Introduction

The Direct Marketing Association (DMA) UK Ltd is the largest trade association in the communications sector, representing both users and suppliers of Direct Marketing. We represent the majority of the major users of postal services and our client membership base represents the largest Royal Mail customer group. We represent all aspects of the supply side of postal services - from mailing houses to consolidators and from agencies to data bureaux - as well as mail users themselves.

All our members use postal services for some aspect of their business and for many it represents a significant part of their business. How the postal market evolves will have a direct impact on both whether their business survives and on the number of people they employ.

When considering the impact of OFCOM's proposals for the future regulation of the postal services market it is important to remember that it is not only Royal Mail's profitability and employees that will be affected. The future of hundreds of other companies – many of them SMEs – and thousands of jobs outside Royal Mail are at stake as well.

Our response to the consultation follows the specific questions in the consultation document.

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

We agree with the assumptions set out in paragraph 5.86 in terms of defining the boundaries of the Universal Service and the margins required to sustain Royal Mail in the long term, and make it sufficiently attractive to an investor.

As OFCOM itself notes, however, the biggest area of risk lies with Royal Mail achieving its business plan in terms of cost reduction and modernisation. The analysis highlights just how sensitive Royal Mail's profitability is to missing it's targets stating that "*a 1% shortfall in efficiency against the base case has a material impact on Royal Mail's future profitability, potentially reducing profit by up to 50%*".

Given that historically Royal Mail has consistently failed to meet its own targets in these areas we believe that the proposed regulatory framework does not provide the safeguards nor provide the real efficiency incentives required.

Breaking the spiral of lower volumes resulting in higher prices, which in turn mean lower volumes can only be broken through cost reduction and we see little evidence of real incentives or penalties to encourage this.

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?

We agree that for the sake of clarity and certainty OFCOM should impose a regulatory condition to provide the universal service. The regulatory condition should define exactly what is required of Royal Mail as the USP in terms of services and standards.

The regulatory condition should also include how OFCOM intend to monitor the provision of the universal service and what penalties or corrective actions would apply if Royal Mail fail to meet the specified standards.

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.

Although we understand why OFCOM is proposing not to impose any price controls (except for 2nd class stamps) we cannot support this proposal. The removal of all price controls is the one part of this consultation that has caused most concern among our members and that we believe poses the biggest threat to the universal service.

We agree that previous price controls have not prevented substantial price increases and we understand the case being made for more commercial freedom for Royal Mail but there is strong evidence that pricing will impact on the volume of mail that businesses send and that this, in turn, will impact the universal service.

The fundamental question is whether Royal Mail can be trusted to behave in a way that will mean that there is a viable postal services market in the medium term or whether they will use their commercial freedom to make short term profits from increasing prices instead of reducing cost. OFCOM believe that Royal Mail are "best placed" to decide pricing and they would not take actions that threatened their future. Unfortunately we believe that the evidence from past behaviour doesn't support this and the regulator needs to protect Royal Mail from itself!

OFCOM believes that regulation should be "appropriate and proportionate" and we strongly believe that given its potential impact on mail volumes it is certainly "appropriate" to regulate pricing. Past behaviour and any evidence of abuse of its monopoly position should also be a factor in whether to regulate and we believe that given Royal Mail's track record regulation would be "proportionate".

We believe that the evidence for the need for some continued regulation of Royal Mail's prices can be grouped into a number of specific issues:

- Lack of customer focus

Both Hooper reports highlighted the need for Royal Mail to become more customer focussed and how important it was for them to understand their customers' business and how their products were used. The DMA has seen no evidence of any improvement – in fact in some areas there appears to be even less understanding of their customers than before. A recent example of the proposal to implement a "delivered by Royal Mail" mark on machineable mail is a good example of Royal Mail's internal focus and not understanding how their customers use mail. Unfortunately there are many other instances of Royal Mail proposals that have either been dropped, amended or withdrawn when customers have pointed out that they were unworkable or would have unintended consequences. We believe that it is extremely dangerous to allow an organisation with this track record to have "carte blanche" around pricing and that there is a real danger of unintended consequences.

- Price elasticity

OFCOM itself has pointed out the dangers of relying on price elasticity modelling based on historical data and we agree that this is no indication of future actions. The other problem with price elasticity modelling is that it assumes that "lost volume" can come back if the prices were reduced but in most cases once a business has decided to move away from using mail that volume is lost for ever. The effect of the price increases earlier this year have yet to be seen – 7 months is far too short a time for many organisations to react. OFCOM has heard evidence from many major users of mail that those increases prompted moves to reduce mail volumes but that these might take another 18 months for the impact to be felt. The fact that volumes have held up in the short term cannot be taken as "proof" of elasticity or how much the market will bear.

Annex 1 is an example of the kind of response that we have received from members that demonstrates that the price increases earlier this year have directly led to reduced mail volumes and, although it may not be directly relevant to this consultation, reduced employment. Unfortunately many members put a lot of effort into providing evidence of the impact of increasing mail prices in response to Postcomm's consultation and feel that they wasted their time because it was – in their view – completely ignored. As a result many have lost faith in regulatory consultations since they perceive the proposals as a "done deal" and don't believe that their evidence will have any impact. There are also some members – particularly those who rely heavily on Royal Mail, such as mailing houses - who are unwilling to upset Royal Mail for fear of victimisation (although the DMA has never seen any evidence that this has actually happened).

Business bulk mail underwrites the universal service and is sensitive to price increases. The impact of any price increases in 2012 may also be increased if – as most expect – bulk mail becomes subject to VAT. For many of the major users of mail – Financial Services, Charities and Government – this in itself is a significant cost increase before any proposed increases from Royal Mail.

We cannot find any evidence of 15-20% price increases for business customers among any of the other major postal operators across the world. In fact most other postal operators have restricted increases, typically to 5% or less, to try to maintain volumes. In March 2011 the Boston Consulting Group's analysis of USPS concluded that "price increases will drive volume away" and were not a solution to USPS's problems. (In fact USPS has effectively reduced prices for business customers by offering special incentives and "extras".) In Germany a combination of regulation and competition has kept prices down for business customers and they saw a slight increase in mail volumes even for transactional mail!

Royal Mail has not been able to reduce costs to keep in line with falling mail volumes and yet there is strong evidence that increasing prices will accelerate the volume decline. If OFCOM is to protect the universal service in the medium term then keeping as much mail volume as possible - especially transactional mail - for as long as possible to give Royal Mail more breathing space is critical. At a recent conference Royal Mail's Chief Executive positioned Royal Mail as a "media and parcels delivery company" appearing to have abandoned the transactional mail market completely. The evidence from other markets is that you can slow the decline in transactional mail volumes and that treating it as a "cash cow" is both premature and an example of why there is a need for the regulator to "sense check" Royal Mail's pricing if it is to fulfil its duty of protecting the universal service.

- Incentives for efficiency/cost reduction

Previous attempts to improve efficiency through price controls have not worked simply because the regulator has always been forced to back down because of Royal Mail's financial position. Simply removing price controls however seems to provide even less incentive for efficiency improvement. In a normal commercial environment prices are limited by how much customers are prepared to pay, which in turn then provides the incentive to improve efficiency and reduce cost. (It often also provides the incentive for innovation – something that has been lacking in the postal services market.) In a monopoly these constraints on pricing aren't there and it is all too easy to simply increase prices rather than the more difficult cost reduction and efficiency improvement. It is interesting that in those postal markets where there is real competition that the dominant supplier has been forced to achieve significant cost reductions to maintain or improve profitability. This is in marked contrast to the position in the UK where we see the CWU responding to Royal Mail's latest results (that show a very modest improvement in profitability) with a demand that their members should "share in success" with improved pay.

- What would we recommend?

We understand the justification to move away from the existing "ex-ante" regulation but there is a real danger to move straight to removal of all price controls. As OFCOM points out the consequences of getting it wrong are significant. Equally the consequences of getting pricing wrong may not be seen for some time and without a mechanism for swift corrective action could see users and competitors leaving the postal services market. We would recommend an approach that has 2 additional safeguards that are both "appropriate and proportionate".

1. That there is a cap on Royal Mail's ability to increase prices without reference to the regulator. This could be based on RPI plus say 5% or a maximum of 10%. This would allow Royal Mail much more commercial freedom than at present whilst protecting users from excessive price increases. Any increase above this cap would be subject to a consultation with users to understand the impact on them and the universal service.

2. Regular meetings between Royal Mail and mail users, trade associations and customer groups hosted by OFCOM to discuss pricing issues and its impact on the market. (This is something that would be happening anyway in a normal commercial environment but, unfortunately, we believe that without a statutory requirement is unlikely to happen with Royal Mail.)

These safeguards could be reviewed after 2 years and removed unless there was evidence that they were still required.

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

We agree that regulatory safeguards are required but although there are safeguards for consumers and for DSA competitors there appear to be no equivalent safeguards for business customers. We also believe that there is the need for additional safeguards as outlined in our response to 6.2 above.

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

We agree that a monitoring regime is essential to protect the market and the continued provision of the universal service.

The proposed monitoring regime, however, doesn't cover the pricing of products outside the universal service and we would like to see OFCOM monitoring against both excessive and discriminatory pricing. There is considerable evidence that mail users are more prepared to use competition law to protect themselves from monopoly abuse and we believe that this would be detrimental to both the market and Royal Mail by distracting management and resource. OFCOM monitoring against excessive pricing of products (as opposed to monitoring excessive profits of Royal Mail) could prevent users resorting to Competition Law.

The proposal on monitoring also doesn't provide any detail on the limits or thresholds that would prompt some action, what that action would be, or how long it would be before it was triggered. It is absolutely essential that there is a process that results in swift corrective action. Reacting 12 or even 6 months after something has happened is too long and could mean that mail volume or a competitor is lost for good.

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

Although most DMA members are more concerned with bulk mail products we believe that it is important to have some form of price regulation for the most commonly used consumer products in line with most other European countries and the US. The proposed safeguard cap is consistent with the research so we support this proposal provided that the pricing of other products doesn't distort the market – for instance if there were further large price increases for transactional bulk mail and/or it was subject to VAT then stamped 2nd class mail may be a cheaper option than bulk mail for some users.

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.

Although we understand the rationale behind this proposal we cannot agree. The postal services market and mail volumes in particular have been completely unpredictable over the last few years.

Mail volumes are – at least in the medium term – critically important in determining Royal Mail's profitability and maintaining an affordable universal service. Historically no-one has been able to predict mail volumes accurately – the rate of e-substitution, the growth in internet fulfilment and the potential from multi-channel communications have all been either over or under estimated.

We strongly believe that there is good evidence that the behaviour of the dominant postal services provider has a big impact on the volumes through pricing, product innovation and specifications. We also believe that competition – and what kind of competition (i.e. end to end vs. downstream access) also has a huge influence on mail volumes. Looking at what is happening in other markets around the world there are wide variations. Some, such as Nordic countries (-14%) and the US, are showing double digit declines, others such as France (-3.5%) are seeing a much smaller decrease in volumes with Germany even showing a slight overall increase in mail volumes last year.

Given this uncertainty we believe that a 7 year lifetime for any regulatory regime is too long without a formal review. It is interesting that in the Telecommunications market 3 years is considered to be the appropriate length of time for price controls and that OFCOM itself has favoured shorter time periods as more appropriate for other markets in the past. Within this consultation itself OFCOM is also proposing a review of Access regulation after only 18months to take account of changes.

Although OFCOM is proposing to monitor what is happening and to make changes as necessary we don't believe that this is a sufficient safeguard. We don't know what the criteria and thresholds for intervention and it isn't realistic to expect the Regulator to predict every scenario that might trigger action so we therefore believe that there should also be a statutory review after 3 years.

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

The consultation document does not provide any detail on how OFCOM proposes to carry out its obligations under the Act and assess end-to-end competition. What criteria would be used to assess whether end-to-end competition is considered to be threatening the universal service?

The DMA would welcome end-to-end competition (see 7.2 below) since this would provide the best incentives for Royal Mail to reduce costs, improve efficiency, innovate and become customer focused. Alternative mail delivery networks would also be beneficial if there was further industrial action at Royal Mail. Not only would the impact of the industrial action be diluted but if users could use alternative delivery networks it would mean that they would be still using mail rather than being lost to other channels such as email.

Question 7.2: Do you agree with Ofcom's proposals to impose an obligation on Royal Mail to provide access at the Inward Mail Centre? If not, please give reasons.

Yes. The DMA strongly believes that competition has been good for the postal services market in the UK. This view is supported by independent reviews, the Hooper reports and OFCOM's own analysis.

Ultimately we would like to see the development of end-to-end competition as the evidence from other markets is that this delivers real choice, keeps prices low for users and provides the best incentive for the dominant supplier to increase their efficiency. DSA does provide limited competition with minimal impact on Royal Mail's profitability since it retains a significant proportion of the mail revenue when a customer uses one of their DSA competitors.

DSA does allow Royal Mail's competitors the opportunity to build a business and mail volumes that, we hope, will lead to the development of their own delivery networks.

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

DMA members want to see continued DSA competition and it is therefore important that Royal Mail's competitors are protected from "margin squeeze". We don't intend to comment on the details of the proposals since it is more appropriate that this should come from the DSA operators themselves except that any monitoring process must result in quick action. Most of Royal Mail's competitors work on very small margins and if it takes too long to investigate and react to "margin squeeze" it may result in them going out of business.

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.

As with 7.3 above it is more appropriate that the detailed response to this question should come from the DSA operators themselves. In general we believe that there has to be equivalence and no "undue discrimination" for DSA competition to work. Not having equivalence doesn't just affect the DSA competitors themselves but also their customers' perception of mail itself with the risk of accelerating or prompting moves to other media and channels.

Although this section deals specifically with DSA competition the principle of equivalence should also apply to Customer Direct Access contracts as well.

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.

Yes, we agree with the objectives. Clearly establishing the costs relating to the universal service and fair allocation of overheads is vital in establishing prices and profitability although it isn't clear whether Royal Mail are yet in a position to provide OFCOM with robust enough data to meet these objectives. It will also be interesting to see more detail around how OFCOM proposes to monitor "the efficiency of the universal service".

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

The DMA aren't qualified to comment on whether the reporting is appropriate and proportionate. OFCOM with its experience of regulating other markets has to determine whether it has the information it needs to ensure that it can meet the objectives outlined in sections 8.9 to 8.12, and we would expect reassurance from the regulator that this is the case.

It is not clear what reports OFCOM itself would produce as a result of this information and what would be available in the public domain.

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?

It is vital that there are consistent ways of reporting and although the imposition of Regulatory Accounting Guidelines was not within Postcomm's powers we support OFCOM's proposals. As with 8.2 above we do not feel qualified to comment further and expect the Regulator to determine whether these proposals are sufficient to achieve the objectives for robust regulatory financial reporting.

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?

Yes - these proposals follow on from discussions with Postcomm earlier this year and it was clear then that it will be difficult to get agreement from all parties involved as to exactly what should or should not be included. Again we would look to the regulator and its experience of regulation in other markets to provide reassurance that these proposals are sufficient to meet the regulatory financial objectives.

ANNEX 1

Example response from DMA member

Newhall Publications Ofcom Consultation response for the DMA

Background

Newhall Publications Ltd publish a subscription magazine called Candis and has 190 employees. We have been using the Royal Mail for 11 years as a strategic partner to deliver monthly copies of Candis Magazine in volumes of 250K per month. The trend is that our circulation has been decreasing but we have been cross selling and supplementing revenue using other product mailings.

Impact of proposed changes

At the time of the last postal price increase there was a regulator in place but RM was still able to put through a huge price increase, which materially affected our business. For the additional burden placed on use we could have employed a further 3-4 staff so it had a real impact on employment within the company. What would happen under the proposed "soft touch" regulatory regime? RM has a very poor track record in dealing sympathetically with its bulk mail customers.

In real terms, RM is worse off because of its previous price increase. We had to reduce our budget substantially in marketing and sales promotion of Candis magazine; as a result circulation is almost 20% lower that it was before the price rise and total RM income is therefore lower than it would have been with no price rise.

Further, above inflation, price rises are a near certainty under the new regime. This will result in less income for our business as we are unable to invest in product promotion, a necessity to reduce staff numbers and overall will reduce RM income again.
We are having to invest heavily in digital as a result of rising mailing costs and have launched a digital version of Candis on Apple's Newsstand.

Any future price rise will jeopardise our investment in development of the business and will increase our focus on digital ways to fulfil some of our marketing and business strategies. We have recently launched in retail as an alternate route to the magazine market rather than using direct mail.

We have a falling circulation and as such have a reducing income so any large increase in April would be crippling at a time when we need to invest to se us through the recession.
We have always found the notice terms by Royal Mail very short and the last price rise was forced upon us in short time frame adding a burden of extra operational expense.

As there are no real alternative methods for us to deliver our magazine only receiving 90 days notice of a major cost increase does not leave us much time to change our strategy to manage any increase. We have several months stock of mailing materials which could need changing if a different strategy is adopted to combat the affect of a forced price rise.

In summary we can not believe that Royal Mail which is still a monopoly in the last mile can be allowed to have an uncontrolled impact on us and so many businesses. In principle we are committed to print long term, but can only remain so if we are not penalised by RM.