

Review of the regulation of Royal Mail

DX (Group) plc Submission

Thank you for the opportunity to contribute to the discussion about the state of regulation of Royal Mail. DX understands that that the discussion paper Ofcom published on 17th July 2015 is the start of a process by which you will consider how Royal Mail should be regulated and we look forward to engaging in this process. The following pages provide an outline of DX's view of the state of the postal market and regulation of Royal Mail; please contact us if you require clarification or would like to explore any of the points in greater depth.

A brief summary of the key points follows:

- Ofcom is completely correct to consider the effectiveness of the existing regulatory structure
- The existing regulatory structure has failed to promote competition adequately, leading to the exit of the only substantial competitor in the bulk mail delivery market
- Consumers and larger customers have suffered because of Royal Mail's unfettered market dominance
- Ofcom needs to impose robust regulatory controls that prevent anti-competitive behaviour by Royal Mail and protect customers from the effects of Royal Mail's dominance
- Ofcom should deregulate Royal Mail's metered (franked) mail services by removing them from the universal service obligation

Question 1: Do you agree with our view that there is a need to consider the effectiveness of the existing regulatory structure. Please state your reasons.

DX strongly agrees with Ofcom's view that there is a need to consider the effectiveness of the existing regulatory structure. We believe this because it seems to us that the current regulatory structure has failed on several measures:

- Royal Mail's prices have risen more than they should have;
- Royal Mail imposes conditions on customers in a non-commercial manner; and
- Ofcom has failed to fulfil its "principal duty under the Communications Act 2003 to further the interests of citizens and consumers, *where appropriate by promoting competition*"¹.

¹ Paragraph 1.1 of Review of the regulation of Royal Mail, Ofcom, July 2015

Ofcom's current regulatory structure gave Royal Mail considerable commercial and operational flexibility to manage the challenges it faced in March 2012. In order to prevent Royal Mail abusing this flexibility Ofcom imposed three safeguards:

- a monitoring regime;
- a cap on the price of Second Class stamps for letters and parcels; and
- access regulation.

Alongside these safeguards was Ofcom's expectation that competition would constrain Royal Mail's behaviour.

However, experience shows that these measures were incomplete.

It is difficult to appraise the effectiveness of the monitoring regime because this is primarily an internal activity in Ofcom, which is presumably unable to share the data it receives from Royal Mail with third parties. In any case, it is doubtful whether third parties would be able to do anything with it.

The cap on the price of Second Class stamps appears to have been ineffective because Royal Mail has failed to make full use of it, implying that the cap is higher than the monopoly price that would have been set in its absence.

Although access regulation has ensured the continuation of access competition, it has failed to prevent Royal Mail exploiting its market power. Examples of this behaviour include:

- setting discriminatory prices to exclude competitors from both the access and delivery markets;
- increasing prices above those that would be expected in competitive markets; and
- imposing terms and conditions that customers would reject in competitive markets.

One would hope that privatisation and the interests of private shareholders would drive improvements in Royal Mail's efficiency. At the same time, however, one would expect them to exploit market power and set prices to maximise profits. The unfortunate outcome might therefore be an efficient Royal Mail that makes considerable profits because of its monopoly pricing power. This harms the postal industry (and bulk mailers in particular) because they have to pay too much. This is likely to accelerate migration to alternative communications media.

In the absence of actual substantial competition, Ofcom needs to impose a new regulatory framework that reproduces the outcomes that normally emanate from such competition. This requires a substantial level of intervention into Royal Mail's business.

At the same time, even though Ofcom now appears to have concluded that the development of widespread competition for the delivery of mail is unlikely, we believe that Ofcom must be careful not to foreclose market entry. Competition is the best means for creating innovation that benefits customers and the wider market. Ofcom needs to learn from Whistl's experiences trying to enter the delivery market and implement measures that effectively protect competitors from Royal Mail's misuse of its market power. These measures need to go substantially beyond a reliance on competition law, which has proven itself to be too slow to provide the assurance the market needs.

DX appreciates that Ofcom has a duty to secure the provision of a financially sustainable and efficient universal postal service and that the specification of that service is not within Ofcom's remit. It has always concerned us, though, that Ofcom has consistently stressed this duty whilst appearing to neglect its duty to promote competition. Ofcom always points out that where there is a conflict between its duty to secure the universal postal service and its principal duty under the Communication Act 2003 to further the interests of citizens and consumers, where appropriate by promoting competition, its duty to the universal service takes precedence. This might be a correct interpretation of the legal constraints placed on Ofcom but, in order not to promote competition, Ofcom still needs to establish first that the promotion of competition is inappropriate, that it does not further the interests of citizens and consumers or that it conflicts with the duty to secure the universal postal service. DX is not aware that Ofcom has performed this analysis and we have seen no evidence that demonstrates that the promotion of competition is inappropriate or that it does not further the interests of citizens and consumers. Recent work by Ofcom has shown that the universal service was not under threat because of competition, even at the higher levels provided by Whistl. The promotion of competition therefore does not conflict with the duty to secure the universal postal service and Ofcom has no reason not to promote competition. DX believes that a lack of clarity and purpose about the promotion of competition in the postal market has led to the current low level of competitive activity and the resultant maintenance of Royal Mail's substantial market power.

Question 2: To what extent do you consider Royal Mail's pricing and non-pricing behaviour is constrained by other postal operators and additional factors such as e-substitution?

The constraints on Royal Mail’s behaviour are limited in both extent and effect. DX believes that further regulatory constraint is required for both retail and wholesale services and for both the pricing and non-pricing behaviour.

<p>Constraints on pricing behaviour by other operators</p>	<ul style="list-style-type: none"> • Low effectiveness in some sectors, higher in others • Since Whistl’s withdrawal from the delivery market there are no constraints on pricing from other operators in the bulk mail sector • Competition by document exchange operators and delivery operators such as CFH might constrain some business mail prices although the USO VAT exemption for metered mail reduces its effectiveness • Operators such as Yodel and Hermes are providing real competition in the packet and parcels sectors. This has led to Royal Mail reducing retail prices although it has not reflected this reduction in wholesale packet prices
<p>Constraints on pricing behaviour from e-substitution and other factors</p>	<ul style="list-style-type: none"> • Low to moderate effectiveness • Despite the effect of e-substitution on volumes Royal Mail has been increasing its prices, suggesting that e-substitution is not an effective constraint on pricing • Price differentiation between the advertising and transactional mail sectors leads to the conclusion that competition from other media is a more effective constraint on the price of advertising mail. • Royal Mail appears to be neglecting the effect of e-substitution on transactional mail and sets prices that will hasten the development of alternative media and their eventual adoption.
<p>Constraints on non-pricing behaviour by other operators</p>	<ul style="list-style-type: none"> • Not aware of any
<p>Constraints on non-pricing behaviour from e-substitution and other factors</p>	<ul style="list-style-type: none"> • Low to moderate effectiveness • MarketReach is a Royal Mail initiative to counteract the effect of e-substitution

Question 3: To what extent do the competitive constraints faced by Royal Mail vary by different types of mail, e.g. for letter services, between advertising mail, transactional mail and publishing mail and for parcel services, between single-piece and bulk parcels?

In general, we believe that Royal Mail faces a low level of competitive constraint. Its provision of the universal service and the legacy effects of its monopoly in many parts of the postal market mean that it is the default choice for many mailers. The VAT exemption on universal services shields Royal Mail from competition, including otherwise viable competition for metered mail in the SME sector. Royal Mail faces real competitive constraints only in markets that have never been part of the monopoly (e.g. express parcels), markets closely related to these (e.g. bulk parcels and packets) and certain niche markets such as the document exchange.

The bulk mail market is a special case because it is split into upstream and downstream sectors. Upstream competition is intense whereas downstream competition is non-existent.

Royal Mail's pricing behaviour should indicate the markets in which it believes it faces competition. For instance, the existence of a price differential between advertising mail and transactional mail suggests that the advertising mail market is more competitive than transactional mail. However, the competition in the advertising mail market must be coming from media other than post because there are now no substantial alternative postal operators competing for this business. In addition, Royal Mail might be underestimating the medium to long-term effect of competition in the transactional mail segment where its higher prices could well be encouraging the development of alternative media and the eventual loss of this volume from the mail market. Royal Mail's retail packet prices indicate competition in this market, presumably from low price operators such as Yodel and Hermes. However, the equivalent wholesale prices are very high, squeezing the headroom for customers and operators who would like to offer a service using Royal Mail's network.

Question 4: Do you consider that Royal Mail faces appropriate incentives to deliver efficiency improvements?

Where Royal Mail is not subject to substantial competitive constraints (most of its business) it does not face appropriate incentives to deliver efficiency improvements. The incentives on monopolists to innovate are weak because volumes under monopoly conditions are lower than under competitive conditions and the returns from innovation are therefore also lower. As previously discussed, the competitive constraints on Royal Mail are generally weak and therefore do not incentivise Royal Mail to deliver efficiency improvements.

Question 5: Do you consider there are any areas of existing controls on Royal Mail activity where there is the potential for deregulation?

DX has consistently argued that the USO status of metered mail is anomalous, unnecessary and that it distorts competition. This is because USO services are exempt from VAT, providing Royal Mail with a substantial price shield against competition.

We do not believe that the assessment of whether metered mail should be in the universal service has been done in a thorough, independent and objective manner.

Mail meters (franking machines) allow customers to pay for mail on account and to print mail indicia rather than apply stamps. The smallest machine costs £15 - £49 / month to rent and has a break-even point of 90 letters / month². This cost and the resultant break-even volume place mail meters out of the reach of the overwhelming majority of mailers and their use is limited to businesses. The metered mail product is therefore one that does not need to be available on a universal basis but only to those business customers who wish to use it.

Furthermore, there are substantial differences between the metered products and their stamped equivalents. Users of metered mail have to prepare their mail to exacting Royal Mail specifications including:

- restrictions on the geographical area in which the mail may be posted;
- the use of particular pouches, trays and bags, and;
- segregation of class and service.

These operational features are similar to those of bulk mail products which are not within the universal service. A further difference between metered mail and stamped mail is the considerably lower price of metered mail. DX wonders how Royal Mail can justify this lower price in any way other than it being a response to competition. We do not believe that the underlying difference in costs is large enough to justify the difference in price. We suspect that metered mail does not contribute as much to the provision of the universal service as stamped mail.

There is no evidence to suggest that the removal of the metered mail product from the universal service would result in any changes to the service currently provided. Where other products such as

² <http://frankingmachineguide.com/>

bulk mail have been removed from the universal service, Royal Mail has continued to provide them at uniform national prices on a six day basis despite the lack of an obligation to do so.

Ofcom should therefore deregulate metered mail and remove it from the universal service obligation.

Question 6: Do you have any further comments or views on the issues identified in this paper?

General

- As a private sector entity, Royal Mail's primary objective is to increase value for its shareholders. There are clear tensions between this objective, Royal Mail's universal service obligations and the requirements of competition law. These tensions will require constant monitoring if competition in the postal market is to develop on a fair basis.
- DX has the impression that Ofcom is too busy with other industries to really get its teeth into the Royal Mail monopoly. Our impression is that the strategic issues in the large, growing, exciting media markets that Ofcom regulates distract it from the detailed work that is necessary in the postal market. But power in the postal market is considerably more concentrated in the incumbent than in the telecommunications markets where substantial competitors have been able to establish themselves and the need for regulatory intervention in the postal market is correspondingly higher.
- As mail volumes have declined, Royal Mail has responded by increasing prices rapidly. This appears to be the reaction of a monopoly that is focussing on short term gains at the expense of long-term losses caused by accelerated volume losses. The problem is that Royal Mail's price setting ability in wholesale services means that other operators and customers will eventually suffer from Royal Mail's short-termism.

Access

- Royal Mail feeds contractual changes into the market on a piecemeal basis. Although individual changes might be small, they accumulate to major changes over the course of a year. If faced with these changes in one go contract holders would not agree to them. There needs to be a formal change control process that includes Ofcom as some sort of arbitrator.

- Royal Mail tends to bundle undesirable contractual changes together with desirable ones in such a way that pragmatic customers have no option other than to swallow the undesirable change in order to avail themselves of the desirable one. Royal Mail would find it very difficult to obtain agreement to these changes in a competitive market in which customers could move their business to another supplier.
- This point is linked to fair and reasonable termination provisions with adequate notice periods. Any changes to the contract need to be mutually agreed through a change control process.
- Royal Mail needs to agree sensible liability provisions.
- We need consistent headroom across all access products. The current flexibility allowed to Royal Mail to determine the relationship between retail and wholesale prices creates substantial uncertainty and allows Royal Mail to exclude access customers at short notice (e.g. recent changes in packet prices).
- RPI-X type price control linked to point-to-point headroom controls are necessary to provide efficiency incentives and stability for customers.
- There is a need to limit the frequency and nature of changes. Royal Mail should be able to manage with a single set of changes every year except in the event of emergencies.
- Access requirements need to be extended to all products and formats. The provision of extraction services should be mandated.
- Small parcels should come into the regulated area. There is no question that other smaller entrepreneurial businesses without national scale should be able to put packets and parcels, locally, up to 5Kg into Royal Mail's network.
- The market would also benefit from deferred speed services.
- There should always be direct linkage between retail services and equivalent access services. Incentives offered on retail services should be reflected directly in access services.
- Royal Mail Retail should be subject to the same or similar terms and conditions as Access customers.

Regulation

- Publication of retail bulk mail rates would provide transparency and allow identification of anti-competitive activity. If this is not possible then Ofcom should publish an externally audited statement that Royal Mail is complying with its regulatory and competition law obligations. Retail prices should be explicitly based on underlying access prices.

- Ofcom's strategy has been to rely on competition as the main regulatory lever but Ofcom's failure to promote competition has resulted in this lever breaking and becoming ineffective. In the short term, Ofcom now needs to impose comprehensive regulatory controls on Royal Mail whilst still promoting competition that is a more effective form of long term regulation.

Parcels

- In an environment of numerous parcel resellers (Parcel Monkey and similar) it is now quite easy for consumers to select an alternative to Royal Mail for the occasional parcel they need to send cost-effectively.
- The dynamics of the parcel delivery market are complicated by the emergence of alternative delivery mechanisms such as collection points and locker banks. The manner in which these have developed place certain parcel carriers at a competitive advantage because they have an ownership relationship with the delivery mechanism or have a “first mover advantage”, each of these factors acting to exclude other parcel carriers. Consumers are therefore unable to have parcels delivered using their preferred delivery mechanism.

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