Royal Mail Retail and equivalence in access pricing

- Royal Mail Retail to be established in a separate legal entity with separate, independent management from Royal Mail Group/Wholesale, to ensure transparency and equivalence
- Royal Mail Retail needs to purchase access services on the same, published terms as access customers
- Restrict Royal Mail's ability to make unilateral changes to access terms

Stop de-stabilising behaviour

- Royal Mail's right to make radical, unilateral changes to access contract terms (pricing and non-pricing) has fundamentally de-stabilised the market and needs to be curbed
- OFCOM needs to be more actively involved in the fair operation of the Postal Common Operational Procedures agreement where we have experienced a number of breaches [CONFIDENTIAL: CFH1]
- Benefit consumers by allowing cheaper and easier access to the redirections database, to increase the number of items delivered to the right address first time

Question 1: Do you agree with our view that there is a need to consider the effectiveness of the existing regulatory structure? Please state your reasons.

We strongly agree with this view, for a number of reasons:

- Royal Mail has, this year, successfully eliminated its largest letter delivery competitor (Whistl) and CFH is increasingly concerned that their attentions will now be turned to eliminating delivery competition from CFH and upstream competition from access operators. This needs to be prevented.
- We are concerned at the significant existing and very rapidly growing differentiation (the delta doubled in 2015) between the prices charged under the C9 contract (on which terms CFH has always traded) and those lower prices charged under other Access contracts (which were introduced in early 2013). There is no plausible cost justification for the extent of the differential and this additional cost has a direct impact on the profitability of CFH's business. This differential needs to be removed.

Access 70 CBC prices

	C9 contract (pence)	2013 contract (pence)	C9 increment %
2012/13	18.903	N/A	N/A
2013/14	19.957	19.47	2.5%
2014/15	20.775	20.268	2.5%
2015/16	22.229	21.170	5%

Aside from having to maintain a separate price list and send additional notices of contract changes, we can see no legitimate cost-justification for this very significant price differential. The sole purpose of this differential, in our view, is to drive CFH into accepting a set of contract terms which, as recent events have shown beyond doubt, would be damaging as they give Royal Mail near unfettered power to introduce pricing and non-pricing changes which can be used to eliminate competition. Key objections (though there are a number of others) are to Royal Mail's right to make unilateral changes to any contract terms (including the notice provisions themselves) and the right to terminate for convenience.

The effect of the differentiation is that CFH is penalised by Royal Mail for acting to protect its business. CFH's fears about possible Royal Mail behaviour are the reason for our refusal to be forced into accepting unacceptable terms and have been proven to be entirely justified.

It is our view that this pricing differentiation is currently prohibited by the existing USP Access Condition (if not, also, competition law) but no action has been taken to prevent it. If the conditions do not currently prevent precisely this type of behaviour, then it is clear that the regulatory framework needs to be reformed to ensure that they do. The following two conditions, in particular, are relevant:

USP Access Condition 3.1

"The provision of D+2 Access in accordance with USPA 2.1 above and pursuant to any existing D+2 Access Contract **shall be provided on fair and reasonable terms, conditions and charges** and on such terms, conditions and charges as OFCOM may from time to time direct." [emphasis added]

USP Access Condition 5.1

"The universal service provider **shall not unduly discriminate against particular persons** or against a particular description of persons in relation to matters connected with D+2 Access." [emphasis added]

For a small business like ours (whose turnover is a fraction of a single percentage point of Royal Mail's), the cost of enforcement (as a percentage of our overall revenue and profit) is very significant especially as there is no prospect of recovering those costs even if we are successful. We believe that Royal Mail deliberately exploits this inequality of arms. Consequently, much tighter *ex ante* regulation is needed to provide effective protection and promotion of competition.

We need a regulatory framework which puts the onus on Royal Mail to justify any pricing differential to OFCOM and the market. In the absence of that justification, no differential should be permitted. [CONFIDENTIAL: CFH2]

Question 2: To what extent do you consider Royal Mail's pricing and non-pricing behaviour is constrained by other postal operators and additional factors such as e-substitution?

We do not believe that there are any real competitive constraints on Royal Mail's behaviour.

Royal Mail point to e-substitution as a purported justification for some of their pricing behaviour, but their pricing strategy pays that no heed. Take for example their decision to charge higher prices for business mail, which is **more** at risk from structural, irreversible e-substitution than advertising mail, which is subject to more ephemeral movements among the different advertising media.

Access 70 CBC [C9 Contract rates]

	Business Mail (pence)	Advertising Mail (after Responsible Mail discounts) (pence)	Business mail price increment %
2012/13	18.903	14.703	28.57%
2013/14	19.957	15.457	29.1%
2014/15	20.775	15.755	31.86%
2015/16	22.229	16.869	31.77%

Royal Mail's actual behaviour is aimed at maximising revenue from the part of the market that cannot move to e-delivery. Royal Mail shows no signs of trying to compete with e-delivery. This is worrying for the physical delivery industry and for the neighbouring mail production markets (in which CFH has made very material investments in state-of-the-art production technology) because this exploitation of certain customer groups **increases the risk of an acceleration in the rate of movement to e-delivery at a future date**.

To address this risk, price controls should be imposed to (a) apply pressure on Royal Mail to constrain its price increases and realise efficiencies much more quickly and (b) remove any unjustified differential in pricing which is based on content or payment channel.

No constraint on pricing behaviour: Royal Mail is able to act independently of the market. This was seen in the massive price increases in 2011 and 2012, in particular. It is further evidenced by their ability to increase prices for only certain class of contract holders (see C9 contract price differential above).

As can be seen from the pricing table above, **the annual increase in the access prices in 2015 which CFH must pay was just under 7% -** which is a huge price increase, especially since inflation currently sits around zero. CFH is unable to absorb these price increases and, so, they are passed on to customers.

If efficiency gains are being made, this pricing behaviour illustrates that Royal Mail does not feel compelled to share those gains with customers. There can be no doubt that the exclusion of Royal Mail's largest competitor from the market has removed the most significant constraint on Royal Mail's behaviour. The remaining constraints, such as they are (e.g. shareholders, management, customer buying power, risk of e-substitution), are inadequate to exert sufficient pressure.

As for the constraints on the pricing of single item mail, we do not accept that the difference between stamped and franked mail can be justified. For years, stamp and meter prices were the same. In 2007, the second class, single-item stamped price was 2 pence (9.5%) higher

than the equivalent meter price. Now second-class stamped services are 15 pence (38.5%) higher than their meter equivalent.

Either the cap on stamp prices is set far too high or the discount on single item services paid for by franking machines is excessive. As stated above, any differentiation in prices should be subject to justification and prior regulatory scrutiny.

In order to protect small volume customers and drive greater competition into the market for single item services, OFCOM should look at removing the restrictions currently placed by Royal Mail on franking machine suppliers. At the moment, only Royal Mail letter services can be paid for using this equipment.

Another measure which could be taken to benefit the small-volume user is to grant access to the Post Office network. The Post Office is unique in the EU, as it is separately owned from the universal service provider, and so there is a better opportunity (and easier justification) to provide greater consumer choice, increase footfall in the post office network and thereby reduce the call on public funding by granting access to all postal operators (not just Royal Mail). It would be unrealistic to imagine that other postal operators would match the revenue generated by the Post Office from Royal Mail and, so, we have no objection to the commercial arrangements (other than the current restrictions) remaining in place, to ensure that the minimum public money is required.

No constraint on non-pricing behaviour: The absence of constraints on Royal Mail's non-pricing behaviour can be seen from their right to change non-pricing terms unilaterally. As stated above, it is only CFH's (justified) refusal to sign up to the new terms that has prevented these unconstrained changes from being imposed upon us.

Question 3: To what extent do the competitive constraints faced by Royal Mail vary by different types of mail, e.g. for letter services, between advertising mail, transactional mail (mail sent following a consumer's interaction with a company), and publishing mail (such as newsletters and magazines); and for parcel services, between single-piece and bulk parcels?

We are sceptical about there being material variation in competitive constraints depending on the content of a mail item. As stated above, Royal Mail currently acts as if it is impervious to external constraints.

The main risk arising from this lack of constraint lies in Royal Mail's over-exploiting a (perceived) ability to increase transactional mail prices to increase revenues. This is the key risk because this behaviour will lead to an earlier tipping point for a decision to invest in the technology needed for e-delivery.

The relative discounts offered for advertising mail are aimed less at competing with other media and more at achieving a strategic goal, namely, securing increasing amounts of 'sending customer' information and, thereby, seeking to take control of the customer base in the medium term.

The key objective of the new regulatory framework should be to get prices as low as possible (not just for marketing mail) and to have as many operators as possible offering services to ensure that the benefits are passed on to customers, thereby persuading them to keep using mail and, thus, reducing the speed of structural decline of physical post. This will support OFCOM's primary duty to ensure the provision of a universal service.

Question 4: Do you consider that Royal Mail faces appropriate incentives to deliver efficiency improvements?

In the absence of material delivery competition, Royal Mail does not face appropriate efficiency incentives.

Management clearly lacks the incentive to take on the trade union and renegotiate wage terms and working conditions, which they are entitled to do under the wage settlement. This means that the labour costs are higher than should be the case and this will be passed on to customers in higher prices. If management lacks this incentive from existing measures, it is clear that additional measures are needed.

Shareholders will secure adequate returns through price increases and, so long as that is possible, this will be the 'easy street' option Royal Mail management seems destined to walk down. Once the practice of increasing prices to offset volume decline is no longer possible then there may be increased pressure from shareholders but those are not the conditions which are likely to exist in the short term.

Customers, as stated above, lack the buying power and alternative suppliers to leverage better prices.

E-substitution is not acting as much as it should to make efficiency improvement a management priority. Ignoring this structural issue will mean that management is storing up problems for the medium and longer term. This is of direct concern to our own business and for the wider industry.

A large part of Royal Mail's costs lies in final delivery. This, by definition, is a labour-intensive activity. This means that, to drive efficiencies in this area, Royal Mail will need to reduce its people costs. As management are ducking this critical issue, they need to be compelled to take action. However, Royal Mail also has excessive common costs, which need to be tackled.

The appropriate efficiency measure for a labour-intensive monopoly: While RPI based measures are commonplace in seeking to drive real-terms efficiency improvements, they are most often used in asset-intensive utilities. As such, they may be less effective in the postal market.

Given the high proportion of people costs, we would recommend a measure (perhaps in addition to an RPI price cap measure) which focuses more on the efficiency of the entire business by calculating the total cost per post(wo)man hour. The hours spent in delivery can, with tighter management, undoubtedly be reduced somewhat but, assuming that the number of hours spent on efficient delivery is largely fixed, the key measurement (and target) would be the total cost per delivery hour. This measure would use total costs of the business and so would add an incentive to reduce both direct delivery costs and common costs, including the massively bloated overhead which the management currently tolerates. This would give a good measure of the (in)efficiency of the organisation as a whole but would not reduce service quality because there would be an inbuilt incentive to keep the baseline number of post(wo)man hours, otherwise the rate of efficiency will reduce. It will be important, therefore, to start with an assumed, efficient level of post(wo)man hours, in order to keep an incentive to reduce the current number of hours, where it is possible to do so without service degradation. If Royal Mail management succeeds reducing the actual hours to the 'efficient hours' level, Royal Mail will be reducing actual costs but will not be worsening its efficiency levels for the purposes of the measurement.

Question 5: Do you consider that there are any areas of existing controls on Royal Mail activity where there is the potential for deregulation?

The core message is that more regulation is needed to give stability.

The one area for potential de-regulation is to remove the provision of single item services which are provided at a discount (notably, franked/metered services) from the Universal Service Obligation.

This could be achieved by revising the definition in Schedule 1 of the Postal Services (Universal Postal Service) Order 2012 [as amended], in the following way:

Single piece service

1. “Single piece service” means a postal service for the conveyance of an individual postal packet to the addressee, for which the price per postal packet is not subject to any discounts related to —
 - (a) the number of postal packets sent in connection with the person who paid for the service;
 - (b) the positioning or formatting of text on the postal packet;
 - (c) the use of markings which facilitate the use of machines to sort postal packets;
 - (d) presortation into geographical areas for delivery; ~~or~~
 - (e) the purchase of any other conveyance of the same or any other postal packet; ~~or~~
 - (f) the payment method used.

By doing this, VAT would need to be applied to these services as they would be neither USO services nor mandated and regulated access services. The distortion of competition which currently exists when trying to sell to customers who cannot recover VAT (i.e. small customers with an annual turnover of £82k, charities or financial services) will also be removed. This would create greater choice and competition and will provide cheaper prices in the long run for these customers.

Franked/metered single item services are operationally very different from single item services paid for with stamps and do not, therefore, belong in the universal service, for a number of reasons:

- The franked/metered services are not universally available, as a customer must pay the significant costs (machine lease, ink, uploads of postage rates etc.) associated with operating a franking machine;
- Taking the cost of the meter into account, this would not pass the affordability test;
- Collections of franked mail do not take place from all pillar boxes (access points) – some small volumes may be accepted in this manner only;
- Collections from pillar boxes which do accept franked mail typically take place only five (not six) days per week;
- Saturday collections of franked mail often only take place at Post Office counters;
- Franked mail is generally collected from the site where the meter is located and, depending on the volume of mail, may be subject to a separate collection charge;
- If, on the other hand, franking machines are to be treated as part of the universal service network by virtue the arrangements which Royal Mail has in place, it begs the question as to whether they should be considered to be part of the universal postal network to which OFCOM can, and should, mandate access.

Question 6: Do you have any further comments or views (supported by evidence where available) on the issues identified in this discussion paper?

As this is a fundamental review, it is time to scrutinise many accepted or traditional practices which are inappropriate and also important to set a stable regime in place for, at least, five years.

- As stated above, unless fully cost-justified, Royal Mail needs to remove differential pricing applied to customers on different forms of the access contract
- To ensure that single-item and low-volume prices are cost-reflective, any discount of meter mail prices needs to be justified by reference to Royal Mail's avoided costs compared with the non-discounted single-item services (stamped mail).
- OFCOM needs to review any restrictions imposed (whether by contract or custom and practice) on suppliers of franking machines as it is not currently possible to sell non-Royal Mail letter services through those machines
- OFCOM should review constraints placed on the Post Office which currently prevent it – and its franchisees – from providing services to other operators at post offices. As the Post Office has received public funding, opening them up to wider use would create greater consumer benefit than restricting their services to a single supplier of post and parcels services
- Royal Mail's right to make unilateral changes to access terms needs to be stopped. Tremendous damage has been done to competition and the industry by such unilateral changes
- Customers need more choice, especially now that downstream delivery choice has been significantly curtailed. OFCOM can achieve this by extending mandated access to services such as a nationwide first class service.
- OFCOM must also ensure that existing choice for smaller customers is protected and promoted by ensuring that there is effective price squeeze protection in place between metered prices and access prices
- Royal Mail Retail needs to purchase all services on the same, published terms as access customers (save where operational necessity requires otherwise) and should be run through a separate, independently-managed legal entity
- The framework has to allow for much more rapid product development for the market as a whole and not just for Royal Mail's own strategic ends
- Removing production inefficiencies by using technology needs to be encouraged for the benefit of the industry as a whole. The framework needs to put in place industry bodies whose advice and approval is needed on efficiency measures.