Consumer Focus
Campaigning for a fair deal

Response to Ofcom consultation in relation to *Securing the Universal Postal Service: Proposals for the future framework of economic regulation*

December 2011

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

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Executive summary

This document is the response by Consumer Focus to the consultation by Ofcom on its proposals as set out in *Securing the Universal Postal Service: Proposals for the future framework of economic regulation* of 20 October 2011.

In its document, Ofcom outlines a series of measures to deregulate the UK postal market, including measures to relax price controls for first class or heavier postal items and to set a cap on standard second class letters of between 45p and 55p. In addition, it proposes introducing regulatory safeguards in relation to the monitoring of Royal Mail's performance and through moves towards incremental costing, with a threat to re impose ex ante regulatory techniques if Royal Mail does not undertake necessary cost controls and efficiencies. Otherwise Ofcom proposes to remove ex ante controls entirely.

In relation to the development of competition, Ofcom proposes setting a mandatory access condition on Royal Mail, to move to contract headroom pricing and to assess impacts of potential end to end entrants before considering whether to impose conditions upon them. Ofcom has proposed that these arrangements should last for a seven year period.

Consumer Focus is the body which represents postal consumers. We consider that securing the universal postal service for all consumers is the most important priority of regulatory policy for this sector. We assess Ofcom's proposals in relation to this objective as it affects postal consumers in general and disadvantaged consumers in particular.

We recognise that Ofcom is facing difficult and complex judgements with risks associated with uncertain economic conditions combined with financial problems at Royal Mail and moves to sell the business.

However, we have concerns that Ofcom has not found an appropriate policy balance in its proposals. In particular we consider that a relaxation of ex ante price controls on Royal Mail at this stage of postal market development, and before a sale of Royal Mail is achieved, is a very high risk approach that could damage the UK postal services market and act against Ofcom's primary duty to safeguard the universal postal service.

There is a risk of unintended consequences arising from the proposed weakening of incentives on Royal Mail towards greater cost efficiency and cost discipline. These incentives are already quite weak and are in danger of being weakened further. There are risks that, faced with a choice between taking difficult internal decisions to constrain wages and implement efficiency measures and raising prices, Royal Mail will find it easier to choose the latter.

This could lead to steep prices rises for customers which, in turn, could persuade bulk mailers to make a permanent switch away from mail, critically reducing the revenues which underpin the universal service.

Such a scenario would present reputational risks for Ofcom as it sought to establish itself as a postal regulator. In the worst case it could result in a financially troubled Royal Mail, which remained in public hands, imposing higher and higher prices on its dwindling customer base and with its modernisation programme mired in industrial relations problems.

We consider that the best method for avoiding such an outcome lies in the approaches promoted by Ofcom in its regulation of the electronic communications and broadcasting sectors. Where it has sought to ensure that decisions are clearly evidence based using systematic impact assessment techniques. The result in these sectors has been the development of complex ex ante price controls that promote competition while maximising short term consumer welfare.

To underpin Consumer Focus's view of the possible impact of Ofcom's proposals we have commissioned ESL UK to undertake modelling of Royal Mail's future financial performance under scenarios of a public and a private Royal Mail.

This financial modelling indicates that Royal Mail could achieve reasonable returns under current arrangements or following a sale of Royal Mail without price rises. However, such an outcome would be dependent upon achieving significant progress in implementing operating efficiency and cost discipline strategies in what are likely to be tough market conditions. Internal incentives for such progress are therefore critically important. In an environment where Royal Mail retains significant market power it is not clear how a regulator could provide such incentives without using ex ante price controls.

Ofcom's own analysis suggests that Royal Mail has found it difficult to manage down its costs even with the current ex ante price controls. But this is not an argument for removing price controls. The message should be that the current balance of regulation has set insufficient incentives for the company to be cost efficient. A major factor here has been the political intervention in the sector which was a consistent theme identified in the Hooper Reports. In such a context, we consider that, by itself, further weakening of positive incentives by removing existing controls appears counter-intuitive.

We are also concerned about the proposed duration of the proposed package of measures which raises the possibility of higher prices exacerbating mail volume declines over a seven year period without the prospect of any remedial measures. If Ofcom decides to proceed with its proposals we would strongly urge that it conducts a formal review to assess their market outcomes after a two to three year period.

We have not tried here to anticipate the likely scale of the price rises which may result from these proposals. We suggest that Ofcom should monitor carefully their potential impact not only on poorer consumers in respect of second class letter products but also on rural consumers and on SMEs in relation to packet and parcels services where competition may be limited or absent.

In its consultation document, Ofcom asks for suggestions for different approaches and we propose the following, which we consider would provide a safer and more balanced approach, providing regulatory certainty while – on the one hand – allowing Royal Mail to consolidate its finances and complete its modernisation programme and – on the other – protecting consumers and customers from excessive price rises.

This approach would involve the retention of the full suite of ex ante controls as now, but would also allow Royal Mail sufficient rises in the prices subject to such controls (maybe set at RPI) to put its finances in order without threatening market stability. To ensure regulatory certainty these controls could be set for a five year period, with a review after two or three years. Such an approach would also avoid the potentially severe impacts on customers, SMEs and poorer consumers of unchecked price rises and consequent risks of market decline.

Our proposed package would include these elements:

1. Retention of ex ante price controls in relation to current specifications for a further five year period, allowing Royal Mail to increase its prices in line with RPI to offset its current financial problems while allowing sufficient regulatory certainty for a sale of the company to go ahead
2. During this period, Ofcom would continue to review the scope of the control in light of the development of competition in the market with a view to reassuring market players that price control regulation will remain proportionate as the market develops
3. Ofcom should continue to monitor Royal Mail's performance and that of the postal market as a whole in the UK, the EU and internationally to provide it with sufficient benchmarks to assess the company's performance in order to ensure that its efficiency is in line with its peers
4. Ofcom should continue to require Royal Mail to provide separated accounts for services where it has significant market power and for those where it does not

Introduction and background

This document provides the response from Consumer Focus to the consultation about Ofcom's proposals as set out, Securing the Universal Postal Service: Proposals for the future framework of economic regulation of 20 October 2011.

About Consumer Focus

Consumer Focus is the statutory postal consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland. Consumer Focus recognises the importance to consumers of the universal postal service.

The purposes of this document

This document considers the likely impact of Ofcom's proposals on consumers in general and on vulnerable consumers in particular.

The structure of this document

For ease of handling, following this section, this document is structured as follows:

- Section 2: Postal market development and Ofcom's analysis
- Section 3: Ofcom's consultation questions
- Section 4: Conclusions and Recommendations
- Annex 1: Modelling Royal Mail's performance

The background to Ofcom's proposals

Ofcom's proposals have been made at a time of change in the UK postal market. Key drivers for the proposal include:

- Ongoing financial difficulties at Royal Mail
- The recent move of postal regulation to Ofcom
- Declining mail volumes
- Wider proposals to sell Royal Mail and for the Government to take over its pension funds liabilities

The impact of these drivers is considered further later in this document.

The current price control will not be effective beyond 31 March 2012 and proposed measures should come into force from 1 April 2012. Ofcom has issued two further consultations in relation to the postal services pertinent to this one, namely:

- Review of regulatory conditions
- Statement of charging principles

At the time of writing, it is our understanding that Ofcom further intends to garner stakeholder views on users' needs of the universal service.

Ofcom’s proposals and their rationale

In its consultation document Ofcom argues that:

- Royal Mail has financial difficulties in maintaining its universal service provision
- Price controls of Royal Mail in recent years have failed due in part to these difficulties which reduce the credibility of RPI-x regulatory tools used in comparable utility sectors and also due to insufficient pricing flexibility
- Unanticipated mail volume declines
- Current price controls do not in any case set strong efficiency incentives given that Royal Mail can use its requirements to finance the universal services as a rationale to ask for further price increases if it runs into financial problems

In light of this, Ofcom proposes that:

- In order to ensure market stability Royal Mail should be granted commercial freedom in its price setting for a period of seven years subject to safeguards in the following areas
    - Effective monitoring of performance with the threat of re-regulation if efficiency incentives are failing
    - Ensuring that a basic universal service is available and affordable for all
    - The discipline of competition and innovation
- To ensure affordability Ofcom proposes to set a safeguard cap for Second Class stamps in the range of from 45p to 55p for a standard letter
- In relation to access competition Ofcom proposes setting an access condition on Royal Mail and using a margin squeeze test to ensure that efficient access competitors can compete effectively

In relation to end-to-end competition (which Ofcom considers represents theoretically a greater threat to Royal Mail’s ability to finance universal service provision) Ofcom will assess any actual or planned competition in light of its potential impact on universal service provision and consider whether it would be appropriate to set conditions on such competitors.

Postal market development and Ofcom's analysis

Introduction

In this section we consider Ofcom's view of postal market development and the conclusions which it draws as to appropriate regulatory treatment going forward.

Ofcom's analysis reviewed

Ofcom's analysis includes an assessment that:

a. Royal Mail's financial position is difficult and there is a downside risk that it will not be able to provide the universal service
b. Market conditions, in particular the decline in mail volumes have made it hard to set price control targets accurately
c. Access headroom had encouraged access competition
d. Recurrent applications by Royal Mail for additional price rises had undermined regulatory certainty and eroded incentives for efficiency

We consider each strand of this analysis below.

a) Royal Mail's financial position

A key element of Ofcom's analysis is that Royal Mail's financial position is difficult and will remain so over the next few years due to falling mail volumes.

We accept that Royal Mail has faced financial difficulties over the last few years, as have many companies faced by the current economic crisis. Further, we understand that Royal Mail's ability to finance the universal postal service is a key issue for postal consumers.

However, we would take a slightly different view about the causes of Royal Mail's financial difficulties and how to resolve them.

In this respect we point to the performance of comparable post services which have achieved higher margins under current conditions, the possible impacts of privatisation on Royal Mail and the relative importance of decisions in relation to wage restraint and cost efficiency on Royal Mail's financial performance.

Looking more deeply at these issues we find the following:

- Other EU national posts with private involvement are profitable
- Royal Mail's letter business can be profitable under current conditions and prices if it decides to control the wages of its staff and implement efficiency improvements
- Under a privatised scenario it is possible that Royal Mail can achieve higher returns

Other EU national posts with private involvement are profitable

Other EU national postal companies where there has been private investment have been able to achieve reasonable margins during this time of economic crisis which has stifled growth and exacerbated volumes declines. This is shown by Table 2.1 below:

Table 2-1: Comparable postal operators with private investors

Country	National Postal operator	Legal status	Government share	Main investors	Mail Volume Trend 2010/11 (%)	EBITDA[1] Margin 2010/11 (%)
Austria	Austria Post	Incorporated (with private capital)	51%	Private parties	-2.5	11.1
Belgium	Belgian La Poste	Incorporated (with private capital)	50% plus one share	CVC 50% minus one share	-1.1	21
Germany	DHL	Privatised	0%	KfW 31%	0.1	12.7
Italy	Italian Post	Incorporated	65%	35% Cassa Depositi e Prestiti (a public savings bank)	-4.7	9.5
Malta	Malta Post	Privatised	0%	Redbox Ltd owns majority of shares it is a subsidiary of Lombard bank	Not available	15.6
Netherlands	TNT[2]	Privatised	0%	Private investors	-6	9

Source ESL UK (from operator annual returns)

Despite the effects of the global economic downturn, a number of European posts have generally been able to maintain margins. This has been mainly through a determined strategy to reduce costs via increased cost efficiency, moves towards part time and self employed working patterns, and firm wage control. This compares to Royal Mail's position where volumes have declined by around 4 per cent and the business has made a tiny margin of around 0.4 per cent.[3]

[1] Earnings Before Interest, Taxes, Depreciation and Amortization.
[2] EBIT (Earnings Before Interest and Tax) for EMEA (Europe, Middle East and Africa) area.
[3] Margin calculated on EDITDA basis – Royal Mail Annual Report 2011.

Royal Mail can be profitable under current conditions

To assess potential financial futures for Royal Mail we have undertaken financial modelling of the business's performance under reasonable market assumptions. Our analysis of Royal Mail's finances suggests that it is possible for Royal Mail to achieve reasonable margins under current conditions if it takes necessary business decisions in relation to cost control and cost efficiency.

We can see from Figure 2.1 below that, under current conditions (ie without privatisation and with continued mail volume declines) then it is possible that Royal Mail Letters (as was) would continue to make low or negative financial returns.

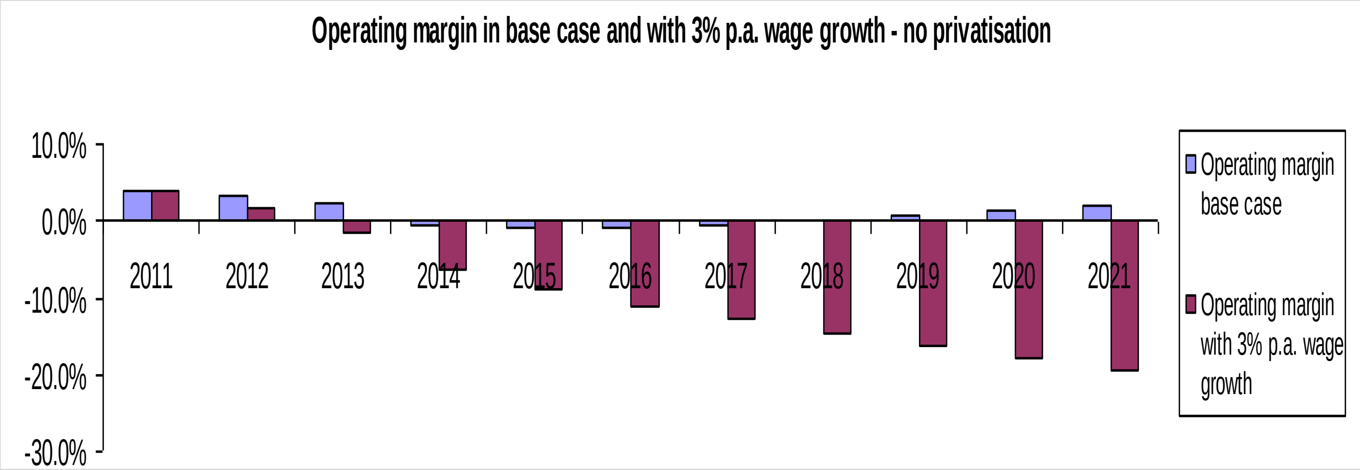
Figure 2.1: Royal Mail's Letters business financial returns under current conditions (£m)

Source ESL UK

The impact of wage rises on Royal Mail's financial performance

However, decisions in relation to cost control play a large part in Royal Mail's financial performance. Figure 2.2 overleaf shows the effects on the margins of Royal Mail's letters business of a 3 per cent annual pay rise under current conditions:

Figure 2-2: The effects of wage growth on margins under current conditions



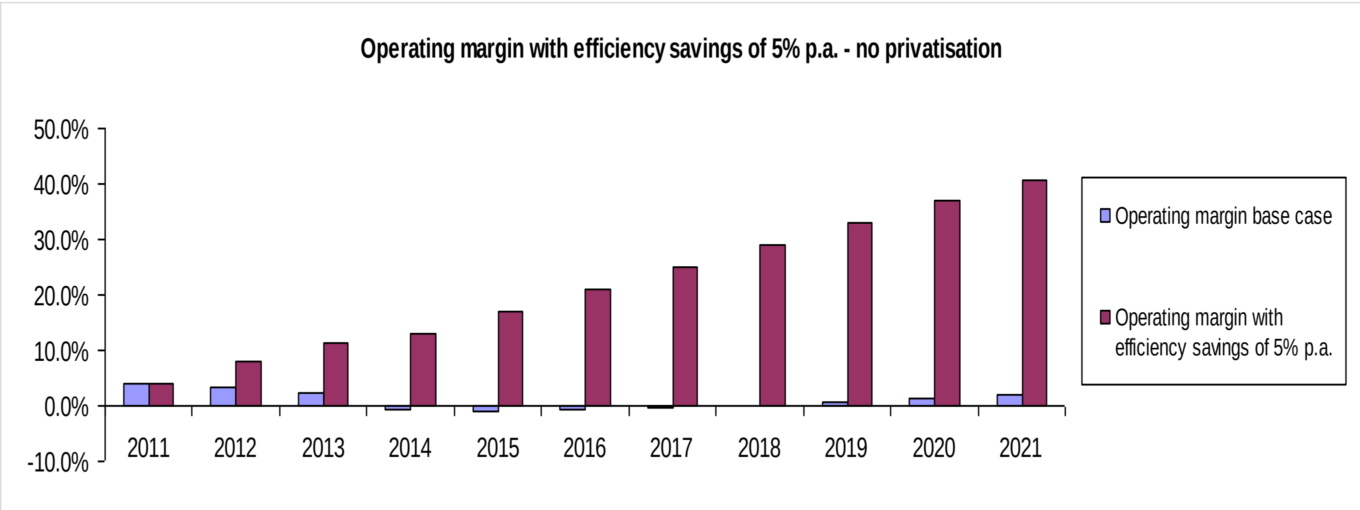
Source ESL UK

The impact of cost efficiency improvements on Royal Mail's financial performance

This broad picture (that Royal Mail largely determines key drivers of its financial performance) is supported by analysis of the potential financial impact of efficiency improvements.

Figure 2.3 below shows the potential impact of additional efficiency improvements on margins under current conditions.

Figure 2-3: The impact of cost efficiency on margins under current conditions



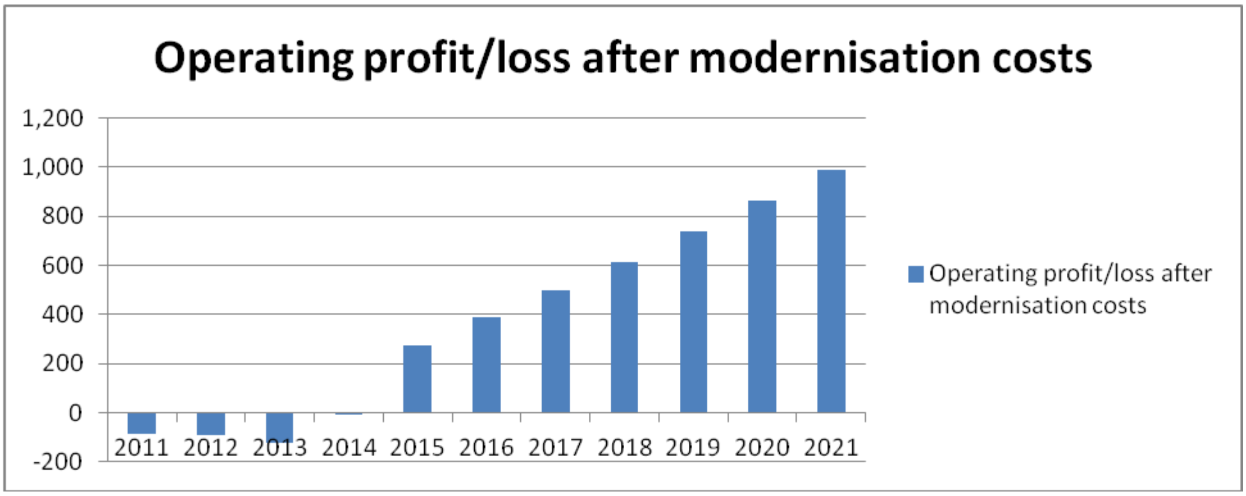
Source ESL UK

This suggests that even more modest efficiency gains would transform Royal Mail's financial performance.

Under a scenario of privatisation of Royal Mail it could earn higher margins

However, it is also possible that a sale of Royal Mail could impact positively on the future performance of the business by increasing incentives for greater cost control and efficiency at the business. Under reasonable market assumptions and assuming Government takeover of the pension funds deficit, this could result in the achievement of reasonable returns at the company without price rises. This is shown in Figure 2.4 below.

Figure 2-4: Financial performance of Royal Mail (Letters business) following a sale (£m):

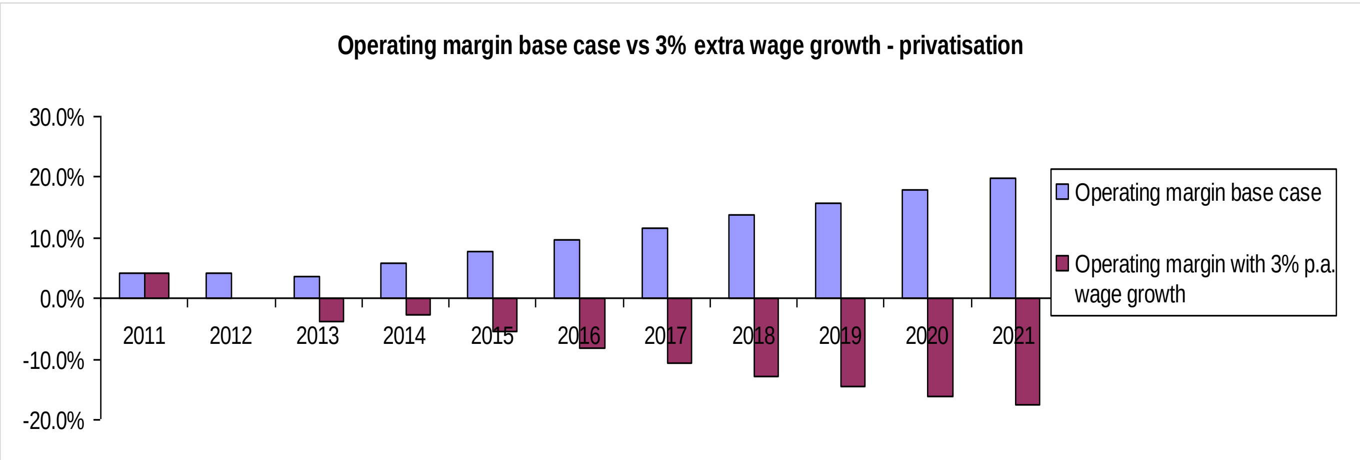


Source ESL UK

The impact of wage growth on margins following a sale of Royal Mail

Wage levels continue to have a significant impact on financial performance. Figure 2.5 below shows the effects of wage growth in a privatised scenario.

Figure 2-5: The effects of wage growth following a sale of Royal Mail



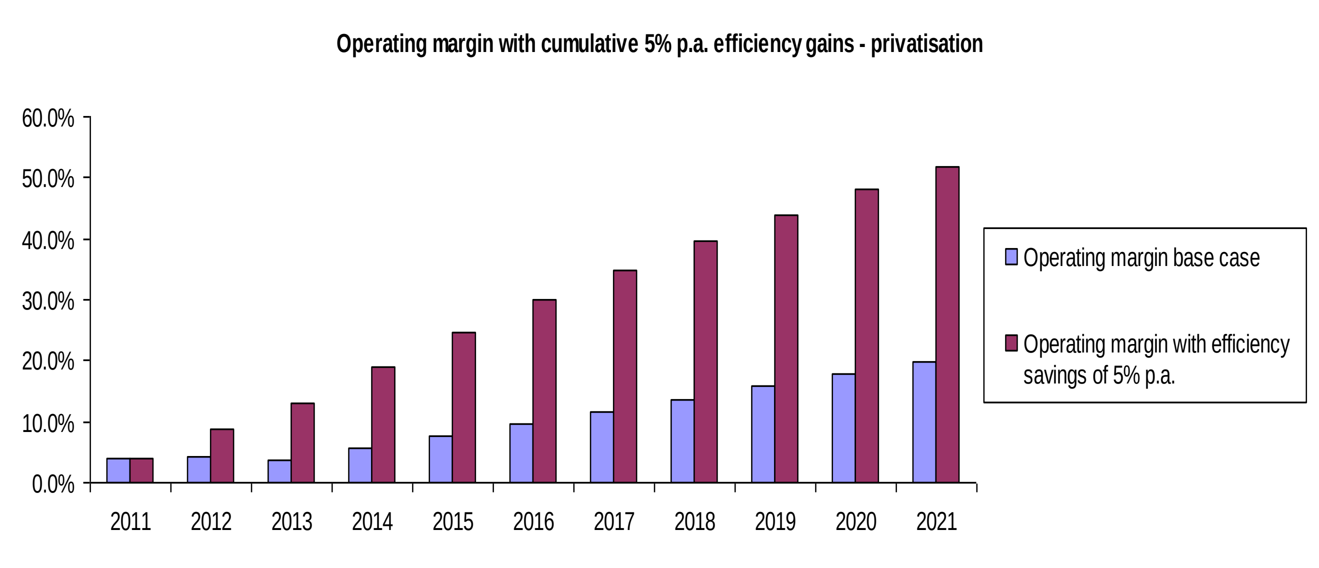
Source ESL UK

The impact of greater efficiency

Put in the context of other changes resulting from the sale of Royal Mail[4] then we can see that additional efficiency savings could also foster high margins as shown in Figure 2.6.

[4] The effect is not as marked under this scenario as a higher rate of efficiency gain is already assumed under a privatised scenario.

Figure 2-6: The impact of higher efficiency on margins following a sale of Royal Mail



Source ESL UK

Summary of our view in relation to the downside risk facing Royal Mail

In summary, our view of market development suggests that other national posts are profitable despite facing adverse market conditions; that Royal Mail's decisions in relation to cost control and efficiency can have significant impact on its financial performance; and that privatisation may also significantly improve margins at the company.

In light of this we consider that while there are downside risks from Royal Mail's financial performance, these are strongly related to decisions which the company may take in relation to cost control and efficiency and also to the timetable of the sale of the company.

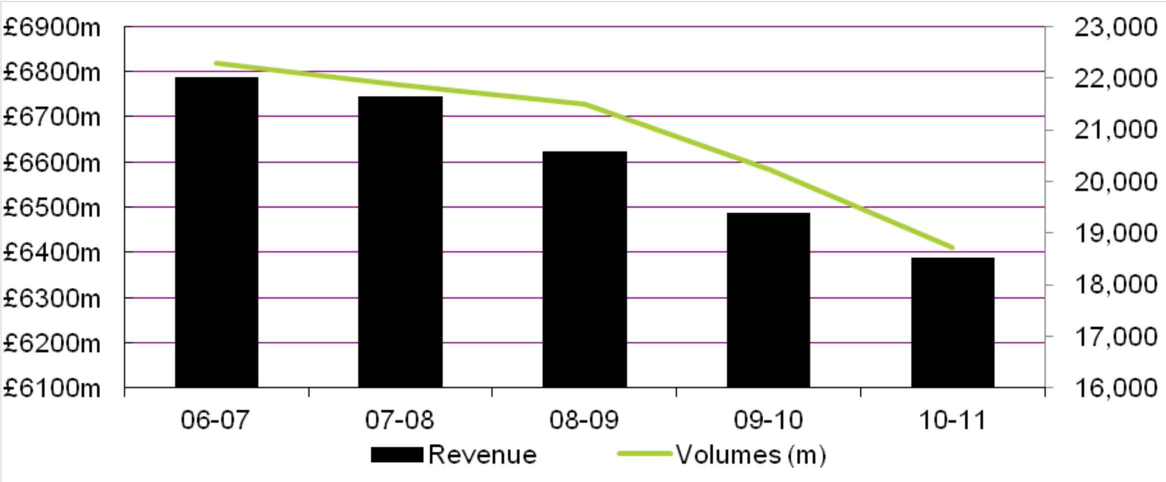
b) Market conditions are unpredictable rendering ex ante controls impracticable

Ofcom argues that the unpredictable nature of mail volumes declines renders it impossible to accurately undertake ex ante controls.

While we understand the difficulties of forecasting mail volumes, we consider that, in practice, disputes about the likely projected turnover of regulated utilities are common features of preparations for ex ante price controls across economic sectors.

Royal Mail has profound regulatory incentives to argue that volumes are declining at a fast pace and to seek additional prices rises. However Figure 2.7 suggests a fairly gradual and predictable decline over recent years, with a slower underlying decline accelerated by difficult economic conditions from 2008 onwards. This picture is broadly consistent with that suggested by Table 2.1 after the volumes figures have been adjusted by the effect of Royal Mail's price increases and also for losses experienced by national incumbents due to end-to-end competition.

Figure 2-7 Royal Mail's recent financial performance



Source: Ofcom

At first glance, a regulator undertaking an ex ante control and taking a very conservative approach could cautiously forecast a volume fall of around 5 per cent annually perhaps with a mechanism for a claw back or additional price rise if volumes decline at a slower or faster level and then (when the economic cycle improves) move to a smaller forecast decline.

Summary of our view in relation to market conditions

The recent history of market evolution in the UK shows a fairly consistent picture of mail volumes decline. It does not suggest that regulators face insuperable difficulties in setting ex ante controls provided they include some flexibility for unforeseen events or economic cycle effects in their controls.

c) The impact of headroom on access

Ofcom argues that 'headroom' in relation to access prices has encouraged third party access competition.

Consumer Focus considers that competition in the postal market is in the interests of consumers in that it can promote efficiency and cost restraint at Royal Mail, allow greater choice for postal customers and lead to greater innovation in the sector.

We note that Royal Mail agreed the access prices, which were set on a 'revenue minus' basis and that third party access competitors have been able to capture significant market share of upstream activities due to their lower costs and their responsiveness.

Further, we consider that it is most important (if the universal service is to be provided in the short term) that Royal Mail is set positive incentives in relation to cost control and cost efficiency. Upstream competition is important to these incentives. We consider that it would send incorrect signals to the market if successful competitors were punished as a result of their success through any regulatory mechanism through which Royal Mail was able to unfairly claw back market share.

In light of this, we would urge Ofcom to ensure that it continues to maintain sufficient headroom to ensure a level playing field for third party access competitors.

In this respect we note the proposal to move to a contract by contract access negotiation with some concern, and alert Ofcom to the possibility that, without detailed regulatory scrutiny and greater cost transparency, Royal Mail could have incentives to unfairly manipulate such individual contract negotiations to its commercial benefit.

Summary of our view in relation to headroom

We would expect headroom arrangements and access prices to reflect accurately costs avoided and competition for upstream activities to be safeguarded.

In this respect we note potential dangers that Royal Mail may use contract by contract negotiation of access prices to discriminate between customers and providers and we would expect Ofcom to remain vigilant to this possibility.

d) Recurrent applications for price rises and regulatory certainty

Ofcom argues that recurrent applications for price rises by Royal Mail have eroded regulatory certainty.

However in practice, we note that the first two price controls set by Postcomm did not lead to Royal Mail successfully requesting price rises and that only since 2008 have such requests been entertained by the regulator.

We consider that this is due to the following factors:

- The economic crisis which exacerbated volumes declines
- Industrial relations problems at Royal Mail which lowered volumes and threatened to disrupt the successful implementation of its Modernisation programme
- Royal Mail's failure to become cost efficient and to control its costs
- Political intervention in the sector following the Hooper Review and the recommendation to privatise Royal Mail and to move postal regulation to Ofcom

The combination of these factors allowed Royal Mail significant negotiating power which it was able to use to extract additional price rises from Postcomm rather than addressing cost issues.

As set out earlier in Section 2 of this document, we consider that mail volumes are declining at a gradual and predictable pace of around 5 per cent annually, with an underlying decline of between 2 and 3 per cent exacerbated by the recession, and possibly also recent price rises.

Summary of our view in relation to price rises and regulatory certainty

The evidence shows that additional price rise requests from Royal Mail during recent years have been due to the economic crisis and Royal Mail's failure to control its costs or make foreseen efficiency savings rather than the form of the price control. It is also possible that political intervention in the sector in relation to plans to sell Royal Mail, could also have emboldened its management to make these requests particularly when proposals were being considered in relation to the future of its regulator.

For the purposes of regulatory certainty we consider that Ofcom should set a price control based on a volume decline of around 5 per cent which includes the possibility of some claw back for Royal Mail or its customers if such a prediction proves incorrect.

Ofcom's consultation questions

In this section we consider the questions Ofcom has posed in its consultation document.

Financially sustainable universal service

Question 5.1

Do you agree with the assumptions set out in paragraph 5.86? If not, please set out you reasons.

Paragraph 5.86 reads as follows:

'In conclusion, therefore, having performed further analysis as described above and considered all the responses to consultation, we are considering the following assumptions in coming to our proposals for a regulatory framework:

- The integrated universal service network defines the appropriate boundaries of the business which is central to the provision of the universal service
- Royal Mail's ability to execute and deliver on its business plan is of primary importance to the achievement of a financially sustainable universal service, and there remains a significant downside risk to the delivery of the plan
- A regulatory framework which provides sufficient safeguards against downside risk, coupled with the intrinsic efficiency incentives underpinned in Royal Mail's business plans, is likely to provide the best opportunity to deliver sufficient cost saving pressures
- An indicative EBIT margin range of 5% to 10% is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return commensurate with the level of risk in the business'

Consumer Focus response

We set out below our views in relation to the assumptions contained in Paragraph 5.86.

The integrated universal service

Ofcom argues in its consultation that the integrated universal service network is central to the provision of the universal service.

Consumer Focus agrees that in the immediate short term it appears unlikely that another potential provider of the universal postal service will emerge and that current arrangements are central to universal service provision.

However, we also consider that it is important to recognise that the universal service is an asset for consumers and does not belong in any way to Royal Mail and could be provided eventually by other operators.

The experience of other EU countries such as Germany (where deliveries in rural areas are contracted out by DHL) suggests that there is scope for other companies (than the national post) to provide universal services.

Further, the European Community framework for postal services provides that potentially loss making elements of universal service provision can be the subject of public tender.

It is therefore entirely possible for Ofcom to ask other companies to bid to provide elements of universal service provision particularly if Royal Mail is seeking subsidy to do so and is not regarded as cost efficient.

In this respect we note the entry of new players into the postal market, not only third party access competitors but also logistics providers who are increasingly delivering parcels and packets directly to consumers. As they grow (in line with the market) then new models of universal service provision may emerge.

In light of this, we do not consider that Ofcom should view current arrangements for universal service provision as inevitable over the medium to long term. Instead it should look (in the interests of customers and consumers) to ensure a level playing field for competitors to Royal Mail and move towards the public tendering of elements of universal service provision where this is in the interests of customers and consumers. Such moves could also be combined with a review of the scope and specification of universal services in light of changing consumer needs.

Royal Mail's ability to execute and deliver on its business plan

Ofcom argues that Royal Mail's ability to execute and deliver on its business plan is of primary importance to the achievement of a financially sustainable universal service, and there remains a significant downside risk to the delivery of the plan.

Consumer Focus does not believe that Ofcom should rely solely/mainly on Royal Mail's internal business planning and short term financial performance. To do so presents significant risks of regulatory capture (ie seeing the market through the eyes of the regulated company).

As set out in Section Two of this document we consider that the main risks to Royal Mail's ability to finance universal service provision are a lack of efficiency and cost control at the company which could foster price increases which over time may create significant volumes declines.

Therefore, we consider that Ofcom's primary duty (to safeguard universal service provision) is best met through a promotion of greater efficiency and stricter cost control at Royal Mail.

Our analysis of Royal Mail's financial performance does not suggest that its universal postal service provision is necessarily loss-making, or that the net impact of technology (including electronic substitution of traditional letters volumes, the growth in internet retail traffic and the potential for more effective automation) on the business is necessarily negative.

Further we consider that any modelling of Royal Mail's financial performance should consider the scenario of a private Royal Mail and that Ofcom should be transparent about its thinking in relation to the possible effects of a sale of the business. Stakeholders can then take a view about the efficacy of current proposals under scenarios where the business is sold and where it is not.

Regulatory framework

Ofcom argues that a regulatory framework that provides sufficient safeguards against downside risk, combined with the inherent efficiency incentives underpinned in Royal Mail's business planning, is likely to provide the best opportunity to delivery cost savings.

As stated earlier our financial modelling suggests that a lack of efficiency and cost control at Royal Mail is a major threat to securing the universal postal service.

Further if Ofcom was to rely on Royal Mail's internal planning then this could constitute regulatory capture.

We accept that Royal Mail has struggled over recent years both to meet its own internal targets for efficiency or those set by its regulator.

However, recent requests for price rises have been due to special factors including the economic crisis, industrial relations problems and also regulatory uncertainties increased by proposals for partial and then full sale of the business.

Prior to these special factors ex ante price control arrangements were putting some pressure on Royal Mail to make efficiencies. It can be argued that this pressure was weakened in the context of Royal Mail remaining a state owned company, and our modelling suggests that a sale of Royal Mail could have significant effects on its performance and cost control.

However, we have concerns that a sale of Royal Mail may not be quickly achieved. Any decision to relax regulatory price controls may further weaken (already insufficient) incentives for efficiency at the company and may result in unnecessary cost increases and cost indiscipline at Royal Mail which may then be passed on as price rises.

Further, if a sale goes ahead, then a private Royal Mail, which would still enjoy significant market power in mail delivery, could enjoy excess returns due to the removal of customer protections.

An appropriate margin for Royal Mail

In the consultation document Ofcom argues that the margin for Royal Mail should be between 5 and 10 per cent.

Our analysis of margins for privatised (or partly privatised) posts as set out in Table 2.1 suggests that some national posts achieve greater margins. Analysis undertaken for Postcomm (based on typical returns at other network industries) also suggested a cost of capital of around this range.

We would therefore accept that the margin for Royal Mail should be in this range.

Securing the provision of the Universal Postal Service

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?

Consumer Focus response

Consumer Focus agrees with Ofcom's proposal to impose a regulatory condition on Royal Mail to provide the universal service.

We share Ofcom's view that Royal Mail is currently the only likely provider of the universal service in the short run and that it is therefore appropriate to impose such a condition in order to ensure the securing 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.

Consumer Focus response

We have set out our view in previous sections of this document that we would expect ex ante price controls to represent the best approach towards securing the universal postal service (by promoting positive incentives towards efficiency and cost restraint) at Royal Mail and protecting customers and consumers.

As described earlier we do not consider that uncertainties around mail volumes growth or decline present insuperable obstacles to undertaking ex ante controls. We would, therefore, expect Ofcom to apply the same principles and detailed regulation in the postal market as it does in those for electronic communications where a company has significant market power.

In this respect we would note the relative complexity of the arrangements that Ofcom is proposing for Openreach.[5]

Ofcom is currently consulting on the charge control review for Local Loop Unbundling (LLU) and Wholesale Line Rental (WLR) services. In both relevant markets (Wholesale Local Access and Wholesale Fixed Analogue Exchange Line), Ofcom has previously identified that BT (Openreach) has Significant Market Power (SMP) and that charge controls are necessary as a remedy to Openreach's ability to set excessive levels of charge for LLU and WLR services in the respective markets.

In case of the LLU charges, Ofcom proposed to set individual charge controls for Metallic Path Facility (MPF) rental and Shared MPF (SMPF) rental, and separate baskets for MPF and SMPF ancillary services and controls outside of the main basket for certain key migration services. The separation is based on Ofcom`s modelling that was, according to their view, necessary to establish the right glide paths to align charges and costs. The changes will ensure that the charges for these migration services do not become misaligned with their underlying costs as a result of being included in a broader basket.

Our financial modelling suggests that Royal Mail can be profitable under current conditions if it controls its costs and achieves reasonable efficiency gains.

However, we would recognise that Royal Mail is facing increasing costs due to the level of inflation and that Royal Mail should have an appropriate pricing flexibility in order to tailor its offer to best safeguard postal volumes and the revenues necessary for universal service provision.

Further, we accept that it is important that Ofcom provides appropriate signals (including regulatory certainty) to the market if a sale of Royal Mail is to be achieved.

However, as stated earlier we consider that proposals to substantially deregulate prices and allow for a significant increase in second class letters price involve unnecessary risks of market decline and disproportionate adverse impacts for customers.

In light of this, and aiming to strike an appropriate balance between competing regulatory objectives, we would propose that prices are held at RPI-0 for a five year period while Royal Mail completes it modernisation process and also (possibly) to allow for a sale of the business. This period could then allow Ofcom to consider further where it could deregulate prices where there is sufficient competition in the market and to analyse market trends.

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[5] OFCOM – Charge Control Review for LLU and WLR services, http://bit.ly/rwTirq

Over the medium term, and as a sale of Royal Mail is allowed to proceed, this should allow the company to make attractive returns over a two to three year period during which the scale of available efficiency gains (under a private sector environment) should become clear.

Ofcom could then conduct a more detailed review of market trends and the efficiency of Royal Mail and introduce new proposals, which we would expect to include new ex ante controls.

Question 6.3

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

The regulatory safeguards proposed by Ofcom include the following:

- Monitoring and potential for re-regulation
- Ensuring that a universal service is available for all
- Competition and innovation

Consumer Focus response

In general, Consumer Focus does not regard ex post regulatory safeguards as sufficient to protect Royal Mail's customers and consumers in areas where it has significant market power.

As shown by our financial modelling in Section Two a lack of cost control and efficiency at Royal Mail are key short term threats to the financing of the universal service.

We would therefore argue that there are inconsistencies between Ofcom's proposals (to weaken regulatory oversight over efficiency and cost control at Royal Mail) and its primary statutory duty to ensure the universal postal service.

We note that reliance on such ex post safeguards does not appear to be consistent with Ofcom's regulation in electronic communications markets where an operator has significant market power.

Our discussions towards a Strategy for Postal Consumers in 2010, consisting of a series of eight high level meetings of stakeholders, identified the importance of affordable parcels services for rural communities and in general for small businesses and vulnerable consumers. We are also particularly concerned that these groups would be most affected by any move towards an ex post approach.

A further report commissioned by Citizens Advice Scotland (CAS) and published in December 2011 also identified the importance of affordable parcel services for those in rural communities. Consumers in remote and rural areas in Scotland rely heavily on online shopping.[6] The CAS report found that rural consumers were particularly vulnerable as end receivers as some alternative operators charged excessive prices to deliver packets and parcels to certain locations or sometimes refused to deliver them altogether – '84 per cent of consumers said that they had been refused delivery because of their "remote" location'.[7]

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[6] 'Over 86% of respondents said they ordered products or services online more than 10 times a year' – *Free Delivery* – Problems with the delivery of online purchases to consumers in remote and rural Scotland*, Page 4. http://bit.ly/rDUROA

[7] Ibid, Pages 5-6. http://bit.ly/rDUROA

CAS has advised consumers to use Royal Mail because of their universal service obligation to offer uniform and affordable prices, but it should be noted that with 97 per cent of consumers in rural areas stating that the cost of delivery affects their purchasing decisions,[8] there could be significant issues for rural consumers if Royal Mail did not keep its Second Class packets and parcels services affordable.

For these reasons, we believe that it is vital that Ofcom maintains a cap on all Second Class packets and parcels for rural consumers, as they provide a vital 'backstop' service in an environment which is seeing increasing volumes of e-fulfilment deliveries.

Consumer Focus is also conducting its own research which will be published as an additional document as part of our Price Control consultation response, focusing upon potential changes in consumer and vulnerable consumer behaviour to a range of mail price increases.

Question 6.4

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

Consumer Focus response

As stated earlier in Section Three we do not consider that ex post approaches are sufficient to foster the efficiency and cost control at Royal Mail which is essential to safeguard the universal service in the future.

In this respect we consider a reliance on these ex post safeguards to be inconsistent with Ofcom's primary statutory duty to safeguard the universal postal service.

Monitoring and potential for reregulation

Towards assessing Royal Mail's efficiency Ofcom proposes monitoring of Royal Mail's financial performance and operational performance, Royal Mail's profitability and the implementation of Royal Mail's modernisation plan.

Consumer Focus general response on monitoring and potential for re-regulation

We do not consider that such monitoring is sufficient ex post. It can be argued that if Ofcom considers the postal market only through the eyes of Royal Mail then it would be liable to extreme regulatory capture.

To provide a broader view it should undertake comparative studies to benchmark Royal Mail against other national postal operators and also against competitive operators. Further it should undertake benchmarking against other network industries to ensure that general sector inefficiencies do not go unchallenged.

Ideally, we would expect Ofcom to move towards a 'Greenfield assessment'[9] of the postal infrastructure to ensure that Royal Mail's legacy inefficiencies are challenged.

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[8] *Problems with the delivery of online purchases to consumers in remote and rural Scotland*, Page 5. http://bit.ly/rDUROA

[9] A theoretical exercise where the 'ideal' structure of a network is assessed through the process of starting with a blank slate and then building the network from there. In the case of assessing Royal Mail, this would be used to work out what elements (and therefore costs) of the network are truly required to provide the current Universal Service offered by Royal Mail.

Ensuring universal service available for all

Ofcom proposes monitoring the affordability of universal service prices, the quality of service performance and consumer harm.

Consumer Focus response

As noted in Section Two of this document our financial modelling suggests that the drivers of Royal Mail's ability to finance the universal service provision are its control over its costs and its success in taking benefit from available efficiency gains.

In general we do not consider that these proposals (which could significantly reduce Royal Mail's incentives towards greater efficiency and cost control) are fully consistent with Ofcom's primary statutory duty to safeguard the universal postal service.

However, we recognise the importance of affordability of universal services both to consumers and also to small businesses. We therefore welcome the proposal to monitor the affordability of services to consumers.

We note that our discussions last year towards an appropriate Consumer Strategy for postal services highlighted the importance of affordable parcels services to rural communities and also that small businesses, particularly in the internet retail sector, may be particularly affected by any deregulation of prices. The very recent CAS report further highlights our concerns, as we have identified on page 21.

Competition and innovation

Ofcom proposes to monitor ex post the development of competition and innovation in the market.

Consumer Focus response

In carrying out its functions Ofcom is guided by its general duty under section 3 of the Communications Act 2003 to foster the interests of consumers by promoting competition. This duty also applies to its functions in postal services, to the extent that it does not conflict with its principal duty under section 29 of the Postal Services Act 2011 to carry out its postal services functions in such a way as will secure the provision of a universal postal service. We observe that in its regulation of the electronics communications market Ofcom has aimed to foster competitive markets and we similarly consider the development of competition in the postal services market is beneficial to consumers in that it promotes efficiency at Royal Mail and provides choice for customers and consumers, all of which protects the universal service obligation.

We would therefore welcome monitoring to ensure that competition and innovation are developing in the market.

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.

Consumer Focus response

Our financial modelling in Section Two of this document suggests that Royal Mail could achieve reasonable margins going forward without significant price rises if it addressed its cost inefficiencies and restrained its costs.

This also suggested that over the medium and longer term cost efficiency and cost restraint at Royal Mail are the key drivers of its ability to finance universal service provision.

We are concerned, therefore that allowing Royal Mail to substantially increase its prices could foster financial indiscipline at the company, increase the pace of mail volume decline and impact adversely upon consumers and SMEs at a moment where they are already squeezed elsewhere.

We note that Ofcom has not presented a detailed financial analysis of market trends or Royal Mail's costs and revenues going forward and in the absence of this it is difficult to accept that price rises from 36p to 45p are necessary or that they set positive incentives for Royal Mail.

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.

Consumer Focus response

While Consumer Focus recognises the importance of regulatory certainty, we do not consider that it would be appropriate to set such arrangements over such a long period. It is unusual in economic regulatory precedent, where three or four year controls are more common.

Further as stated earlier in this document, we are concerned that any relaxation of controls over a long period will substantially weaken existing incentives for cost restraint and efficiency at Royal Mail, particularly if a sale of the business is not achieved.

Given this, and considering that significant price rises over a long period could undermine demand for universal services, we would consider that relaxing price controls for such a long term could run counter to Ofcom's primary statutory duty to safeguard universal service provision.

Competition in the postal market

Question 7.1

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

Consumer Focus response

Consumer Focus believes that competition in the postal market provides benefits for consumers and customers, both through promoting efficiency at Royal Mail and in offering greater choice.

The Community Framework for postal services requires that Member States[10] can only impose limited restrictions (general authorisations in relation to issues such as security of mail) on companies providing postal services.

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[10] For the New Member States this requirement begins in 2013.

If there is a need to compensate the Universal Service Provider (USP) for any net costs imposed by universal service provision then the Member State can tender out the 'costly' services, compensate the USP for the net costs of universal service provision through state aids or a compensation fund levied on all operators, or impose licence obligations on entrants.

In light of this we do not consider that Ofcom has the power under EU rules to block end to end operators in the postal market. We note that in seeking to impose any conditions on such operators it must act in accordance with the principle of proportionality, interpreted as meaning adopting the 'least restrictive' means of securing universal service provision.

This could be interpreted as follows. If Ofcom decided to impose licence obligations on entrants, it could only do so where other measures had been considered, such as:

- state aids to Royal Mail for objectively calculated net universal service costs
- a compensation fund arrangement to share costs between entrants or
- tendering out of loss making services

Further, any such licence obligations would not be consistent with EU rules if they were not objectively based and transparent or if they were intended to prevent competition or were discriminatory between market players.

In light of the above we would consider that any attempt by Ofcom to restrict or use authorisations of end-to-end entrants as a form of restrictive licensing would foster significant regulatory uncertainty and would run the risk of being counter to EU rules.

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.

Consumer Focus response

Consumer Focus believes that the development of third party access for upstream services has benefited customers, helped safeguard postal volumes and provided incentives for Royal Mail to become more efficient in providing upstream services.

Therefore, we welcome Ofcom's proposal to impose an obligation on Royal Mail to provide access which we regard as essential for access arrangements to continue.

Question 7.3

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

Ofcom's proposals include:

- Same scope as the access headroom control which currently applies to Royal Mail second class bulk mail (MailSort 2 or equivalent services) for letters and large letters
- Ofcom monitoring Royal Mail's upstream revenues against fully allocated costs (FAC) for all affected services including a reasonable rate of return
- FAC to exclude costs which are clearly not incremental to the affected activities (specifically central overhead allocations which are approx 5-10 per cent of the cost base) and to be adjusted to reflect equivalence differences as discussed above

- Subject to maintaining a minimum FAC headroom across all affected services, on individual contracts, Royal Mail not to charge below a proxy for the incremental costs of those contracts. In the absence of reliable data we propose a relatively conservative estimate of incremental contract costs which we estimate to be 50 per cent of the associated FAC

They are to be reviewed after 18 months with aim of moving then to competition law by 2014/15.

Consumer Focus response

Consumer Focus recognises the importance of effective measures to counteract margin squeeze if upstream competition (third party access) is to be viable.

In this respect, while we welcome the moves towards greater cost transparency and incremental costing we are concerned that a move to assessing headroom on individual contracts could provide Royal Mail with incentives to manipulate information asymmetry and abuse its negotiating power with individual suppliers. Further we would emphasise the importance of Ofcom’s vigilance in respect of the accuracy of incremental cost data.

We would also be concerned about any plans to move to competition law within a short period as we would consider that ex post enforcement may be insufficient to protect competing operators to Royal Mail.

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.

In setting Terms and Conditions for access Ofcom has proposed:

- ensuring equivalence should align to the concept of no undue discrimination
- including a non-discrimination obligation in the USP access condition against which any allegations that differences in operational terms are important can be assessed with reference to impact on competition

Consumer Focus response

Consumer Focus welcomes Ofcom’s emphasis on the importance of non discrimination between providers and insertion of a non discrimination obligation in the USP access condition as both will help to safeguard third party access competition.

Regulatory financial reporting

Ofcom proposes that it should require Royal Mail to:

- report separately on the different parts of its business relevant to our regulatory duties
- further improve the documentation of costing and regulatory accounting more generally
- increase the extent of relevant financial information that is published on a regular basis
- enhance the level of assurance that we can place on the financial information reported for regulatory purposes

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.

Ofcom sets objectives in relation to:

- understanding how costs and revenues are apportioned
- monitoring the relative profitability of different product groups

Consumer Focus response

Consumer Focus supports measures in Ofcom's proposals to increase transparency in relation to Royal Mail's costs.

As stated earlier in this document, however, we do not support the relaxation of ex ante controls which is implicit in these reporting proposals.

We consider that in the absence of ex ante controls it is important that Ofcom ensures that it has detailed product specific information in relation to all market segments where Royal Mail retains significant market power in order to ensure that Royal Mail is not abusing its market power to exploit or exclude captive customers or consumers.

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.

Consumer Focus response

We consider that it is appropriate and proportionate for Ofcom to collect detailed separated accounts in relation to USO products, non-USO products, downstream access services and end to end only products.

As stated earlier we would also wish Ofcom to undertake an ex ante control and this would also imply collection of information in relation to products where Royal Mail has significant market power (which would be price controlled) and those where it does not.

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?

Consumer Focus response

Consumer Focus regards the rules and requirements in the draft Regulatory Accounting Guidelines as representing an appropriate and proportionate level of cost transparency, except insofar as such requirements do not include a breakdown between products where Royal Mail does and does not have significant market power.

Question 8.4

Do you agree with our proposals set out above in relation to accounting separation?

Consumer Focus response

As stated earlier Consumer Focus does not support the withdrawal of ex ante price controls and therefore would also seek for accounting separation for products where Royal Mail has significant market power and for where it does not.

Apart from this point we consider that it is proportionate for Ofcom to collect detailed information from Royal Mail as proposed.

Any other risks or information

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?

Consumer Focus response in relation to risk

As stated in Section Two of this document we consider the main risk to the future financing of the universal service to lie in Royal Mail's inability to take benefit from available efficiency gains and to control its costs. Recognition of the scale of risk imposed by these failures (ascribed to political intervention) lies at the heart of the Hooper Report(s).

In this context, we consider that proposals both to withdraw from ex ante price controls and to allow for significant increases in the price of second class products will weaken present incentives on Royal Mail to become more efficient and to restrain costs. In light of this, we consider that the current proposals may increase the risks that Royal Mail will be unable to finance the universal service in the medium term as price rises may encourage switching away from Royal Mail, exacerbating mail volumes declines.

While it is possible that a sale of Royal Mail may offset the impact of this relaxation of regulatory oversight on efficiency, if a private investor moves more aggressively to take out costs, given current market conditions it is by no means certain that a sale can be achieved or that if it was achieved it would represent a fair value for the company. There are profound risks therefore that the current proposals may foster a longer term decline in the competitive efficiency of a public Royal Mail at the expense of consumers.

Consumer Focus response in relation to information

As stated earlier we do not consider that Ofcom should only monitor Royal Mail's achievement of its own internal business planning. We would also expect Ofcom to monitor developments in the wider postal market in the UK, in the EU and internationally. Further, we would expect that Ofcom should benchmark the performance of Royal Mail regularly against that of comparable postal operators and those in other sectors.

Over time we would consider it useful for Ofcom to undertake Greenfield analysis of Royal Mail's universal service provision.

Conclusions and recommendations

In this document we have considered Ofcom's proposals in relation to their possible impact on securing the universal postal service and on consumers.

Our findings

Our analysis, based on financial modelling of Royal Mail's performance going forward and our understanding of the sector suggests the following:

- Other EU national posts are achieving reasonable margins on mail services despite a gradual contraction in traditional letters volumes
- Our modelling suggests that the main drivers of Royal Mail's financial performance going forward are likely to be its level of efficiency and cost control
- In light of this any moves to weaken incentives for efficiency and cost control at the business, (for example to allow for significant price rises) may damage its ability to the finance of the universal service over the medium to longer terms
- Competition in the mail market has benefited consumers in increasing incentives for Royal Mail to be efficient and in providing choice for upstream customers
- In theory the sale of Royal Mail should increase incentives for the company to become cost efficient and to control its costs
- However, there are significant risks that the sale of the company will not be achieved and (under current proposals) this could leave a public Royal Mail with little incentive to cut or control costs compared to raising its prices

Conclusions

From these findings we would draw the following conclusions:

a) These proposals could undermine Royal Mail's ability to finance the universal postal service by weakening incentives for cost efficiency and cost restraint at the company.

We would consider that these proposals could foster greater inefficiency and cost indiscipline at Royal Mail and encourage price rises which may lead to switching away from mail products potentially undermining the financial viability of the universal postal service. This is due to:

- the effect on Royal Mail of the proposals which when faced with difficult decisions to control costs may prefer to increase prices
- further weakening of already insufficient incentives at Royal Mail for efficiency and cost control, which are vital to the financial viability of the universal service in the medium to long terms
- consequent effects on mail volumes of price rises could exacerbate electronic substitution trends particularly where users have alternatives for example in advertising and marketing

b) The proposals stem from an unbalanced assessment of the risks facing the sector.

While we understand that there are risks to the financial viability of the universal service from Royal Mail’s current financial performance, we consider that the main risks to this viability lie in Royal Mail’s lack of efficiency and cost control rather than in market uncertainty.

In this respect, we consider Ofcom’s current approach relies to some extent on unstated assumptions that an early sale of Royal Mail may then engender greater efficiency improvements at the company. In its own terms we consider that this approach is therefore heavily exposed to a risk that such a timely sale will not be achieved.

Further, assumptions that a private investor would not also seek significant prices rises may prove optimistic. Such price rises may encourage switching from Royal Mail’s products and, in the worst case scenario, subsequent market decline could create a ‘death spiral’ for the company, rendering the universal service unviable.

c) In making these proposals we consider that Ofcom has not sufficiently assessed their impact as a whole, or on particular groups customers or consumers.

Ofcom’s proposals do not contain a detailed quantification about the scale of possible price rises particularly for products where there are particular consumer needs such as universal service parcels and packets in rural areas, or on the potential financial impact of these proposals on small and medium sized enterprises and on micro businesses in particular. Further alternative approaches are not considered or assessed in any detail and there is no detailed cost benefit or distributional analysis. As such, we would argue that Ofcom should consider more deeply the impact of their proposals before taking such a bold step.

Our recommendations

In light of the above we would recommend that Ofcom:

1. retains ex ante price controls in relation to current specifications for a further five year period, allowing Royal Mail to increase its prices in line with RPI to offset its current financial problems while allowing sufficient regulatory certainty for a sale of the company to go ahead
2. continues to review the scope of the control during this period in light of the development of competition in the market with a view to reassuring market players that price control regulation will remain proportionate as the market develops
3. continues to monitor Royal Mail’s performance and that of the postal market as a whole in the UK, the EU and internationally to provide it with sufficient benchmarks to assess the company’s performance in order to ensure that its efficiency is in line with its peers
4. continues to require Royal Mail to provide separated accounts for services where it has significant market power and for those where it does not

Annex 1: Modelling Royal Mail's performance

In this Annex we set out the architecture and assumptions of the indicative modelling of Royal Mail's Letters business's financial performance undertaken by ESL UK.

We note that this modelling does not aim to replicate detailed financial planning, but intends to assess the overall financial position of the business and the importance of key drivers such as wage growth and cost control to Royal Mail's profitability.

Modelling architecture

The model was constructed on an excel spreadsheet comprising of headline revenues and costs of (what was) Royal Mail's Letters business projected forwards over 10 years, using 2011 results as a base year. As the results for Royal Mail Letters business have now been combined with those of what was Parcel Force World Wide in a new UK Letters and Parcels business, 2010 figures were used to project forward results for what would have been Royal Mail Letters.

Treatment of key modelling uncertainties

Due to the large number of uncertainties in relation to the future development of the UK postal market, and of Royal Mail, any financial projections should be treated with some caution. Key uncertainties include the following:

- Will Royal Mail be sold and what would be the effects of a sale?
- What are future market trends in relation to volume decline or growth and possible down trading of postal products?
- What are the lag effects of previous price rises at Royal Mail?
- What would be the effects of any future price rises at Royal Mail?
- What will be the pattern of industrial relations at Royal Mail?
- How successful will Royal Mail be in implementing its modernisation plans in relation to becoming more efficient and restraining its costs?
- What will happen in respect of the pension fund deficit?
- What will be the pattern of additional capital expenditure at Royal Mail?

These have been treated in our modelling in following manner.

The effects of a sale of equity on Royal Mail

In order to reflect uncertainties around the sale of Royal Mail Group, we have modelled for two scenarios, a base line scenario set under current conditions and a scenario where the company is sold.

In practice, however, we recognise that given the political will for a sale and the approach of the company's management many of the potential effects of a sale are now ongoing.

Under the scenario where Royal Mail is sold we have assumed that there would be a full sale of Royal Mail Group (excluding Post Office Ltd) but that there will also be an employee share of about 10 per cent of the shares.

In general we would assume that this would have the following effects on Royal Mail Letters:

- The management would be put under greater pressure to achieve completion of the first phase of modernisation and to move forwards much more swiftly to make costs flexible and to drive down wage costs
- Any employee shares would be quickly traded making no real difference on the company's behaviour. At Deutsche Post where 6 per cent of the shares were initially bought by employees, these were quickly traded post initial public offering
- Management would also be under greater pressure to maximize revenues through more aggressive commercial behaviour and to move away from provision of loss-making elements of the universal service

For example, we would expect a private Royal Mail to continue to seek to:

- withdraw where possible from price controls
- substantially raise its prices
- obtain changes in universal service requirements, for example to reduce current quality of service requirements (to allow it to avoid air transport costs)
- seek to avoid mandatory ex ante regulation of downstream access

Assumptions in relation to market trends

To assess the likely pressures on Royal Mail Letters revenues we have looked at underlying market trends in relation to the likely growth in the segments of the mail market identified by Postcomm in its Competitive Market Review of 2008.

We have incorporated these market trends in our Base Case analysis as shown overleaf in Table A1.1

Table A1.1 Mail segment volume trends projected forwards

Product	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Transactional	-15%	-15%	-10%	-10%	-10%	-10%	-10%	-5%	-5%	-5%
Fulfilment	5%	5%	5%	5%	5%	5%	5%	5%	5%	5%
Advertising	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Publications	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%
Social	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%	-5%

For transactional mail, which accounts for just over 20 per cent of revenues we can forecast continued heavy declines as senders of mail continue to find electronic alternatives to postage. To some extent this reflects erosion in barriers to switching to electronic alternatives, cost pressures on mailers and also drivers by public sector mailers towards electronic government and electronic forms. While added value mailing innovations (such as trans-promotional mail) may halt some of this decline we do not consider that they will have a significant impact upon it).

Fulfilment traffic will continue to grow. However, while overall internet retailing distribution will continue to achieve fairly high growth rates of around 15 to 20 per cent per annum, we have forecast that Royal Mail will only benefit from part of this rise. This is because increasing competition in this area will either force down its prices or reduce its market share. In light of this we have forecast a market growth for Royal Mail of 5 per cent a year.

Advertising mail has grown over the last decade despite the onset of electronic substitution over the last five years or so. However, it appears that this market has matured in the UK and that, although volumes may recover slightly over the next few years as the economy improves, there will be little growth in advertising volumes. In light of this we have assumed a fairly flat position for direct mail going forward.

Publications traffic appears to be in long term decline with the increasing publication on line and a broader pressure on magazine and newspaper numbers. Reflecting this we have forecast a continued yearly decline of 5 per cent.

Social mail is now largely confined to greetings cards, post cards and the very occasional letter. Given demographic trends and continued electronic substitution of greetings cards we estimate a yearly decline in this area of 5 per cent.

Total volume trends have then been modelled on the proportion that each of these traffic components is of total volumes. As these proportions change over time (as low growth segments fall and higher growth increase) the pace of volume decline gradually lessens, and then aggregate volumes start to grow again later in the modelling period.

Effects of down-trading from first to second class products

The modelling does not consider possible effects of future down trading due to price rises. Time series data is not fully available on the effects of past down trading apart from figures of £70 million quoted in Royal Mail's accounts from 2008/09. We have assumed that this figure will continue to be a realistic proxy for this impact going forwards.

The possible effects of price rises

The modelling is conducted in nominal terms and therefore any increases in output prices for example due to inflation will have corollary increases in input prices and therefore an overall net zero effect. Otherwise the modelling does not assume price rises but is based on constant prices.

The development of industrial relations at Royal Mail

The modelling has not included a scenario of an industrial dispute at Royal Mail, although it is implicit in the modelling assumptions that industrial relations difficulties constrain the pace of the implementation of Royal Mail's modernisation.

Royal Mail's ability to cut its costs

As noted in the previous section Royal Mail is able to reduce its costs through greater technical efficiency, greater cost flexibility and through reducing the remuneration and changing the terms and conditions over time for its staff.

Savings from greater technical efficiency

As discussed earlier Royal Mail is now in the midst of updating its technical efficiency. In 2009/10 this process reduced headcount by about 7,000 and allowed for a decrease in distribution and conveyance costs for the Group of £53 million with cost savings for Royal Mail Letters of £206 million.

As it appears that most of the savings from consolidation of mail centres and installation of new delivery sequencing machines have not yet been made, and in light of the significant capital expenditures made already, we would estimate that at a minimum that there are additional available savings (from headcount reductions and better use of transport (Conveyance and Distribution) of £200 million per year for 2011 and 2012 with £150 million per year saving to people costs from headcount reduction and £50 million from transport costs. To illustrate the impact of a more rigorous approach to cost efficiency we have also modelled the effects of additional cost efficiency drivers of 5 per cent year on year.

Greater avoided costs due to volume declines (and greater cost flexibility)

Royal Mail has made little progress so far in making its costs more flexible to volumes, although network re optimisation could be seen as a one-off adjustment to a reduction in volumes. We consider that there will be some progress on this in 2011, 2012 and 2013, but that the bulk of the savings will come after this date in the second phase of modernisation.

We have assumed that the link to revenue of Royal Mail Letters' costs will increase from a conservative estimate of 0.6x to 0.7x of change in unit revenue in 2011-14 to 0.8x by 2015.[11] This will increase the level of avoided costs due to volumes decline which we have estimated in our model by considering the likely revenue impact and then multiplying by the level of variability and then assuming that this reduces people costs by reducing hours worked.

Changes to labour cost levels

The three year pay deal set pay increases at 2 per cent for 2011 and 2012 and 4 per cent for 2013. We have assumed that this deal will be honoured with or without privatisation. However, after this point (ie from 2014 onwards) we have assumed that underlying wages will remain flat in nominal terms while new grades of postal workers with fewer rights are brought in and a firmer stance by the company in relation to cost controls.

To illustrate the effects of wage rises we have modelled the impact on margins of a 3 per cent annual wage rise also.

The pensions deficit

The modelling assumes that under current arrangement the pension fund deficit contribution from Royal Mail will remain whereas under the privatisation scenario Royal Mail's current pensions' deficit contribution will be taken over by the UK Government from 2014 onwards.

Capital expenditure

In revisiting his review Hooper dropped the assumption that Royal Mail will need an extensive capital injection to finance mergers and acquisitions. While it is possible that a private management may seek to build further upon GLS we have not factored any such expenditure or returns it may generate into our analysis.

We have however assumed that underlying Capital Expenditure at the business (£292 million in 2011) will remain constant throughout the modelling period.

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[11] Royal Mail has argued that about 40 per cent of its costs are fixed due to network constraints.

Consumer Focus
Campaigning for a fair deal

Response to Ofcom consultation in relation to Securing the Universal Postal Service: Proposals for the future framework of economic regulation

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