Securing the Universal Postal Service

Proposals for the future framework for economic regulation – 20 October 2011

TNT Post UK Limited response

SUMMARY

We support a regulatory system in which a profitable, efficient Royal Mail - which provides a universal service meeting the needs of consumers and which is capable of attracting external, shareholder investment - operates in a fully competitive and undistorted market-place. There remain a number of obstacles to achieving this goal which are not all adequately addressed by the proposals:-

- The proposals give Royal Mail a very significant degree of commercial freedom to increase prices and to compete but competition in the market remains distorted by the VAT rules. This distortion limits the extent to which competition can be relied upon to: keep prices down, invest, create jobs, deliver customer choice, innovate and apply the continual pressure needed for greater efficiency.

- Excessive reliance appears to be placed on Royal Mail's self regulation in not increasing prices too much for fear of encouraging e-substitution. Customers are very concerned about a second year of significant price increases. Given the limited competitive pressure from end-to-end competition on Royal Mail, we question if there will be sufficient pressure on Royal Mail to accelerate its efficiency improvements and to price its services at a level which does not harm the market in the medium to long term.

- Restricting access to the IMC does not meet customer demand nor does it expose Royal Mail to competition on its first class services, leaving customers exposed to the risk of excessive price increases. There is evidence that OMC injection and OMC extraction will satisfy the statutory tests and should also be mandated with terms agreed on a fair and reasonable basis.

- Restricting access to Letter and Large Letter formats and not extending it to packets would be to deny customers choice on which they have come to rely and allow Royal Mail to exploit is dominance on packets below 500g and on low volume packet services below 2kg. In the way that the statutory tests are satisfied for Letter and Large Letter formats, the same applies for packet formats up to 2kg and we see no justification for limiting the scope of mandatory access in the manner proposed.

- End to end competition will best develop if access competition continues but significant investment is not yet possible due to the continued VAT distortion beyond USO services. OFCOM needs to bear this important dynamic in mind when deciding how to regulate access services and the level of freedom it should grant to Royal Mail in setting the lower level of retail prices. Regulatory failure in this area could undermine access competition and, thereby, also end-to-end competition.

- There is a need for much clearer guidance on how the margin squeeze test will be applied and the process which will be used to monitor and, where appropriate, intervene.

- As a stand-alone postal business active in the D+2 and later upstream markets for pre-sorted and high volume unsorted mail, we have a number of reservations about moving to a LRIC-based margin squeeze test given the lack of confidence in reliable upstream LRIC data ever being available, Royal Mail's stated preference to eliminate upstream competition and the absence of economies of scope among upstream competitors.

- A possible unintended consequence of the proposed margin squeeze test is that Royal Mail will be encouraged to offer Mailsort 3 services with upstream prices which are below LRIC.

- Given the proposed flexibility on pricing, which marks a major departure from the current situation where customers are treated equally on transparent and non-discriminatory terms, OFCOM should publish clear guidance as to when Royal Mail is permitted to offer differential pricing.

- OFCOM's guidance should confirm unambiguous terms that pricing any contract below LRIC is never permitted.

- Zonal pricing is now the basis for more than half of all access volumes and regulation needs to be more keenly focussed on how zones and zonal prices are derived. Guidance alone is likely to be insufficient and

only assessment and approval by OFCOM of material changes to zonal structures and prices will give the market the appropriate level of comfort and stability.

- To avoid undue preference or discrimination by Royal Mail's wholesale business and as an important part of equivalence, the surcharging mechanisms in the national access agreement need to be based on costs of delivery and equalised across all customers including Royal Mail's own retail services. The surcharge system should have as its basis the Zonal Geographic Posting Profile methodology as now adopted for more than 50% of access volumes.

- Zonal pricing is accepted as a principle and acknowledged as the means of preventing cherry-picking. However, if pricing changes are too frequent or not adequately monitored and cost-justified, there is a material risk that zonal pricing can be used as a means of creating market uncertainty with the aim and/or effect of deterring investment in end-to-end competition. Clear guidance, close monitoring and effective intervention are all critical to ensuring that zonal pricing is designed to reflect genuine costs rather than defeat genuine competition.

- We have a fundamental concern about the suggestion that Royal Mail should be free to negotiate individual terms for downstream access and would not need to publish the terms. This could lead to material discrimination and the introduction of terms which could have the effect of preventing downstream competition e.g. through volume discounts or profile discounts which would dissuade an operator or customer from using a delivery network other than Royal Mail's.

FINANCIALLY SUSTAINABLE UNIVERSAL SERVICE

Question 5.1: Do you agree with the assumptions set out in paragraph 5.86 above? If not, please set out your reasons.

5.1.1. In order to attract external investment and best serve the market, Royal Mail needs to become more efficient by reaching the automation levels; introducing flexible cost structures and, thereby, achieving the type of profitability level present in its most efficient European peers such as PostNL and Deutsche Post.

5.1.2. As concluded by WIK Consult, in their recent report [**Exhibit 1**] on the effect of end-to-end ("**E2E**") competition on the universal service provider ("**USP**") and on the provision of the universal service, the presence of E2E competition in the countries studied (including The Netherlands and Germany) had a beneficial effect on the USP and, specifically, it provided "strong incentives" for modernisation. Revenue loss from E2E competition is, in their opinion, "much less important a risk" than the declines of total market volume or from changing behaviour end electronic substitution. They further concluded that to sustain the Universal Service in an increasingly digital society, modernisation is "a necessity".

5.1.3. Royal Mail's cost reduction plans are ambitious and, in the absence of the type of external E2E competition pressures experienced in other European markets, it is questionable if these can be achieved in the timescales envisaged. This risk of delayed modernisation is correctly characterized as a significant risk.

5.1.4. Given the absence of E2E competition, we do not accept that there are sufficiently powerful "intrinsic efficiency incentives" within Royal Mail's business plan.

5.1.5. Only once there is certainty of a level playing field on VAT for all non-USO services will Royal Mail be genuinely exposed to the risk of E2E competition. Even then, it will take a number of years for that competition to develop and it will depend on other market and regulatory dynamics as to whether or not investment will follow, such as overall volumes and pricing levels.

5.1.6. The range of 5 – 10% EBIT, with an indicative operating margin of 8%, represents a reasonable level of return. A continued drive for greater efficiency; increasingly flexible cost-structures; a review of the mandatory services comprised in the universal service obligation ("**USO**"); abandonment of non-commercial pricing practices designed to retain market share rather than maximise profit and diversification into different geographic and product markets will all be required to maintain and improve on such EBIT levels.

5.1.7. Royal Mail's efficiency suffers from the current VAT exemption because it means that it cannot recover a large part of the VAT on the goods and services it purchases from external suppliers. This makes outsourcing and sub-contracting less attractive than it might otherwise be and therefore locks in a level of inefficiency. That is because in-house supplies are not exposed to the same efficiency pressure as they have up to a 20% cost advantage over an external supply. Illustration:

Type of supplier	Input cost	VAT @ 20%	Royal Mail cost
External	100	20	120 (minus the proportion of recoverable VAT)
In-house	115	Exempt	115

SECURING THE PROVISION OF THE UNIVERSAL SERVICE AND PROTECTING CUSTOMERS

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?

6.1.1. Given the requirement in the Postal Services Act 2011 ("**PSA 2011**") to secure the minimum requirements of the universal service, it seems logical to impose that obligation upon Royal Mail: the only entity capable of complying with that USO.

6.1.2. An alternative approach would be to impose no USO at all but, rather, leave it to the market to provide the service. However, because the PSA 2011 precludes there being more than one provider of the universal service before 2021 (unless Royal Mail goes into administration), the question is really whether Royal Mail would be willing to provide the service voluntarily, in accordance with the minimum requirements set out in s.31 PSA 2011.

6.1.3. The reality of the postal system is that, without the volumes from business mailers who use predominantly non-USO services, there could be no universal service with anything like the coverage, frequency or price as currently exists. Businesses are estimated to send around 87% of all mail. Therefore, it will be crucial to observe the needs of these business mailers when setting the parameters of the USO and the minimum requirements in the future. If volumes do, as expected, continue to decline structurally then, even if there is an economy-related volume increase in the future, Royal Mail's ability to meet the minimum requirements will come under significant pressure. It is to be hoped that Parliament will listen to Royal Mail's concerns when, following OFCOM's review of the universal service, any changes are submitted for affirmative resolution.

6.1.4. Building on some of the excellent work already carried out by Consumer Focus and Postcomm, a mature debate at both a UK and EU level as to the minimum requirements of the USO must be started and it must take as its basis the needs and likely future needs of business mailers, upon which any social service is almost entirely dependent. The market conditions in other EU countries, where E2E competition has emerged and businesses have choice, are showing that businesses consider certainty of day of delivery as being more important than more frequent delivery.

6.1.5. If a similar demand pattern emerges in the UK, Royal Mail should be given the flexibility to adjust its business to respond to that demand. For this, they will need to develop more flexible and less traditional working patterns than currently exist. If Royal Mail does not achieve this flexibility, it may be appropriate for state funding to be made available for meeting the cost of consumer services which are not required by business customers.

6.1.6. OFCOM should also be increasingly willing to exercise its powers under s.33(2)(b) PSA 2011 to consider requests for exceptions arising from geographical conditions or exceptional circumstances. A more radical approach to defining delivery points may also be appropriate, with a break from tradition of delivery to each and every door. This has been seen in, amongst other countries, Canada. Should such delivery infrastructure e.g. in the form of banks of post-boxes, become more widespread, it will be important that E2E operators have access to it from the outset, to prevent the creation of an operational barrier to competition which would work against the interests of customers.

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.

6.2.1. We have repeatedly said that constraining Royal Mail prices through a price control rather than relying on competition and the market to set the upper level of prices is undesirable. The former price control was flawed in a number of respects:

- it was too complicated;
- it wrongly took the regulatory asset base in a labour intensive industry as the cornerstone for price regulation;
- it relied on predicting volumes which, in retrospect, in light of unimagined economic downturn and (more predictable) structural decline were inaccurate;
- it presumed a commercial hunger to create efficiency by a business which is state-owned and exposed to no E2E competition;
- it failed to take affordability into account in setting the price caps, the measure required by the EU Directive, and instead sought to set caps based upon an allowed revenue.

6.2.2. For all these reasons, we broadly support the move the removal of all price controls except on 2nd class letters, with the following caveats:

- to ensure that all customers have access to an affordable, universal postal service, it is crucial that second class, single item large letters, packets and parcels are also covered by a price cap since there is still very limited competition in the C to X sector;

- in the absence of OMC extraction access services by competitors, the removal of first class caps could lead to an undue exploitation of customers of single item next day services so a cap should be considered pending finalisation of such terms; and

- similarly, the absence of OMC injection access could lead to undue exploitation of bulk mail, next day customers and so a cap should be considered pending finalisation of such terms.

6.2.3. A price control on access prices is not necessary, though there is a risk to customers that Royal Mail will fail to be sufficiently cautious in setting its prices. Royal Mail should also keep in mind that its access services will, in due course, almost certainly be subject to VAT. Perennial and material price increases coupled with a 20% increase for VAT exempt customers are likely to have an impact on volumes and should be borne very firmly in mind.

6.2.4. Our views on the need for effective margin squeeze protection and zonal price monitoring are set out in more detail below in response to questions 7.3 and 7.4.

Question 6.3: Do you agree with Ofcom's proposals to put in place regulatory safeguards as described above? If not, please provide reasons.

6.3.1. USO: For the reasons stated above, we believe that it will be appropriate to apply a universal service obligation on Royal Mail, provided that the needs of postal users are carefully monitored to ensure that the extent of mandated services is kept to a minimum, leaving Royal Mail with as much flexibility as is appropriate.

6.3.2. Re-regulation: We have a number of reservations about re-regulation as a viable regulatory approach, which can be summarised as follows:

- it does not provide market certainty, especially if it might impact prospective investment plans by a competitor or Royal Mail itself;
- the overall conclusion seems to be that it is has proved impossible to regulate the postal market effectively to date. This suggests that, if there were a more suitable form of regulation, then that should be used now rather than removing price controls on all but second class stamps. Absent such regulation, this begs the question as to what type of regulation would be suitable if subsequently introduced;
- OFCOM may struggle to justify re-regulation in light of its statutory duties, in particular the duty to ensure the provision of a universal service and the duty to minimise regulation under s.6 Communications Act 2003;
- In light of the foregoing, it is questionable if Royal Mail would consider the risk of re-regulation as a suitably large risk to act in a particular way, notably in constraining its prices.

6.3.3. Monitoring: Given the potential difficulty in re-regulating, as described above, the purpose of monitoring must therefore be coupled with (a) competition across the value chain where Royal Mail is capable of abusing or leveraging its significant market power in order to constrain excessive pricing behaviour and (b) effective and prompt measures which prevent and punish anti-competitive behaviour. The likelihood of enforcement and certainty of penalties would operate to impact the behaviour of a commercial organisation but we recognise that, while in public ownership, these incentives are likely to be dulled.

6.3.4. Competition and Innovation: We fully support the view that end-to-end competition will constrain excessive pricing. This need not be confined to large business users, however, if wider access, including access to extract mail at the OMC, is made available. We discuss this in more detail in our response to question 7.2 below. Royal Mail still delivers in excess of 99% of letter mail and there is no doubt that the threat of end-to-end competition has been too weak to drive greater efficiency within Royal Mail. This is not surprising given the constraints of (a) a VAT distortion which effectively prevents competitors from delivering half of all the business mail and (b) the surcharge mechanism ("**NGPP**") in the first national downstream access agreement, which effectively penalised operators and their customers for using Royal Mail on a non-exclusive basis. Fortunately, the latter constraint has now been removed but only after our lodging a formal complaint in December 2006 and intensive regulatory involvement by Postcomm, which culminated in the introduction of a new surcharge mechanism based upon costs of delivery. However, until such time as there is a level playing field for VAT, there is a material risk that Royal Mail will use the interim period to maximise price increases but place less focus on improving efficiency. This does not benefit consumers, business mail customers, the industry or, in the longer term, Royal Mail's own prospects.

6.3.5. Innovation has been relatively modest since competition started to emerge in 2004. This is largely because of the absence of end-to-end competition and the reliance, therefore, on the final delivery service provided by Royal Mail through downstream access. That said, customers have enjoyed a number of innovations and benefits including:

- greater transparency e.g. through bag tracking

- better management information
- attentive account management
- contractually agreed service levels with agreed compensation levels
- price benefits including discounts for unsorted mail
- hybrid mail services
- later collections enabling customers to produce more mail in a day

6.3.6. The process for resolving access disputes has proved ineffective. We provide some suggested improvements in our response to question 7.4 below. Of [**Business Confidential: Confidential Annex reference 6.3.6A**] requests for access terms only [**Business Confidential: Confidential Annex reference 6.3.6B**] resulted in the offer of terms. [**Business Confidential: Confidential Annex reference 6.3.6C**] This apparent lack of incentive on Royal Mail's wholesale business to grant terms has stifled innovation. It has also meant that the incidences of non-equivalence between internal and external customers are more widespread than would otherwise be the case. We set out our May 2011 response to Postcomm's access review in [**Exhibit 2**] and address a number of issues in answer to question 7.2 below.

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

6.4.1. In light of the proposed flexibility, a monitoring system is crucial. Royal Mail retains a near monopoly on final delivery. There has been no recent pronouncement from Royal Mail to say that they perceive any benefit deriving from competition – quite the opposite. It is likely that they will take steps to retain market share in delivery and regain market share in upstream services. This is a concern. Our biggest concern is to ensure that monitoring detects and enables prompt and effective intervention in the following cases:

- The setting of retail prices in a manner which hinders competition in selling upstream services;

- The setting of final delivery prices which are not based on a fair and adequate allocation of costs and which thereby deter investment or hinder competition in providing delivery services;

- The frequent and unpredictable movement of underlying costs and related prices;

- Failure to treat Royal Mail's own retail business in an equivalent manner to external customers;

- Different but unjustified pricing to similar customers.

These are considered in more detail in our response to questions 7.3 and 7.4 below.

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.

6.5.1. We have consistently said that the test for setting any price control on universal services should be as specified by the EU Postal Directive, namely "at affordable prices for all users". This is mirrored in Requirement 3 of s.31 PSA 2011. What is "affordable" needs to be based upon appropriate user research but, looking at total household spend on postal services, the proposed range of 45-55 pence for a second class letter does not appear to be unaffordable.

6.5.2. There is a question as to whether some form of cap should considered for services where there is no or only emerging competition, notably in large letter, packet and parcel format single item services. In the C to X segment, it is recognised that Royal Mail retains significant market power but the competition law test which prevents excessive pricing is a different one from the requirement to ensure that the prices are "affordable". In order to discharge the obligation to ensure a universal service at affordable prices as set by Article 3.1 of the EU Postal Directive (and Requirement 3 s.31 PSA 2011), it seems appropriate also to consider applying a cap on:

- Large letter, packet and parcel formats for domestic and international single item services; and

- International single item letter services.

6.5.3. While an RPI cap may be appropriate for domestic services, international prices are driven by international agreements and treaties and, therefore, any future increases would need to permit these to be taken into account.

6.5.4. There is, though, a question about potential undue discrimination. Until now, retail and wholesale bulk mail prices have, at least in theory, been set on the basis of work-share and avoided cost, taking the stamp price as the starting point. This has broken down over the years with the claim that stamp prices did not cover the costs of the underlying services. If the new pricing freedom allows Royal Mail to address this issue, what is not clear is the correlation, if any, between single item and bulk mail prices. OFCOM's guidance on this point would be very useful.

6.5.5. In addition, we are not persuaded of the case for removing caps on first class mail. It is clear that the first class network has a higher cost base, including tens of daily flights to ensure nationwide coverage, which justifies the charging of a higher price. However, for so long as first class services are included within the mandatory services which comprise the universal service obligation, these, too, need to be "affordable". It is also important to recognise that first class services are, currently, the most frequently used services by single item consumers and that affordability of these services needs to be assured. It is not clear what measures OFCOM can take in the event that first class services they are set at a level which is not "affordable".

6.5.6. From a competitive perspective, there is a concern that "captive" customers using single item services will be charged prices which enable cross-subsidy of "non-captive" bulk mail customers. While a degree of cross-subsidy is permitted, it ceases to be acceptable when the single item prices are excessive. To minimise this risk, proper cost allocation and equivalence on transfer pricing will be crucial but a cap based on "affordability" would also appear to be an appropriate safeguard.

6.5.7. In any event, but particularly in the absence of any cap on the prices of first class services, OFCOM should consider sympathetically any request to mandate access at those parts of the Royal Mail network used to provide the universal service (in this case, a first class service): namely, the Outward Mail Centres (for both injection and extraction services). That way, the presence or threat of imminent and prompt entry in the C to X next day segment will act as a constraint on the upper level of first class pricing. We address this point again in our response to question 7.2.

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.

6.6.1. The reality of the Government policy to attract external investment into Royal Mail is that an investor will wish to invest in a profitable company which has a predictable regulatory framework, upon which it can make medium term decisions and from which it can derive an attractive return on investment. Assuming that the sale of Royal Mail will not take place until 2013 or 2014, this would leave a remaining period of some five years. For that reason, seven years is a long but understandable period.

6.6.2. On the other hand, we have expressed our reservations about the ability of OFCOM to re-regulate and this puts some doubt on whether seven years may be too long a period. Provided that the monitoring mechanisms and processes for intervening to protect competition from anti-competitive behaviour are robust and effective, this will be an acceptable duration.

6.6.3. We set out in our responses to questions 7.3 and 7.4 our concerns and suggestions for ensuring that the system is robust and effective.

Question 7.1: Do you agree with our approach to assessing end-to-end competition? If not, please give your reasons.

7.1.1. OFCOM recognises that Royal Mail has a monopoly on delivery and also the benefits of end-to-end competition: notably the incentives for greater efficiency. In a framework where price caps are removed on access services, the market will demand greater choice, pressure for efficiency and innovation. In the absence of competition, the extent to which these key ingredients will be provided by Royal Mail will be a matter for Royal Mail. That is unsatisfactory.

7.1.2. The WIK Report demonstrates that end-to-end competition with the competitors delivering between 10 – 17% of total volumes (and accounting for 11.8% of revenues (Germany) and 5.6% of revenues (Spain)) has not undermined the universal service and has acted as a spur to modernisation. This is important empirical information when assessing the theoretical impact of delivery competition on Royal mail.

7.1.3. OFCOM rightly concludes that the application of zonal pricing means that "the potential for geographical entry representing unfair "cherry picking" is reduced if not completely eliminated." More than 50% of access volumes, including all of those sent by TNT Post, are now effectively subject to zonal pricing, through the surcharges which now apply to those national access agreements which contain a zonal geographic posting profile ("**ZGPP**") mechanism. The ZGPP system works as follows: if a customer posts mail to the four zones which reflects a mix which, within tolerances designed to reflect statistical reliability, averages out at the national price, then no surcharge is applied.

7.1.4. On the other hand, if the profile contains a higher than expected proportion of mail destined to more expensive zones (such as London and rural areas, where Postcomm concluded that the costs of delivery are higher), Royal Mail is entitled to raise a surcharge to reflect the additional costs of delivery. In this way, where a customer – whether because of their mail profile or because they choose to use other delivery companies to carry out the final mile delivery – has an expensive profile, Royal Mail will be properly remunerated. The development of zonal pricing is a fundamental safeguard for the USO and, subject to the points made in response to question 7.4, should obviate the need for any further regulation.

7.1.5. As contemplated by Annex 7, footnote 11 of OFCOM's consultation document, in order to ensure that the customers are not precluded from using end-to-end competitors by the NGPP surcharge mechanism (which is not cost-based, fair or reasonable) and to ensure that all customers are treated on an equivalent basis, OFCOM should issue guidance that all national access agreements should be subject to the ZGPP mechanism. ZGPP surcharging has been effective since April 2011 so this equalisation of terms should take place as soon as possible. In its decision on zonal definitions and costing, Postcomm had expected ZGPP surcharging to be in place by April 2010.

7.1.6. Within a postal business, very few costs are fixed. With volume declines inevitable, it is crucial that all operators, including Royal Mail, adopt the most flexible possible cost models. "Difficult to change" is not the same as "fixed". End-to-end competition will force an acceleration of modernisation and innovation which will make postal services more responsive to evolving customer needs. It is likely to be uncomfortable for Royal Mail but radical change clearly is necessary, as so clearly described by the Hooper reports. End-to-end competition will be the key driver for that change, particularly if Royal Mail should leave public ownership in the next year or two.

7.1.7. OFCOM recognises that if end-to-end competition should offer a delivery frequency of fewer than six days per week, this could "still, overall, lead to net benefits, if it represented an efficient operator providing incentives on Royal Mail and benefit for customers".

7.1.8. This is exactly how competition has emerged in other countries. In Sweden, an ABC model has emerged:

Bring CityMail uses a rolling scheme for mail delivery called 'ABC-delivery'. With ABC-delivery, mail is delivered on the first day in one area of a city, on the second day in another and on the third day in the last area of a city

In Germany, TNT Post Deutschland delivers:

5 days per week, Tuesday to Saturday

In The Netherlands:

SelektMail distributes printed matters in two delivery rounds a week (Tuesday/Wednesday and Thursday/Friday). For delivery SelektMail uses a rolling system similar to CityMail Sweden.

z. As previously stated, WIK concludes that end-to-end competition has assisted the USP:

> In the liberalised postal markets we surveyed, universal service providers have undergone major organisational changes to achieve greater efficiency. End-to-end-competition has provided strong incentives for this modernisation that included, for example, an overhaul of post office and delivery networks, , sorting technology, formats and price structures, as well as their operational and management structures. In order to ensure universal service can be sustained in our increasingly digital societies, modernisation of universal service providers is a necessity. In the four different countries, we believe end-to-end competition has helped to achieve a sustainable universal service, and indeed improve universal service quality, by putting pressure on incumbent operators to modernise.

7.1.9. The Government has instructed OFCOM under s.41 PSA 2011 to require operators to notify them of any plans for the commencement or expansion of letter delivery businesses of a "specified scale". This is not a wholly new requirement since operators are used to providing Postcomm, and now OFCOM, quarterly volume and revenue data and an annual forecast. However, it is to be hoped that this will not impose an undue regulatory burden on postal operators.

7.1.10. The market needs regulatory stability. While it is proposed that Royal Mail should have seven years of regulatory clarity, quite the reverse is being proposed for its competitors. It is being proposed that OFCOM will assess potential entry "on a case-by-case basis to determine whether [OFCOM] should consider taking any regulatory steps to ensure [its] duties under the Act." This provides little or no regulatory certainty to would-be investors in end-to-end delivery networks, even though the benefits are recognised.

7.1.11. We are of the firm view that seeking to impose regulatory obligations on operators who are willing to take the commercial risk of investing in the UK market is undesirable for a number of reasons:

- Royal Mail needs to modernise and become more efficient but regulatory price caps which were previously aimed at encouraging this behaviour are to be removed so there is an excessive reliance being placed on Royal Mail's self-restraint with customers being most at risk;

- Modernisation at an appropriate pace, without the presence of competition, is less certain even though it is essential. The creation of regulations on end-to-end competitors would be counter-productive if they relieve the very pressure which needs to be applied to Royal Mail to modernise;

- Evidence in other countries has shown that employment conditions are the cornerstone to the financial success of labour-intensive postal services and competition provides the best possible benchmark for the applicable labour conditions;

- Customers increasingly want choice, especially following material price increases in May 2011 and in the expectation of further significant increases in 2012 and perhaps thereafter. There is growing concern among business mailers that transactional mailers are perceived as a "cash cow" by Royal Mail's most senior management;

- Royal Mail has failed to innovate or offer the wide range of wholesale services over the last seven years which would have permitted greater innovation by access operators. End-to-end competition is therefore the best way to introduce greater and more rapid innovation to the market;

- There are already a great number of variables and risks for any would-be entrant to consider such as:
  - available volumes

- uncertainty about zonal structures (including the number of zones) and pricing
- customer inertia in light of limited geographical coverage
- the impact of VAT
- Royal Mail's competitive reaction
- availability of labour
- productivity levels
- capital investment costs

- Competitors are unlikely to gain access to all mail flows so Royal Mail will remain a monopoly on C to X, first class and certain geographical areas;

- Even where competition has emerged in other jurisdictions, such as in Sweden, where Bring CityMail serves over 50% of Swedish households, the USP has fared well;

- Royal Mail's headcount will reduce but, if there is no end-to-end competition, this will result in a higher level of net job losses than if other operators are able to recruit new staff;

- Case by case regulation which may interfere with the liberalisation of the market is potentially subject to legal challenge for infraction of the EU Postal Directive which envisages: competitive procurement of the services in order to provide the USO (Article 7.2), use of public funds (Article 7.3(a)) or the establishment of a compensation fund (Article 7.3(b)) but not any other methods for financing the burden (if any) of providing the USO. Under PSA 2011 s.44, OFCOM may not conduct a review of the financial burden (if any) of meeting the USO for five years (unless otherwise directed by the Secretary of State). Therefore, due to the combination of EU and UK law, there is no scope (absent a direction from the Secretary of State) for a compensation fund before 2017 and no scope for other measures contemplated by s42 PSA 2011 at any time which are not contemplated by Article 7 of the EU Directive.

- A regulatory measure which is based upon the exclusive status of the designation as USP but which prevents free competition is potentially incompatible with Article 106 TFEU which provides as follows:-

Article 106
(ex Article 86 TEC)

1. In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in the Treaties, in particular to those rules provided for in Article 18 and Articles 101 to 109.

2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union.

- Although there is a primary duty on OFCOM to secure the provision of a universal service, imposing regulation in a way which would hinder competition is subject to a number of statutory constraints which we believe would make any such regulation either inappropriate or unlawful if there were no evidence that the universal service would necessarily be undermined. Relevant provisions provide:

    - regulation not permitted unless the measure is one "OFCOM consider <u>necessary</u>" - s.42 PSA 2011;

    - the duty to further the interests of consumers in relevant markets where appropriate by promoting competition - s.3(1)(b) Communications Act 2003 ("**CA 2003**");

- the duty, when furthering the interests of consumers, to "have regard, in particular, to the interests of those consumers in respect of choice, price, quality of service and value for money" – s.3(5) CA 2003;

- the duty to have regard to "the desirability of promoting competition in relevant markets"- s.3(4)(b) CA 2003;

- the duty to have regard to "the desirability of encouraging investment and innovation in relevant markets" – s.3(4)(d) CA 2003;

- the duty to ensure that the regulation is "transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed" – s.3(3)(a) CA 2003.

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.

7.2.1. Mandating access to the IMC for the reasons previously set out in our response to Postcomm's access review [**Exhibit 2**] is crucial. The statutory tests in s.38 PSA 2011 are clearly satisfied. Indeed, in the light of the proposed removal of price caps on access and retail services and OFCOM's recognition that the existence of access services will facilitate end-to-end competition, all of the tests in s.38(4) are even more easily satisfied now given the increased role of competition in the promotion of efficiency and effective competition and the conferring of user benefits.

7.2.2. If access becomes voluntary, Royal Mail would have the choice to stop upstream competition and, having diluted or eliminated the upstream operator's customer base, also delayed or potentially thwarted any downstream competition.

7.2.3. We do not accept that Royal Mail would be willing to offer access services voluntarily. Our experience is, in the vast majority of cases, the contrary. A number of recent statements by the most senior management of Royal Mail have also indicated a desire not to offer access services, given the commercial choice. To quote Royal Mail's Group Director of Regulation and Government Affairs, in a witness statement, dated 4th July 2011, which was served upon TNT Post UK Limited as part of the ongoing litigation over the extent of Royal Mail's VAT exemption:

> "***Nor does the licence allow Royal Mail to refuse to offer terms to provide Downstream Access to a competitor which wishes to secure such access and is willing to pay for it, even if Royal Mail might prefer, as a commercial matter, to turn the competitor away. … Royal Mail is effectively forced to facilitate the business operations of its competitors through the mandatory provision of access to its postal network … Royal Mail does not see Downstream Access as a "service" from a business perspective (since it is a mandatory sharing of Royal Mail's postal network with persons who are, largely, its competitors) …***"

7.2.4. There continues to be customer demand for other forms of access. As shown in [**Exhibit 2**], this covers a demand for nationwide, next-day service and for OMC extraction services (e.g. where items have been returned via the pillar box network). As mentioned previously, the removal of price caps on bulk and single item first class services will expose captive customers to monitored but uncontrolled pricing by Royal Mail. In the D+1 market, Postcomm has acknowledged in its Initial Proposals of April 2011 that Royal Mail has significant market power for all items.

7.2.5. Access should be mandated for all current formats, namely Letters, Large Letters, A3 Packets and Packets. There are currently contracts in place for packets access and this is a crucial area, especially where there is no or only limited competition. Furthermore, customers do not establish their businesses on the basis of Royal Mail format specifications of large letters v. packets so drawing the line for mandatory access on the basis of those definitions fails to take market reality into account.

7.2.6. We note that OFCOM remains open to receiving requests, supported by detailed evidence, for other forms of access either now and at a point in the future. In light of the proposed regulatory changes, we expect that the demand for other forms of access, which allow a next day, nationwide service will grow. As is clear from [**Exhibit 2**], Royal Mail has previously offered TNT Post terms for OMC injection access on certain aspects of which TNT Post sought a determination. In light of this, we see no reason why, given that Royal Mail was willing to offer terms which were largely acceptable, OFCOM should not now immediately impose a USP Access Condition under s.38 so that the Schedule 3 dispute resolution procedures can be invoked. [**BUSINESS CONFIDENTIAL: Confidential Annex reference 7.2.6A**]

Question 7.3: Do you agree with Ofcom's proposals in respect of regulating margin squeeze? If not, please give reasons.

7.3.1. The benefits of access (plus the need for mandatory access at the IMC and, we would advocate, elsewhere in the network) are, we believe, abundantly clear. The importance of access for the future development of end-to-end competition is also fundamental. Therefore, it is critical that the form of regulation designed to prevent price or margin squeeze is effective, lest these existing and future benefits be lost.

7.3.2. While understandable that Royal Mail would utterly reject a regulatory system which imposed a loss-making access price upon it, coupled with a system which set headroom levels above fully allocated costs, the radical proposal to remove caps on access prices has undoubtedly altered the drivers for rejecting such a system. In a market where Royal Mail will be completely unconstrained by downstream competition in setting its access price, it should be able to make a very significant profit. The risk is that, having made profits downstream, this will create the opportunity for Royal Mail to aggressively squeeze upstream competition – and thereby the prospect of downstream competition – out of the market while suffering little or no financial impact.

7.3.3. The need to reduce the level of regulatory protection against margin squeeze is no longer as critical to Royal Mail's business success as it was previously nor is diluting that protection necessary to secure the provision of the universal service. However, if set at an inadequate level, there is a risk that OFCOM's other statutory duties - notably its duties to benefit consumers through the promotion of competition, innovation and investment under s.3 CA 2003 – will not be properly discharged.

7.3.4. A move along a glide-path to *ex post* competition law appear to be a desirable, long-term aim but we have a number of reservations. OFCOM has acknowledged that:

- there are obvious benefits from access competition;
- there is no end-to-end competition and competition will take years to emerge (and we would add that it cannot even start until the VAT distortion is removed);
- Royal Mail "*may have a different incentive to make changes over a shorter period of time in order to disrupt the market and encourage customers to switch to Royal Mail*"
- "*given the benefits of effective competition described above, we do not consider that relying on competition law alone and not imposing any regulatory conditions would be an optimal outcome*"
- "*relying on ex post safeguards alone could lead to the risk of irreversible and permanent damage to access competition*" (and we would add, therefore, also end-to-end competition)

7.3.5. Given the rigorous procedures a regulator must follow in pursuing any *ex post* competition law enforcement, the process frequently takes over a year and this is more than sufficient time for any access operator's business to be undermined by a concerted attempt to remove that operator from the market. It is absolutely crucial, therefore, that the regulation is effective. The potential effects of regulatory failure in this area are enormous.

7.3.6. We fear that a move to a LRIC-based margin squeeze test will not adequately protect competition, for the following reasons:

- the market reality is that customers still expect a discount for not trading directly with Royal Mail;
- there remain considerable doubts about whether reliable upstream LRIC data can ever be produced;
- only Royal Mail can afford to survive on LRIC cost covering for any period of time. Any other operator would be forced to exit as its operations would cease to be profitable;
- Royal Mail's competitors do not have the economies of scope of Royal Mail and are unable to cross-subsidise between services as they all, essentially, provide only the same 2-3 day service. If access is limited to only IMC access for a 2-3 day service and Royal Mail is free to offer a full range of other services which, overall, offer customers savings, this can act to

persuade customers to switch to or remain with Royal Mail and its upstream competitors will be unable to react, irrespective of how efficient they are;

- without economies of scope, while Royal Mail's competitors (no matter how efficient) may be able to sustain prices to some customers which are below cost, they can only remain in business if they cover their total costs by setting their prices to other customers at a level which enables them to do so. That is because those upstream services are their only source of income. If exposed to LRIC pricing for a sustained period, they will be unable to compete and will be forced to leave the market;
- competition law has, in the context of predatory pricing[1], recognised that pricing below total cost (or FACis not permitted if it is coupled with an intention to foreclose competition. Within the last six months, Royal Mail's own Group Director of Regulation and Government Affairs, in a statement filed with the High Court, has made it perfectly clear that Royal Mail has precisely this intention and that it should not be "***forced to facilitate the business operations of its competitors"***. While much of the subsequent case law on margin squeeze has focussed on a LRIC based test, the total absence of economies of scope for competitors who operate in the retail segment set against Royal Mail's monopoly in the wholesale market and its significant market power in all D+1 retail markets and in low volume D+2 and later retail markets would indicate that the UK postal market with downstream access as its predominant form of competition is a special case and therefore merits specific regulation to take account of its unique characteristics;
- given the removal of price caps on access services and the ability to set prices at whichever level it considers appropriate, Royal Mail will now be in a far better position to absorb upstream losses than it has ever been since access competition began in 2004. Given its stated preference not to provide access and its acknowledged incentive to encourage customer switching to Royal Mail it might be presumed that it will take precisely these steps unless prevented from so doing by regulation;
- there is no prospect for any alternative to upstream competition until the VAT distortion is removed and competitors have had adequate time to establish alternative delivery networks. Based on latest informal indications, regrettably (and, in our opinion, unlawfully), the earliest likely date for a removal of the VAT exemption on access services is April 2014 but that is on the presumption of there being a move to a LRIC-based margin squeeze protection test and HMRC accepting this as not being a "price control" therefore requiring the removal of the exemption. This presents a dilemma: if we move to a LRIC-based margin squeeze test we risk losing the very customer base which is crucial to the development of an end-to-end delivery capability and, if we do not, we do not (assuming HMRC does not relent in its current position) have a level playing field on which to compete downstream because the exemption on access services would continue;
- in the absence of a robust, independent and reliable way of checking Royal Mail's LRIC data, OFCOM will have insufficient insight into the LRIC figures. However, these are the figures upon which customer choice and investment by competitors would depend. Reliance on Royal Mail LRIC data would mean that the risk of regulatory failure would be high.

7.3.7. There are a number of questions about the services which will be covered by the proposed "margin squeeze" test:

(7.3.7.1) Packets

- Mandatory access for packets where there is no or limited competition is extremely important as this is a growing sector which has only recently been opened to competition. Details of recent developments in this important sector of the upstream arena are shown in [**Exhibit 4**]. As stated above, drawing a regulatory distinction based on Royal Mail's technical format definitions does not accurately match customer demand. Packets should be included within mandatory access and subject to margin squeeze protection.

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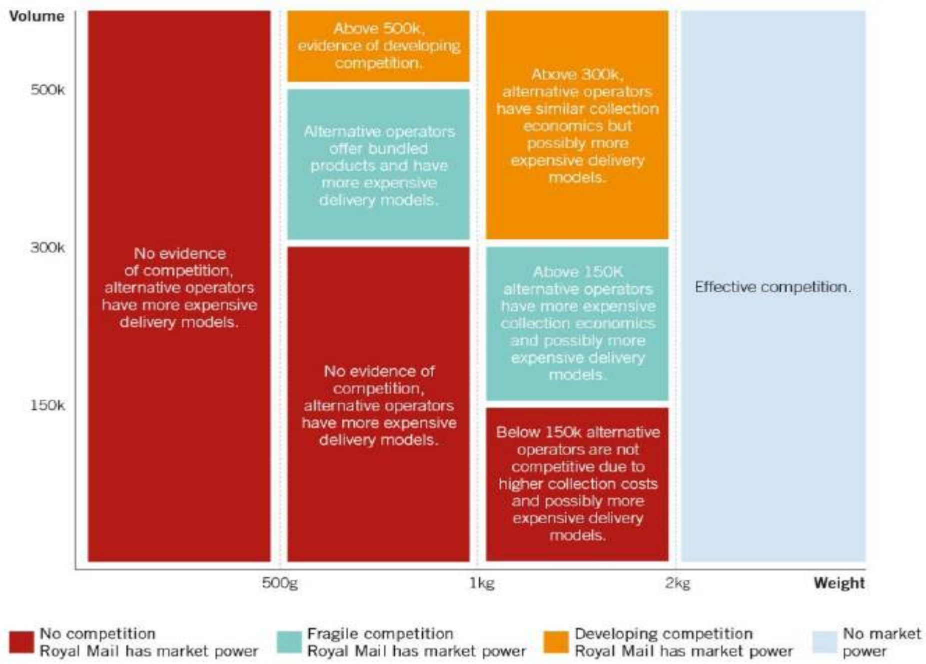
[1] *AKZO v. Commission* C-62/86. As Royal Mail could in theory launch its own upstream service, in addition or as an alternative to providing an integrated end-to-end service, this test on predation for this postal upstream service is relevant to a margin squeeze analysis in a way which may not apply to other industries. That is because these service components are distinct and can be provided separately unlike other margin squeeze cases where raw materials or indistinguishable and intangible services are provided as part of an integrated supply to end customers.

- For certain packets segments (low volume under 2kg and any volume under 500g) there is no downstream competition. The same rationale as applies to letters and large letter formats for mandating and setting a margin squeeze test, therefore, also applies to packets. Following extensive market analysis, Postcomm decided, in November 2010, that there is no downstream packet competition below 500g and only emerging competition in certain sectors below 2kg. Their findings are illustrated below.

- If OFCOM adopts its proposal to remove any margin squeeze test on packets, this would mean that margin squeeze of upstream packet operations would be subject to ex post analysis under competition law but, as acknowledged, this can be a time consuming and, potentially, ineffective process. Given that Royal Mail will have the freedom to price its downstream packet services at the level it thinks fit, there is little risk of upstream competition in the packets area undermining Royal Mail's ability to provide a universal service but there is a significant risk of excluding upstream packet competition from this growing market.

- It is not clear if there is reliable, upstream LRIC data available for OFCOM to be able to carry out an effective challenge of margin squeeze on packets. If that data is not available, there is a material risk of regulatory failure.

Figure 3: Summary of deferred PPS B2X market power assessment



(7.3.7.2) Equivalent Services

- The proposal is to apply the margin squeeze test to Mailsort 2 "or equivalent services". This leads to considerable, potential uncertainty. There is an expectation that Royal Mail will move to a system of distinguishing among (a) transactional mail services such as statements and invoices (Business Mail) (b) publications and (c) direct mail (Advertising Mail). As all of these types of mail currently use Mailsort 2 services, it is crucial that the proposed margin squeeze test continues to apply to all of these formats, even if the target time period for delivery is between the three and seven working day service levels for Mailsort 2 and Mailsort 3 services which are currently offered.

- Given the lack of reliable upstream LRIC data, to minimise the risk of regulatory failure and to ensure that the glide-path is a predictable one (though, please note our reservations about the end goal, as mentioned above), any service should be presumed to be an "equivalent service" unless demonstrated clearly that no customers using Mailsort 2 services would move to using that service.

- We will analyse the detail of the conditions to see if they address this concern and will respond, in due course, to that consultation.

(7.3.7.3) <u>Mailsort 3</u>

- We continue to have reservations about the lack of regulation on upstream pricing for Mailsort 3 – and related Mailsort Lite – services.

- Postcomm reached the provisional conclusion that “D+2 and later” letter/large letter services fall within the same pre-sorted and high volume unsorted markets, in its 1 March 2011 Analysis of Markets document:

Figure 3: Provisional conclusions on market power within retail postal markets

- It is our understanding that, when assessing a postal margin squeeze,[2] a degree of aggregation of costs of the services is permitted but Postcomm did not conclude on the appropriate level of aggregation. However, they did say that they did “not necessarily agree with the breadth of the Royal Mail proposition” that aggregation was to be across all low priority bulk mail services. The subsequent market analysis, summarised in the diagram above and published on 1 March 2011, concluded that there are five “D+2 and later” retail markets. Regulatory certainty should be offered where possible and OFCOM should issue clear guidance as to what extent aggregation is possible within each distinct upstream/retail market. If aggregation is to be permitted within a retail market (but not between retail markets), then LRIC data to support any such analysis will be required. Until such time as that data is available, the ability to protect competition against margin squeeze will not exist. To guard against this risk, OFCOM should adopt the same adjusted FAC test as is proposed for Mailsort 2 (and equivalent) services.

- If OFCOM does not adopt this approach, there is a danger of increasing the risk of margin squeeze on Mailsort 3 services. That is because, if required to meet adjusted FAC on Mailsort 2 (and equivalent) services, Royal Mail may be encouraged to price below LRIC on Mailsort 3 upstream costs so as to price as close to LRIC, overall, in the D+2 and later upstream market. For the reasons stated above, we have a concern about moving to a LRIC test for margin squeeze and, yet, the proposed mechanism could lead to below-LRIC pricing for a significant sector of the bulk mail market.

(7.3.7.4) <u>Differential pricing between customers</u>

[2] See Postcomm’s May 2010 Final Decision: “An investigation into Royal Mail’s offering of Mailsort Light”

- We wait to see the proposed detailed conditions but the proposal to permit pricing on individual contracts at 50% of adjusted FAC raises the question as to when and under what conditions different prices can be offered without offending the principle which prevents undue discrimination. Clear guidance from OFCOM will be important to give valuable regulatory certainty to the market.

- The extent to which differential pricing is permissible, where there is no ex ante margin squeeze test, would also be an area where clear guidance from OFCOM would be very much appreciated. The guidance should also make it completely clear that pricing below LRIC for a particular customer or class of customers is not permitted by competition law (as noted in paragraph 7.48 of Annex 7 of the consultation).

(7.3.7.5) Differential pricing based on mail type

- OFCOM should issue guidance to make it clear when, and on what conditions, Royal Mail may offer different prices for the same physical service, where the content of the item differs. The most obvious example is differential pricing for Advertising, publications and Business mail but the appropriate position for mixed mailings or "transpromo" mail also needs to be addressed.

- If that guidance on differential pricing is different (as we believe it should be) for Royal Mail's wholesale and retail businesses, this needs to be clear.

(7.3.7.6) Unsorted high-volume services

- The position as to the margin squeeze protection for "high volume unsorted D+2 and later" services is unclear. In the absence of separate LRIC data for this retail market (though, please note our concern about the risk of a move to LRIC-based margin squeeze), there is a risk that margin squeeze will go undetected.

- As noted above, with Royal Mail's new pricing freedom on access services, the risk to the universal service is largely addressed which then means that OFCOM should have regard to its other statutory duties, in particular those under s.3 CA 2003 including the duty to further consumer interests where appropriate through promoting competition.

- There are considerable existing concerns about the pricing levels of Cleanmail Advance. Cleanmail is an unsorted product which is sold at a price which is only marginally higher than pre-sorted mail services. In addition to the general, low level of pricing there is a concern that there is undue discrimination and non-equivalence taking place. This is because, rather than surcharge an entire mailing where a specified proportion of the mail does not meet a particular downstream access specification, Cleanmail Advance charges the customers based upon the relevant proportion of mail which can be processed by the Royal Mail sortation machines. The Royal Mail website states (highlighting is added):

Cleanmail® Advance

You can enjoy item based discounts of up to 15% based on letter machineability and address accuracy (automatic sortation) determined by Royal Mail sorting machines.

How does Cleanmail® Advance work?

To use Cleanmail® Advance you must meet defined letter dimensions including address location and clear zones, apply a Licence, post at least 500 Items, complete a Sales Order online and present the letters in trays.

The total billed volume will be based on the sales order volume. Royal Mail sorting machines read the Licence number, check the letter for address accuracy and allocate a discount on an item basis for items automatically sorted. Items failing to be automatically sorted are priced as Account / Franked Meter Standard Tariff.

- By contrast, if a CBC (customer bar code) mailing does not meet the 90% DPS requirement in the CBC specification, based upon a sample taken by Royal Mail (please see further comments on this in our response to question 7.4 below), then the entire mailing may be treated as non-compliant and surcharged by 2.48 pence per item, even though the vast majority of the mail may bear a perfectly legible and compliant barcode and be processed via the Royal Mail automated sorting machines.

(7.3.7.7) Letters and Large letters

- The proposal is that Royal Mail must cover adjusted upstream FAC for both Letter and Large Letter formats. If the requirement is for Royal Mail to cover adjusted upstream FAC across both formats, this might lead to an under-charge for large letters which are more expensive to process upstream. The corollary is a possible over-charge for letter format items. Currently, there are different headroom / margin squeeze measures for the different formats and this represents a significant change. We think it would be useful to have a separate measure for each of letter and large letter formats with a separate FAC measure for each.

(7.3.7.8) FAC average, 50% FAC contract floor and FAC adjustments for VAT

- For the reasons stated above – and in particular the absence of economies of scope – we do not accept that FAC is an inappropriate measure for preventing margin squeeze.

- As to proposed method for deriving FAC (namely, end-to-end FAC less the equivalent access FAC (including wholesale costs)) we have some concerns. If Royal Mail sets its access prices at a profitable level – there no longer being any cap on access prices – then this would appear to have the effect of reducing upstream FAC if that equivalent access price is to be taken as the access FAC. OFCOM should clarify that the access price is not to be taken to be the access FAC but, rather, that the actual costs of access be taken, to avoid an artificial reduction in upstream FAC. It is this figure which should then be applied to the access price to ensure that there is no margin squeeze.

- Some overhead is needed for the upstream service and is, therefore, likely to be incremental. Therefore, to the extent any central overhead can be allocated to those upstream activities, then this should happen.

- The prospective profit for Royal Mail overall is around 8% and we would expect the assumed profitability to be set at this higher end of the 5-10% range.

- In the absence of robust LRIC data, there is a risk in setting an individual contract floor too low by assuming it should be at 50% of adjusted FAC. If there is to be a glide-path to LRIC based test (which, as previously stated, we do not accept to be the appropriate end point) then it must not involve the transitory level being set too low. While we do not calculate LRIC and FAC data in our own business, in [**Exhibit 3**] we show that our own ratio of operational costs to total costs produces a different and higher operational cost proportion. Taking these numbers into account, we believe that a proxy for LRIC should be no less than **[BUSINESS CONFIDENTIAL:Confidential Annex reference 7.3.7.8A]** of FAC (which, itself, needs to be further adjusted in line with the above comments).

- We note that forecasts for costs, volumes and revenues will be used as a proxy for actual costs and that OFCOM will monitor this on a quarterly basis. What is not clear are the steps OFCOM could or would take if it turned out that actual upstream costs are higher than the forecast costs on which actual prices have been based. Given the risk of damage to competition if the forecasts should prove inaccurate, it would be appropriate to adjust the forecast figure to take account of that potential margin of error. Given OFCOM's primary duty is to secure the USO and in light of the removal of price caps on access prices, erring on the side of caution is appropriate. OFCOM can look at Royal Mail's history for volume forecasting against actual volumes to calculate the likely margin of error and should adjust the FAC figure accordingly.

- There are a number of activities which access operators need to undertake and which need to be added to the relevant upstream costs. These activities are shown in the answer to questions 24-25 of Postcomm's access review at [**Exhibit 2**]. "Accessor costs" include: incurring extra costs through lack of flexibility in access times to mail centres requiring the use of multiple vehicles rather than re-use of the same vehicle if more than one access slot were made available; DSA surcharges e.g. for non-compliance with a national or zonal profile; disproportionate sanctions for a small number of non-compliance events; IT charges; inability to challenge unfair charges retrospectively and therefore having to write off irrecoverable amounts; volume forecasting; provision of bag and tray-fill data; uploading of data to create manifests.

- We currently have to apply VAT at 20% to our upstream charges which has two cost impacts:

    - We therefore have the additional costs of administering agency arrangements to minimise the impact of VAT, including a time lag for lost revenues resulting from up to 28 days for Royal Mail to give a credit clearance and issue an SAP for each agency customer and a further period of up to 10 working days for HMRC ruling to confirm that disbursement treatment of the Royal Mail charges (the "**disbursement ruling costs**").
    - More significantly, this means we need to reduce our upstream prices to VAT exempt customers who cannot recover all their VAT ("**VAT discount costs**"). We estimate that [**BUSINESS CONFIDENTIAL: Confidential Annex reference 7.3.7.8B**] of our volumes come from VAT exempt customers. Overall, it is understood that around half of all business mail is sent by customers who cannot fully recover their input VAT. In the absence of equality of VAT treatment on retail prices, Royal Mail's upstream FAC charges would, therefore, need to be uplifted to reflect somewhere between [**BUSINESS CONFIDENTIAL: Confidential Annex reference 7.3.7.8C**] and 50% of volumes bearing an uplift of up to 20% to counteract the need to provide this discount. Should non-USO retail services be subject to VAT then the need for this latter non-equivalence uplift of upstream FAC to cover VAT discount costs would disappear.

- However, if downstream access services remain VAT exempt (which, as stated above, we believe to be an improper interpretation of the European Court's ruling on this matter but appears to be the likely direction of travel by HMRC), we presume it would be open to Royal Mail retail to offer a similar upstream only service (subject to VAT) and for Royal Mail Network Access to bill the downstream element (VAT exempt)[3]. If this separation were required then it may be appropriate to remove the uplift attributable to "disbursement ruling costs". As there is no obvious reason why this option should not be available, what would not be appropriate would be to adjust FAC downwards to reflect the VAT on the nominal access price which is embedded in the Royal Mail retail price. An illustration of the possible VAT outcomes are shown below:-

Illustration only:

	Upstream charge	VAT on upstream charge	Royal Mail downstream access charge billed direct to customer or as a disbursement	VAT on downstream charge	End-to-end charge	VAT on End-to-end charge	Total charge (inc. VAT)	Regulatory adjustment needed to RM upstream FAC costs
Royal Mail retail customers (assuming VAT exemption continues on non USO retail services)	2p (cost allocation)	N/A	18p (transfer price)	N/A	20p	N/A	20p	Adjust upstream FAC to cover disbursement ruling and VAT discount costs of 0.4p
TNT Post agency customer	2p	0.4p	18p	N/A	-		20.4p	
Royal Mail agency customer	2p	0.4p	18p	N/A	-		20.4p	No adjustment to upstream FAC costs needed – equal VAT footing

[3] For completeness, it is worth noting that if bulk mail retail services become taxable from April 2012, this will favour the use of downstream access services by VAT exempt customers if and for so long as these downstream services remain VAT exempt. However, the distortion on downstream competition, of course, would remain.

								upstream
Royal Mail non-agency customer (assuming VAT on non USO retail services)	2p (cost allocation)	N/A	18p (transfer price)	N/A	20p	4p	24p	No adjustment to upstream FAC costs – Royal Mail able to adopt "agency customer" structure.
TNT Post non-agency End-to-end customer	2p (cost allocation)	N/A	18p (cost allocation)	N/A	20p	4p	24p	

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.

Setting terms and conditions

7.4.1. We agree that there is a crucial role for the regulator to play in relation to terms and conditions for access. As can be seen from [**Exhibit 2**], the current regime is not working effectively, particularly when it comes to securing new forms of access. There are four different situations where intervention may be needed:

(7.4.1.1) Setting the scope of mandatory access
OFCOM has an obvious role in assessing where to impose such a condition. As said previously, access to OMCs (both for injection and extraction) will be important, in addition to access at IMCs. The process for assessing requests to widen the scope of mandatory access needs to be efficient, in order to meet customer needs and allow investment decisions to be made promptly.

(7.4.1.2) New access services – process for setting terms
In this case, it will be important that there is a time limit on Royal Mail to provide detailed terms for access to those parts of its network covered by a USP Access Condition. This is important so as to encourage innovation and to enable the market to meet customer needs. Where terms cannot be agreed, OFCOM should have an efficient and clear process by which the access requestor can seek resolution of the dispute. We will review the proposed conditions and revert on this point in more detail.

(7.4.1.3) Settling disputes on existing access terms (strategic)
At times, there are access disputes on more strategic issues. For example, the disputes over the National Geographic Posting Profile surcharge mechanism and over the cost basis for zonal pricing have affected the possible emergence of end-to-end competition. In cases such as these, it will be important for OFCOM to resolve disputes between Royal Mail and access customers as other regulatory considerations are likely to be at stake. Given the need for OFCOM to use its discretion in deciding which disputes to hear, taking into account a number of considerations, including allocation of its resources, it would be ideal if OFCOM were requested to intervene on access disputes in only the most crucial cases or those which have a wider market effect e.g. whether a particular method of sampling compliance is valid and reliable when used to calculate surcharges – a subject on which there is currently tremendous consternation in the market. However, OFCOM will also perform a crucial role as a fail-safe means of resolving a dispute where other means are not possible, are not suitable for resolution of a strategic issue or have been exhausted.

(7.4.1.4) Settling disputes on existing access terms (commercial or operational)
There are also more commercial or operational issues which affect an access customer and Royal Mail's specific course of dealing but which need to be resolved, from time to time. Indeed, there may be a number of issues where resolution is blocked. These cannot always be sorted by commercial negotiation or by mediation (submission to which requires the consent of both parties). This leaves only the options of referring the dispute to OFCOM, when the powers under Schedule 3 come into effect, or taking the matter to arbitration. Arbitration can be as unsatisfactory a process as litigation for resolving disputes where there is an ongoing commercial relationship since it involves an adversarial, formal, expensive, relatively inflexible and time-consuming process. In reality, the expense and time involved in arbitration

and perhaps also even a formal dispute referral to OFCOM is more likely to put off the access customer than ought to be the case. Financial resource and regulatory expertise in postal services is extremely limited outside Royal Mail and no other operator has seen fit to invest in dedicated, full-time regulatory personnel. Furthermore, the cost of resolving a dispute relative to overall turnover is likely to be considerably higher in the postal market than in the other markets OFCOM regulates. Examples of these types of dispute are: refusal by Royal Mail to rectify of an obvious error; challenge to a result of sampling by Royal Mail which has led to the imposition of a surcharge despite documentary evidence of compliance; disputes over lost or damages trays or yorks. Our suggestion is that a neutral third party adjudicator should have the ability to issue a binding decision after being presented with evidence from both sides: orally and/or in writing. Neither party should have the right to refuse to submit to the process, except where the matter is considered by either party to be strategic and where OFCOM has decided to resolve the dispute. This is an important safeguard to stop this process being used as a means of delaying a reference to OFCOM on a strategic issue. Royal Mail representatives accepted this possible additional process, in principle, at an OFCOM workshop on 5 December and the CEDR Group has since expressed its potential interest in providing dispute resolution services for access disputes. We believe that this would have a number of benefits:

- It would be consistent with OFCOM's duty to promote self-regulation;
- It would be a lighter form of dispute resolution and one to which access customers (particularly smaller access customers) would have more ready access;
- It should be relatively cheap, simple and speedy, especially compared with arbitration which will necessarily involve the expense of engaging specialist advisers;
- It does not deny either party's ability to seek resolution by OFCOM;
- It helps to keep OFCOM's resources available for more strategic disputes and thereby keeps down the overall cost of regulation;
- It is a guaranteed means of dispute resolution, rather than mediation which currently requires consent of both parties;
- A system of this type has previously been developed for the telecoms sector;
- It would remove the control of dispute resolution from Royal Mail who has the deepest pockets.

(7.4.1.5) Differential access pricing

We are strongly opposed to the suggestion that Royal Mail should be free to agree bespoke terms for the provision of its downstream services and that the bespoke terms should not be published. We will return to this in more detail in our response to the 13 December consultation on the Review of Regulatory Conditions but summarise our reasoning here. Royal Mail retains a monopoly on letter mail and packets and large letters under 500g and continues to have market power in the under 2kg packets segment. If Royal Mail were to be free to set and keep confidential individual access terms we fear this would lead to:

- Inclusion of terms designed to prevent downstream delivery competition: thereby preventing the external pressure which is needed to drive modernisation and greater efficiency
- Incentives / deterrents for access customers not to use third party delivery operators
- Undue discrimination / preference which may not be detected for a long time, if ever
- Profile pricing creating bespoke and opaque pricing – a tactic previously used in the publications sector which had the effect of driving other companies who delivered publications out of the market
- The ability for the largest access competitors to secure volume discounts and put smaller operators out of business

Zonal pricing

7.4.2. Zonal pricing is more significant than ever before. As mentioned above, more than half of access volumes are now effectively posted under zonal terms (using the national access agreement with a surcharge mechanism based on the proportion of mail falling into the four zones). Zonal pricing is now, therefore, the predominant form of access pricing. The way in which zones and zonal prices/surcharges are calculated will have a multi-million pound impact on the amounts paid by access customers. The degree of regulatory attention paid to zonal pricing must reflect this fundamental change in the basis of pricing.

7.4.3. We agree with the range of risks identified in paragraph 8.8 of Annex 7. The potential impact of zonal pricing on access and end-to-end competition is enormous and the need for effective regulation is, therefore, crucial. Ex post regulation would not provide adequate safeguards for competition. It is also important for market stability that OFCOM ensures that clear messages are sent to would-be investors in end-to-end competition that only efficient entry is to be encouraged because zonal prices are to be set in a manner which is cost-oriented.

7.4.4. Regulatory certainty will be crucial to avoid market instability while sending clear messages to potential competitors that prices will be cost orientated. We have a concern that guidance will not be sufficient to ensure that zonal structures and pricing are set in an appropriate manner and would recommend prior assessment and approval before any material changes are made to the zonal structure or prices.

7.4.4.1. Guidance and related assessment and approval would need to cover the following areas:

- the frequency with which postcode sectors can be reclassified – we would propose no more than once per year and at the time of the annual price review so that customer databases will be relatively stable; national and zonal pricing will be consistent and so zonal based surcharges can be calculated as they are measured over a one year period;
- any reclassification must be cost justified with robust cost data;
- a restriction on the total number of zones – we would advocate a maximum of four, to prevent undue complication for competitors and uncertainty for potential competitors;
- restructuring zones on a basis other than delivery point and business density must be fully justified and subject to a significant period of advance notice in order to send sufficient notice to would be investors in end-to-end networks;
- zones should continue to be based on postcode sectors and not based on postcodes;
- zonal prices must be equivalent to national prices – with equivalent transfer charges (or zonal surcharges) applying to other access customers and to Royal Mail's retail business;
- surcharges for not applying a zonal indicator should reflect the additional costs (if any) of revenue protecting such items;

7.4.4.2. We have mentioned our profound concern about allowing Royal Mail to agree differential terms for downstream access services. In order to ensure that efficient competition has the prospect of developing, there are specific concerns in relation to zonal pricing and we suggest some regulatory measures to address these:

- the prices in a zone (and for every customer) should never be set below FAC for that zone since an entrant does not have the capacity to price below FAC and a strategy by Royal Mail of pricing below FAC is likely to have the effect of foreclosing competition;
- customers should be treated equally and pay the same price with no bespoke "zonal profile pricing" allowed;
- when setting a minimum FAC level, OFCOM needs to decide how it should take account of the non-equivalence created by the VAT distortion and the effect this has on competitors' ability to deliver mail from VAT exempt customers (who are responsible for sending half of all business mail);
- rather than treat the UK as on geographic market, OFCOM needs to consider if each zone should effectively constitute a separate market based on the geographical area covered by a zone – in order to ensure that any test based on covering costs refers to the relevant zone. Put another way, it should not be possible for Royal Mail to cross-subsidize "non-captive" zones (in which competition develops or is more likely to develop) by price increases in "captive" zones (where competition or the threat thereof is weak);

Guidance

7.4.5. Guidance on (un)acceptable levels of retail pricing will be appropriate, given the limited detail which is proposed to be included in the USP Access Condition. Publishing this guidance only in March next year will give precious little time in which to assess the potential impact on our business.

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.

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.

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?

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?

8.1.1. We have had the benefit of reading the Mail Competition Forum response and the annex from SLG Economics appended thereto. We agree with the views expressed in that annex. We would make the following additional points:

8.1.2. As mentioned above, the need for a form of access which would be equivalent to first class bulk mail, with access to the Outward Mail Centres, would be a very important safeguard for customers. For that to work, the relevant transfer price would need to reflect the first class access price rather than the standard access price.

8.1.3. We have also mentioned the concern about there not being a separate set of figures to show the FAC for high volume unsorted mail. This will be important to be able to monitor and prevent margin squeeze in this important and, at the moment, competitive retail market.

TNT Post UK Limited
4th January 2012

EXHIBIT 1

WIK CONSULT GMBH REPORT – 23 September 2011