Introduction

Laithwaites Wine are a mail order wine company who have been established since 1969 and currently deliver wine directly to over 700,000 customers.

Laithwaites use direct mail as a key customer communication and customer acquisition tool for our business.

Consultation response
Please find our responses to the specific questions in the consultation document below:

Question 5.1. Do you agree with the assumptions set out in paragraph 5.86 above. If not, please set out your reasons.
Universal Service Boundaries and Royal Mail's Business Plan - It is important to establish the boundaries and define exactly what the universal service includes. There needs to be clear definition to understand cost allocations and arrive at a consistent view of the cost of providing the universal service. Even if it is difficult to arrive at a consensus about where those boundaries lie it will at least provide the ability to make direct comparisons year on year which has not been the case in the past as cost allocations between different parts of Royal Mail weren't consistent.
Although Ofcom point out that the rate of e-substitution is one of the risk factors in that it is very difficult to predict, there is strong evidence that pricing plays a major role in both accelerating and slowing the rate of substitution. We don't think that Ofcom have given enough importance to this factor in your assumptions. As with many business changes there is a high degree of inertia but once there is sufficient incentive – and the threshold will vary for each organisation - businesses will move away from using mail and never come back. Royal Mail's actions will have a direct effect on volumes, which will in turn have a direct effect on their unit cost (since they have a high degree of fixed costs) and that will impact on their profitability and ability to provide a universal service.
Efficiency Incentives – Laithwaites don't consider that these proposals provide enough incentive for Royal Mail to reduce costs through efficiency improvements. Royal Mail's track record of delivering real cost savings is poor and Ofcom have identified that the biggest single risk lies with Royal Mail achieving its business plan in terms of cost reduction and modernisation. Ofcom's analysis shows that even missing its efficiency target by 1% could reduce profitability by 50% and our concern is that they would use their commercial freedom to recover this through price increases – as they have done in the past.
Ebit Margin Range - The proposed rate of return of around 8% appears quite generous compared to some other postal operators but we understand that Royal Mail has to attract investment and that given Royal Mail's past performance in delivering both profit and modernisation this could be considered "high risk".

Question 6.1: Do you agree with our proposal to impose a regulatory condition on Royal Mail to require it to provide the universal service as set out above? If not, what alternative approach would you suggest?
Yes Laithwaites do agree with the proposal. It does clearly set out what is required from Royal Mail in terms of services and standards. It is also important from our perspective because it allows Ofcom to impose a USP Access condition requiring Royal Mail to continue to provide downstream access.
It isn't clear from the consultation what penalties or actions would apply if Royal Mail didn't meet the conditions and standards for the provision of the universal service.

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

Laithwaites believe that moving straight from a regime of price control to no price control puts the future of the postal services market – and an affordable universal service at risk. We agree that price control has not prevented significant price increases in the past but this has been because the regulator has always been forced to back down when presented with Royal Mail's financial situation. Postal regulators in other countries have been more successful in restricting increases – typically to around RPI. – and in other regulated industries price increases have also been restricted. Currently, for instance, there is media coverage and anger about proposals to increase rail fares by over 6%, yet it was considered acceptable for business users to accept price increases of 15-20% earlier this year.

Laithwaites understand the case being made for Royal Mail to have more commercial freedom (even if we believe that "the Regulator" was sometimes used as a convenient excuse by Royal Mail in the past) but are concerned about whether Royal Mail will use that "commercial freedom" responsibly or simply to achieve a short term boost to profits.

If regulation is to be "appropriate and proportionate" then there is a very strong case for continuing to regulate pricing because of its potential impact on mail volumes and Royal Mail's past behaviour. We cannot agree with the assumption that Royal Mail is best placed to decide pricing and that it wouldn't raise prices more than the market would bear because we believe it has already demonstrated that it will.

<u>The impact of this year's price increases</u>

Using price elasticity modelling to try to establish the price "tipping point" that results in losing significant volume is, as you point out, is extremely dangerous since it relies on historical data, which in the postal market has been shown to be a very unreliable basis for predicting the future. All other major postal operators in Europe (and in the US) have been extremely wary about increasing prices to the business users that provide them with the volume that underwrites the universal service. Independent experts such as the Boston Consulting Group's study on USPS volumes published in March states simply that "price increases will drive volume away".

It is still far too early to fully understand the impact of the price increases in April 2011. 9 months isn't long enough for many businesses to implement changes – some of which may take 18 months or more to take effect. Unfortunately once organisations make the decision to move away from mail it's irreversible and the volume is lost for ever. Unlike a price elasticity model even reducing prices won't win them back, so there are huge risks it getting it wrong. The level of price increases shocked many users and there is no doubt that it has raised the cost of mail to become a boardroom issue for not just ourselves but many organisations (even if it only meant having to ask for more budget). The rumours of a similar level of increase in April 2012 – especially if it is coupled with the imposition of VAT could trigger a collapse in business mail use. Continued effective price control would provide business mail users with a degree of reassurance that they will be protected from excessive price increases. Without that reassurance they will be actively planning how to reduce their costs, especially if they are in Financial Services, a charity or Government who could be seeing a cumulative increase of 40% with the impact of VAT.

Every analysis of Royal Mail has concluded that one of its fundamental problems is that it has been unable to reduce costs in line with falling volumes. Although large price increases may provide more yield for Royal Mail in the very short term they will accelerate the rate of decline. Protecting the universal service and making Royal Mail an attractive proposition for a potential investor should also mean that it makes sense to keep as much mail volume as possible rather than actively driving it away. Maintaining mail volumes would provide Royal Mail the breathing space it needs to catch up so that it can start to match cost reduction with falling volumes. The evidence from other markets is that you can slow the decline – even in transactional mail volumes - and that “milking” captive markets is both premature and an example of why there is a need for the regulator to “sense check” Royal Mail’s pricing if it is to fulfil its duty of protecting the universal service.

<u>Where’s the incentive for cost reduction?</u>
Simply removing price controls seems to provide even less incentive for efficiency improvement. In a normal competitive commercial environment prices are limited by competition and how much customers are prepared to pay. These constraints provide the incentive to improve efficiency and reduce cost. In a monopoly the constraints on pricing aren’t there and it is all too easy to simply increase prices rather than improve efficiency. Price control, provided it is actually applied, is the best incentive for achieving cost reduction through efficiency improvements.

<u>Could it distort the market?</u>
A further concern about giving Royal Mail complete freedom in setting prices is that it could result in unintended distortion of the market. Royal Mail Retail will have the potential to price by application (as it does at present through products like advertising mail) and to negotiate individual prices with large customers. This flexibility coupled with the potential impact of VAT for some customers could result in significant variations in the cost of mail. By limiting price increases and monitoring pricing (both overall and relative to wholesale prices) the regulator has an important role to play to help minimise the impact of excessive or discriminatory pricing.

<u>Conclusion</u>
We believe that there is sufficient evidence that allowing Royal Mail complete pricing freedom from April 2012 is too great a risk that could jeopardise the future of the postal services market, the continued provision of an affordable universal service and the potential sale of Royal Mail to an external investor.
We believe that a simple RPI (or even RPI+) control would

- Provide Royal Mail the incentive to actively pursue cost reduction
- Provide reassurance to business mail users to keep them using mail
- Be consistent with the approach taken in other regulated markets and by other postal operators

Royal Mail would be allowed to increase prices more than the price control only by exception eg to allow for re-balancing or as a result of revised costings that were in line with the regulatory accounting proposed in the consultation.
As we are recommending a formal review of the regulatory regime after 3 years then the price control would be included in that review and, if appropriate, withdrawn then.

Question 6.3: Do you agree with Ofcom’s proposals to put in place regulatory safeguards as described above? If not, please provide reasons.
Even if there is price control in place the regulatory safeguards would probably be required but without price control then these are the minimum that need to be in place. These would be required in addition to those outlined in the response to 7.3 and 7.4 below relating to access.

It is difficult to disagree with the principles of the proposed safeguards but with little detail about how they might actually be applied it is difficult to give any meaningful comment. For instance

- Under what circumstances would OFCOM consider re-regulation?
- What is the timescale for intervention? If monitoring identifies the need for change how long would this take?

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

A monitoring regime is essential to protect the market and the continued provision of the universal service and as with 6.3 above , it is difficult to disagree with general approach but there is little detail on how this would be implemented, or, more importantly what it means. The consultation suggests that this area will be subject to further consultation after February 2012 on how the monitoring will actually take place and what would be available in the public domain.

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

Although we are mainly concerned with bulk mail products it is important to have some price regulation for consumers. The research has indicated that most consumers would be prepared to pay around this level for a 2nd class stamp (although we believe that the research implied there is a psychological threshold at 50p).
Even at its lowest level however this represents a 25% increase in the cost of a 2nd class stamp which is extraordinarily generous compared to most other regulated postal services around the world that are limited – at best – to RPI. Even the beleaguered USPS is limited to a 2.1% increase!
We also have a slight concern that a price controlled 2nd class stamp could be perceived as somehow setting a benchmark for bulk mail prices in that historically these were seen as a discount from the stamp price or public tariff.

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

Seven years without a formal review is far too long. We can understand why there is a desire for "regulatory certainty" from Government's perspective in that it will help create the right environment to attract a potential investor. We would also like to see some stability and certainty in the market but don't think it is realistic that this can last for 7 years.
Mail volumes are – at least in the medium term – critically important in determining Royal Mail's profitability and maintaining an affordable universal service. Historically no-one has been able to predict mail volumes accurately – the rate of e-substitution, the growth in internet fulfilment and the potential from multi-channel communications have all been either over or under estimated.
Royal Mail's behaviour will impact on the volumes through pricing, specifications and even customer service. Effective competition will also influence mail volumes, especially if we see development of more end-to-end competition as has been promised from some of Royal Mail's competitors.
If one looks at other markets it's clear that factors like the economy, competition, availability of high speed broadband and the behaviour of the dominant postal supplier all have an impact. For instance PostNord has seen a 14% decline (although even this consists of 14% decline in Denmark, but only a 4% decline in Sweden), France with a 3.5% decline and Germany with a slight overall increase last year.

The postal services market is very volatile and we don't think that 7 years without a formal review is realistic for any regulatory regime. In this consultation you are proposing to review Access regulation in 18 months to take account of changes and the same logic should apply to the other parts of regulation. Looking at other markets that OFCOM is involved in it seems that around 3 years seems to be appropriate (eg as with Telecommunications) before a statutory formal review.

Question 7.1: Do you agree with our approach to assessing end-to-end competition? If not, please give your reasons.
We believe that the development of end-to-end competition is an important factor for the postal services network. In markets where end-to-end competition has developed there is strong evidence that this has not had any negative effect on the incumbent supplier (typically end-to-end accounts for less than 10% of volume) and has helped to maintain volumes.
In the Netherlands, even with only one competitor, a consortium of large mailers was able to negotiate substantial discounts of more than 20% and the evidence is that wherever there is end-to-end competition this has resulted in lower prices, better service, and more innovation without threatening the incumbent postal supplier. In fact in some markets such as Germany the regulator has had to step in because prices were too low!
The consultation states that the details on how you propose to carry out your obligations under the Act and assess end-to-end competition will be the subject of a further consultation. Until we know what criteria would be used to assess whether end-to-end competition is considered to be threatening to the universal service it's difficult to provide a more detailed response.
It is also not clear what criteria would apply to allow an end-to-end competitor access to parts of Royal Mail's infrastructure, such as PAF, that would be required to provide an effective delivery service.

Question 7.2: Do you agree with Ofcom's proposals to impose an obligation on Royal Mail to provide access at the Inward Mail Centre? If not, please give reasons.
Yes – and we agree that this should be a statutory condition rather than simply relying on Royal Mail to provide it. Laithwaites current business model uses downstream access which has delivered a number of benefits, amongst which are cost savings, greater tracking visibility and stronger account management support.
There is no doubt that DSA has had a beneficial impact on the postal services market in the UK by providing choice, cost savings and keeping customers using mail. This view is supported by both the Hooper reports and your own analysis.

Question 7.3: Do you agree with Ofcom's proposals in respect of regulating margin squeeze? If not, please give reasons.
The consultation document outlines the benefits that downstream access has delivered in terms of improving efficiency and conferring significant benefits on users. If, as is generally agreed by independent reports such as the 2 Hooper reports, competition has been good for the market and has helped to secure the universal service it is essential that it is protected from anti-competitive activity such as margin squeeze.
This protection must include 2 essential elements to be effective

1. a "point to point" rather than a "basket" approach in terms of protecting margins. The basket approach would still give Royal Mail sufficient flexibility to squeeze upstream competitors. We also believe that there is evidence to support the need to extend the margin squeeze protection beyond 2nd class Mailsort and Walksort products. Without

protection there is the possibility DSA competition would be limited to these products and any further development will be stifled.

2. Swift resolution and corrective action. Simply relying on competition law is not adequate protection because of the timescales and complexity. We are aware, for instance, of a complaint against Bpost in Belgium where the regulator, after a prolonged investigation, concluded that Bpost was guilty of discriminatory pricing. Bpost has appealed against this decision and since there has been no judgement yet the result is that they are still offering the same price 18 months after the complaint was originally made!

We still believe that competition is still very fragile and that ideally some form of "ex ante" regulation is appropriate. It is important that DSA competition has some clear indication of what margins it can achieve in order to plan the development of their business and justify investment. The proposed monitoring regime and quarterly reporting is the absolute minimum required since in practice there will be a time lag in OFCOM receiving the information from Royal Mail, analysing it and taking corrective action. In practice, therefore, this could be 5 or 6 months after the price was set.

It is also not clear how the proposals on margin squeeze would apply in relation to Royal Mail Retail promotions, "sales" and other special offers.

Our preference would be a modified version of the existing approach:

Ex ante – Royal Mail would be able to set prices subject to general pricing boundaries, for example including the point at which a reduction to the retail price would be considered to be squeezing the wholesale margin. Key products would be subject to a specified minimum margin between retail and access product price points.

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

We agree that there needs to be equivalence and regulation of zonal pricing. We also welcome the proposal that any disputes should be referred to Ofcom and that Ofcom intend to adopt the same approach as you have done for the telecommunications sector.

We would welcome an independent body (for instance the equivalent of OTA2 – the Office of the Telecommunications Adjudicator) to ensure timely resolution of disputes.

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

It's difficult to disagree with the overall objectives since it would not be possible for Ofcom to be an effective regulator without a clear understanding of the costs relating to the universal service and how overheads are allocated. It isn't clear exactly how you intend to achieve those objectives and the criteria that would apply. For instance how would you determine "the efficiency of the universal service"? Would this be benchmarked against other postal operators?

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

The proposed regulatory financial reporting will deliver the appropriate information required to meet the objectives outlined in sections 8.9 to 8.12. Since this information will form the basis of the regulatory regime we believe that it is "proportionate", especially in return for more commercial freedom.

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

Postcomm tried to impose Regulatory Accounting Guidelines but without success. It is absolutely essential that the regulator – and other organisations where appropriate – have confidence in the financial information provided and this can only be achieved through the imposition of Accounting Guidelines. Without understanding exactly how the information has been derived and having confidence that it is consistent and directly comparable it won't be possible to achieve robust cost transparency and accounting separation, so we support these proposals.

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

These proposals appear to be a development of earlier proposals from Postcomm and we don't have strong views on what should or should not be included. The biggest risk is that excluding parts of the business could distort the results by not taking into account relevant assets or overheads and there could be hidden cross subsidies.

There is precedent of accounting separation in other regulated markets – OFCOM itself has experience of this – and the same principles should be applied.