

19th July 2018

**Re: Amendments to the USPA Condition in relation to the margin squeeze control
Mail Competition Forum (MCF) Response**

The MCF is a forum which represents the interests of many of the leading postal and parcel operators who compete fiercely with both one another and with the incumbent holder of the USO, currently Royal Mail. The objective of the MCF is to support the development of conditions in the UK for fair, vibrant and sustainable competition to Royal Mail within a stable and undistorted market.

Ofcom's primary duty under the Postal Services Act 2011 is to secure the provision of the USO and, undoubtedly, the USO is more secure and stable now, than when Ofcom took over the regulation of the postal market. However, with the USO provision now secure, it is time for Ofcom to take a more active role as regulator and in particular in respect of its Communication Act duty to benefit consumers where necessary by the promotion of competition. MCF members recognise that Ofcom have a variety of tools at their disposal to enable this and margin squeeze is but one of these.

In section 2.3 Ofcom quote "*margin squeeze control has been an effective remedy in protecting access competition*" and quotes market share increases as a proportion of total mail to verify this. MCF members believe that these statistics give a misleading impression of competition growth that they would like to address. In fact, volumes in Access have stayed static since the change in regulation (at around the 7 billion item mark) and the numbers of competitors delivering to Royal Mail's IMC network has decreased significantly from seven to four in the same period. Large scale end-to-end competition has effectively been foreclosed by Royal Mail's anti-competitive price proposals of 2014, still the subject of an unresolved competition law investigation by Ofcom more than four years later. MCF members are pleased that Ofcom have taken the time and trouble to revisit the margin squeeze tests and the level of scrutiny that goes into examining Royal Mail's costs base and allocation methods under both the basket and individual contract tests. With its 2014 pricing proposals Royal Mail has shown that it is not above seeking to gain advantage by manipulating costing data to their advantage and MCF members are pleased that the proposals consulted upon provide Ofcom with greater transparency of the upstream cost stack to prevent such exploitation.

The proposals focus on margin squeeze tests and by necessity deal with a variety of cost allocation issues. MCF members believe that a good number of these issues could be better dealt with by improving the levels of equivalence in the way that Royal Mail Group treats its own retail sales arm (Retail) and its wholesale customers (Wholesale). MCF members would welcome regulatory intervention beyond margin squeeze control to ensure that items collected and delivered by Retail face exactly the same operational and costing regime that Wholesale items do when it is clear that at the moment they do not. In particular, MCF members are appalled by the disparity in treatment, referenced in the document, in the imposition of surcharges between Retail and Wholesale and can see no reason why this is allowed at the moment nor why it should be allowed to continue in the future. This is true at an item level, e.g. with Mailmark missort charges, but is also true at a more macro level with surcharges levied on MCF members for failing to hit Mailing Fall to

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Earth profiles on total annual postings. In its response of 22nd January, Royal Mail says “the primary objective of the surcharges levied by Royal Mail is to drive compliant customer behaviour across all customer groups”. MCF members have difficulty in accepting the veracity this statement when Retail do not as a matter of course consistently levy these charges on their own retail customers but do on their wholesale customers. An “equivalent” system would provide an effective solution to the issues of customer support costs, sub-product costs, commercial costs and revenue protection costs referenced in the consultation. Additionally, Members would like to point out that physical Revenue Protection duties are much reduced thanks to the introduction of Mailmark and the creation of one RP team that does inline revenue protection for both Retail and Wholesale postings.

Question 1: Do you agree with our proposals to add in an explicit reference to exclude overheads and include a rate of return in the upstream cost calculation as detailed USPA6

MCF members don't have access to the redacted information that supports this decision. In principal however relying or assuming that two numbers will net one another off does not seem a particularly sensible approach and so the more explicit wording is preferred. MCF members can't see why it is unreasonable to include both an overhead allocation and a rate of return into the upstream costs so do not support the exclusion of overhead since it will have the effect of reducing the upstream cost and hence require lower upstream revenue to recover them.

Question 2: Do you agree with our proposals to allow Royal Mail to adopt the Direct Method for the purpose of calculating the upstream cost stack?

MCF members are always concerned when Royal Mail propose changes to the way in which it reports or changes its cost base in case this leads to further anti-competitive behaviour, so would naturally be more inclined to resist such change proposals. However, we have been reasonably reassured by Ofcom's comments, and by the very helpful explanatory workshop hosted by yourselves, that the Direct method provides greater transparency of the upstream stack and is less open to potential manipulation than the indirect method. Additionally, we are told the Direct method is easier for Royal Mail to prepare. Historic comparisons made to Ofcom between the two methods have demonstrated that there is little material difference, but members note that these comparisons will not be available going forward.

Cost allocation is clearly an important factor in deriving the upstream costs. MCF members are concerned that RM may have both the incentive and the ability to manipulate this process to the benefit of their business. Ofcom have cited the example of customer support and bulk mail marketing support costs and it is important that Ofcom consider such disparities because tampering with the allocations can alter the costs included in the test and damage the prophylactic purpose of the margin squeeze tests.

MCF members are concerned that if Ofcom does agree to adopt the Direct method, Royal Mail will then make a sequence of cost allocation 'corrections' that in isolation seem immaterial but collectively result in a shift in the margin squeeze quantum's. The Direct method would appear to be more susceptible to such changes than the Indirect method where an adjustment to the method may need to be agreed with Ofcom.

MCF members are therefore placing their trust in Ofcom's judgement on the suitability of the Direct method and on Ofcom's ability to challenge changes to Royal Mail's cost allocations going forward and support the proposals.

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Question 3: Do you agree surcharges should be included in the margin squeeze control?

MCF members are dismayed by the disparity in treatment of Wholesale and Retail customers with regard to surcharges. Including surcharge revenue in the margin squeeze test may encourage compliance on equivalence by encouraging Royal Mail Group to charge its own Retail business and their customers on an equivalent basis but MCF members would welcome regulatory intervention to ensure that this is the case, rather than encourage it through this mechanic.

MCF fully support the inclusion of surcharges in the margin squeeze control.

Question 4: Do you agree with the methodology to implement surcharges in the margin squeeze control

MCF members refute the arguments put forward by Royal Mail to explain the disparity of charging between Retail and Wholesale. It is simply a nonsense to say that Access customers are more willing to incur surcharges than Retail customers because of the cost of change. The quantum of items processed by Access customers delivers sizable surcharge fines, many of which are not cost reflective. It is a scandal that Royal Mail actively discriminate in the imposition of surcharges between its own business and wholesale customers and the methodology employed must ensure that this stops. MCF members would also draw Ofcom's attention to the fact that dealing with surcharges places a non-RM cost burden on the supply chain with operators and intermediaries breaking down the costs and attempting to recover these from their posting customers. These charges are considerable, the surcharge always retrospective, mostly unwelcome and involve a disproportionate amount of effort for the sums involved. While it is difficult at this time to precisely quantify these additional costs, our collective estimate suggests an administrative cost in excess of £1m p.a. across operators, intermediaries, mailing houses and customers. While RM wholesale apply these surcharges to its 35 or so customers these have in turn to be passed onto the thousands of posting customers supported by Wholesale's 35 customers. If RM Group is not surcharging its retail arm in an equivalent manner these costs are not being borne by Royal Mail but are being imposed on the wholesale customers.

MCF members ask Ofcom to impose an obligation on Royal Mail to monitor compliance in each area that Wholesale faces surcharges and ensure that it accounts for any deviations in its retail business in exactly the same way as its wholesale customers for the margin squeeze tests. So in the way that for example RM collects and charges Mailmark missort data or Fall to Earth surcharges to its wholesale customers, it must collect and calculate the equivalent charge for its own retail business and include this in the margin squeeze cost stack.

In summary MCF members welcome the increased transparency that the proposals bring. Furthermore, members urge Ofcom to build on their work protecting competition by ensuring equivalence in both the quantum and application of surcharges by Royal Mail group between its own retail arm and those of its Wholesale customers.

On a further matter relating to the margin squeeze controls, the MCF would welcome more information being provided by Ofcom on whether Royal Mail are complying with the requirements in practice.



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Although some mention of Royal Mail's compliance is included in the Annual Monitoring Report, the MCF believes there is opportunity for Ofcom to say something about compliance with the controls at other times also, perhaps early in each financial year and after the January and April price changes (given that USPA 6.2 says that Royal Mail must expect to meet the margin squeeze test "at the time of setting new prices" and USPA 6.7 says Royal Mail must demonstrate compliance on a quarterly basis).

We recognise that the data itself would be commercially confidential and that Ofcom should not fetter itself by making any statement which could prejudice a subsequent investigation. However, we believe it would be possible and important to the industry for Ofcom to give some assurance that Royal Mail was complying, for example by saying that "Ofcom has reviewed the margin squeeze information provided by Royal Mail for [period][price change] and on the basis of the information provided currently considers the margin squeeze controls to be met".