

## CWU Submission to Ofcom Consultation: Securing the Universal Postal Service Proposals for the Future Framework for Economic Regulation

### Introduction

1. The Communication Workers Union (CWU) is the largest union in the communications sector in the UK, representing over 200,000 employees in the postal, telecoms and related industries. It is the recognised union in Royal Mail Group for all non-management grades.
2. The CWU welcomes Ofcom's consultation on the future of postal regulation from 2012 and the opportunity to contribute toward the development of a new regulatory model. Ofcom's consultation marks a significant change in regulation and recognises the failure of the previous regulatory model.
3. The postal industry has experienced great uncertainty in recent years. Royal Mail has faced an unprecedented set of circumstances: premature liberalisation, damaging regulation, the legacy of chronic underinvestment, a massive pension deficit, a declining market and a modernisation programme requiring extensive change for workers. Royal Mail needs greater freedom to compete in order to secure its future and with it that of the universal service. Moreover, the postal industry badly needs a period of greater stability.
4. We welcome many of Ofcom's proposals, particularly around the deregulation of non-universal service products and, though we would prefer to see no mandatory access, we further welcome the direction of changes to the downstream access regime. We believe this package is a minimum necessary to give the postal industry the opportunity for a successful future. It is essential that these changes are secured in full.
5. The Postal Service Act included an obligation on Ofcom to ensure an appropriate commercial rate of return for the universal service. The manner in which Ofcom proposes to apply this is welcome.
6. While we recognise that prices will need to rise to secure Royal Mail's financial position, we have genuine concerns over the impact of Ofcom's proposals on the future affordability of the universal service. We believe the interests of domestic customers and small businesses continue to need some protection.

## Ofcom's Proposals

7. Ofcom is proposing to make the following changes to regulation from April 2012:

- Remove price controls on first class mail, business mail, bulk mail and second class large letters and parcels
- Cap the price of second class stamps for standard letters at between 45p and 55p
- Allow Royal Mail to earn a commercial rate of return on activities associated with the universal service
- Oblige Royal Mail to allow competitors access to its network
- Allow Royal Mail to set access prices; monitor and control the difference between Royal Mail's access and retail prices to prevent price squeeze
- Require notification of any new or developing end-to-end competition; assess its impact on the sustainability of the universal service and where necessary to impose conditions on the operator
- Require Royal Mail to provide extensive financial reporting information

## The Universal Service

8. The CWU welcomes Ofcom's recognition that the universal service faces a real risk from Royal Mail's current financial position and the uncertainty in the mail market. Ofcom's regulatory decisions will go a long way towards deciding the fate of the universal service and it is vital that the regulator does all it can to honour its primary duty to secure its provision.
9. Protecting the universal service means ensuring that Royal Mail - rightly recognised by Ofcom as the only postal operator capable of providing a universal service - is financially secure so that it can continue to provide this universal service; it also means ensuring that the universal service remains affordable.
10. We welcome many of the deregulatory measures proposed by Ofcom. The regulator recognises that the postal industry, with its damaged and declining market, is in a unique position requiring a different approach to regulation. Ofcom is proposing to remove most price controls and give Royal Mail greater freedom to compete. We hope this will enable Royal Mail to improve its financial position.
11. While Ofcom is acting to make the universal service financially secure, it is important that it also gives sufficient regard to its affordability. Ofcom is proposing to remove price controls from universal service products, retaining a price cap on second class mail only. While we recognise that prices will need to rise, we have concerns as to whether Ofcom's proposals will be sufficient to protect the needs of domestic consumers and small businesses. We believe the regulator must retain appropriate monitoring and control mechanisms to ensure the price of all universal service products remains affordable.

12. Domestic customers and small businesses are not protected by the market. Unlike bulk mailers they do not have a choice of postal operator, nor are they likely to do so in the future. It therefore remains essential that these customers continue to have some regulatory protection.
13. In considering its future regulatory approach Ofcom must also have regard to future pressures on the USO. Falling mail volumes, resulting in fewer items per delivery, is putting a strain on the USO as the cost of delivery remains largely fixed while revenue declines. This position is being further exacerbated by a growing number of delivery points, meaning the actual volume of mail is spread to more addresses. The mix of mail being delivered is also changing. Packet volumes are rising while standard letter volumes are declining. And the time taken to deliver these items is not being properly reflected in traffic weighting calculations used by Royal Mail. These factors are combining to mean a higher unit cost for Royal Mail and need to be taken account of when considering financing and efficiency issues in relation to the universal service.

#### Affordability

14. Ofcom is proposing to remove price controls from universal service products and replace them with a price cap on second class stamped standard mail only. The cap is proposed to be somewhere between 45p and 55p.
15. Ofcom refers to Postcomm's February 2011 discussion paper on affordability which claimed that postal services comprise 40p of the £455 average weekly expenditure and concludes this means postal services are affordable for consumers. Despite acknowledging that it has not undertaken any analysis of affordability for small businesses, Ofcom concludes that if prices are affordable for consumers they are also affordable for small businesses.
16. We recognise that reaching a definition for affordability of postal services is not straightforward. Postcomm and now Ofcom have sought to argue that because postal services make up such a small proportion of weekly household spend, prices can rise significantly and still be deemed affordable.
17. This argument initially appears compelling. However, it does not answer what proportion of household spending a good or service would need to make up before it ceased to be affordable. By this measure, if stamp prices rose ten times they would still be affordable. But it is very unlikely that stakeholders would reach the same conclusion. We recognise that Ofcom is not proposing price rises along these lines. Nevertheless we are concerned that their definition of affordability does not rule them out.
18. We believe Ofcom should have a higher regard for the needs of small businesses. The consultation document states that: "it is our working hypothesis that if prices are affordable for consumers they will also be affordable for small businesses". We believe the needs of small businesses and domestic consumers are distinct. Their posting profiles will be different as will their sensitivities to price.
19. Small businesses are very dependent on stamped mail. The Federation of Small Businesses (FSB) has found that 90% of small businesses use stamped mail and use the post office to buy

stamps and send mail. Changes to stamp prices could have a significant impact on the business models and viability of small businesses, who, just like domestic consumers, are and will remain dependent on Royal Mail. Ofcom should give them due consideration and should not simply assume that their interests are in line with consumers.

### Price Controls

20. We are concerned that Ofcom's proposals for deregulating pricing controls on universal service products may not adequately ensure their future affordability. While we recognise that prices will need to rise to secure Royal Mail's future, we think greater regard needs to be given to affordability, not only for the narrow definition of vulnerable customers contained in the Communications Act 2003, but for all domestic customers and small businesses.
21. We would like to see the regulator retain some monitoring and control mechanisms to ensure universal service products remain affordable. Ofcom should fully assess the impact of price rises on domestic consumers and small businesses on an annual basis.
22. This alternative to Ofcom's proposals would still enable price rises, but could better ensure that the interests of universal-service-dependent consumers are protected. Domestic consumers and small businesses have not had their interests served by the introduction of competition; their ongoing protection is necessary.

### Commercial Rate of Return

23. The CWU welcomed the inclusion in the Postal Services Act of an explicit requirement on Ofcom to ensure that the universal service provider is able to make a reasonable commercial rate of return on any investment incurred for or in connection with the universal service.
24. Moreover, we welcome Ofcom's recognition that all costs and revenues associated with the upstream and downstream activities in the former Royal Mail Letters business unit are central to the universal service and that it is on these activities that the business should be able to earn a commercial rate of return. Previously, Postcomm has considered the financing of the universal service simply in terms of the costs and revenues associated with universal service products. This did not adequately reflect the way the universal service operates and the interrelation between universal service and non-universal service products. Royal Mail's ability to provide a universal service is dependent on its national integrated network. All mail passing through this network is associated with the universal service and benefits from its existence.
25. We further welcome Ofcom's recognition that the former approach of calculating a rate of return based on tangible net assets is not appropriate in Royal Mail's case, given its network and costs are largely people based. Instead, Ofcom is proposing to allow Royal Mail to earn a commercial rate of return on all activities connected with the universal service. This will provide Royal Mail with a greater degree of flexibility and allow it to function in a manner that better reflects the operating conditions of comparable companies.

26. With regard to the rate of return proposed by Ofcom, between 5% and 10% EBIT (Earning before Interest and Tax) we would urge the regulator to set the allowed commercial rate of return at the higher end of the scale to allow Royal Mail a greater degree of flexibility. We note that the CEPA paper on the financeability of the universal service which accompanies this consultation shows that the Dutch operator has been allowed a return of 10%. Given the extent to which TNT has been held up as an example of a successful postal operator we would question why it should not equally be appropriate to allow a similar level of return to Royal Mail. Moreover, we understand that for Ofcom to theoretically allow Royal Mail to earn a margin of up to 10% does not guarantee that the company will be able to do so; it simply means that the regulator considers it to be a realistic target and would not seek to intervene while Royal Mail is making returns below this level. We believe that it is reasonable for the company to aim for returns in line with those earned in its highest performing comparators. The regulator should encourage and reflect this by indicating a rate of commercial return at the higher end the scale.

### **Removal of Non-Universal Service Price Controls**

27. The CWU supports Ofcom's approach regarding the removal of price controls on non-universal service products. As Ofcom recognises, Royal Mail is currently in a precarious financial position. The impact of a very restrictive regulatory regime, the early liberalisation of the UK postal services market and falling mail volumes have all threatened the future of Royal Mail's business and consequently the viability of the universal service.
28. Subject to the protection of universal service customers – domestic customers and small businesses – we believe Royal Mail should be given freedom to price products commercially, unrestrained by regulatory price controls. As Ofcom notes, price controls have previously been unsuccessful. We endorse the conclusion that Royal Mail's best chance of success is to allow it to compete fairly and in a deregulated commercial environment. These changes must be implemented in full if Royal Mail is to secure its financial position and ensure the future of the universal service.

### **Access**

29. As we stated in our submission to Ofcom's access review in May 2011, we support the full deregulation of downstream access and are opposed to the mandating of access. We would therefore like to see Ofcom go further than its current proposals; nevertheless, we recognise that Ofcom is proposing a significant move in the right direction and we welcome its proposals for partial deregulation. These deregulatory proposals constitute the minimum necessary changes to give Royal Mail the freedom to compete and it is essential that they are secured in full.

### Mandatory access

30. We do not believe mandating access is necessary or desirable. Ofcom clearly recognises Royal Mail's difficult financial position and the threat this poses to postal services in the UK and the universal service. The introduction of downstream access and the inappropriate regulation that has accompanied it has been a major contributing factor to Royal Mail's current position. We cannot see why the regulator should choose to continue mandating such a system. At a time where the regulator is recognising that the best way to ensure the future of Royal Mail is to remove regulatory intervention, we would urge Ofcom to follow this through consistently and not to mandate access.
31. We do however recognise that Ofcom's proposals mark a significant shift in approach from the current regulatory regime. If access is to be mandated we would support it being limited, as Ofcom proposes, to the Inward Mail Centre (IMC). This is where the bulk of access to Royal Mail's network currently occurs and is a form which sits most appropriately with the company's operational practices; mandating access at other points in the pipeline is likely to be more disruptive and less efficient.

### Pricing

32. We welcome Ofcom's proposals to allow Royal Mail freedom to set access prices. However, we would urge the regulator to ensure this freedom is genuine. In defending itself against criticisms of the access regime, Postcomm routinely stated that it was not responsible for the low level of access prices as these had been agreed by Royal Mail. This description of events does not accurately describe the situation. Our understanding is that Royal Mail reached the first downstream access agreement under pressure of intervention from the regulator. An inappropriate price was thus agreed and reflected in future access prices.
33. We would like the regulator to be mindful of the extent to which it involves itself in the setting of access prices. It is vital that access prices are set at a reasonable level that allows Royal Mail to cover its costs, compete effectively and make a reasonable rate of return. We would therefore urge the regulator to distance itself from this process and not to set the terms of engagement for setting access prices.

### Margin-squeeze control

34. Again, we welcome Ofcom's proposal to remove the current access headroom regulation. This has been a hugely damaging piece of regulation that was kept in place for too long.
35. We recognise that in the absence of appropriate cost data the regulator will wish to be reassured that margin or price squeeze is not taking place. However, we would urge the regulator to ensure that the proposed temporary margin-squeeze control does not inadvertently require Royal Mail to maintain an excessive margin between its access and retail prices.

36. One of our major concerns arising from impact of downstream access has been the extent to which it has undermined Royal Mail's upstream business. The fall in upstream mail volumes has damaged the business financially, but it has also undermined the viability of the Royal Mail's entire upstream operation. A successful integrated end-to-end business is essential for Royal Mail's future and that of the universal service. We need to see Royal Mail not only stem the loss of upstream mail volumes but start to win them back. We hope Ofcom's proposals will not continue to stifle Royal Mail's ability to compete. Moreover, we would urge Ofcom and Royal Mail to work swiftly to ensure the necessary financial data is available to enable the move from this temporary margin-squeeze control to a monitoring approach.

### **End-to-end Competition**

37. We welcome Ofcom's recognition that end-to-end competition poses a threat to the sustainability of the universal service. As is well documented, Royal Mail is facing a very difficult financial situation. The company could not withstand the loss of market share in deliveries. To do so would threaten the viability of the universal service.

38. The Postal Services Act allows for the imposition of a notification requirement on any postal operator entering or expanding into the delivery market. Where developments pose a threat to the universal service Ofcom may impose conditions on the private postal operator. It is very important that this mechanism operates effectively and that the regulator takes swift action in such cases to protect the universal service.

39. We support the introduction of such a requirement and would encourage the regulator to use all the powers available to it to protect the universal service from the potentially damaging impact of competition.

40. We will respond to the regulator's separate and more detailed consultation on the notification requirements in due course.

### **Financial Reporting**

41. We note that Ofcom is proposing to pursue Postcomm's previous proposals for extensive financial reporting. We are sympathetic to Ofcom's need for a clear understanding of Royal Mail's finances - in particular, detail relating to its costs and revenues - in order to regulate effectively. However, we have two key concerns: that Royal Mail should not be unfairly burdened by financial reporting requirements; and that Royal Mail should not be compromised by having to publish financially sensitive information.

42. We have concerns that the level of information Ofcom is requesting that Royal Mail publish may result in an excessive burden on the company, particularly if it is being asked to produce information solely for regulatory purposes. We would urge Ofcom to seek to minimise the extent of the financial reporting it requires of Royal Mail.

43. While we recognise that there is a strong case for Royal Mail to provide extensive financial information to Ofcom, it does not follow that this information needs to be put in the public domain. Competitors' oversight of the regulatory process should not include access to detailed

commercially-sensitive information. Royal Mail's position should not be unduly compromised by the publication of such information; nor should it be required to put in the public domain a level of detail that its competitors would not see fit to publish in relation their own operations.

## Efficiency and Innovation

44. Ofcom argues that Royal Mail must continue to improve efficiency if it is to avoid increasing prices to address falling volumes. The regulator states that if its new regulatory framework does not lead to increased efficiency it will have failed to meet one of its fundamental goals. It is therefore proposing to monitor Royal Mail's performance with the option to re-regulate if Royal Mail is not found to be making adequate efficiency gains.
45. Previous efficiency targets imposed by Postcomm were shown to be unachievable. Ofcom acknowledges this and is therefore not proposing to implement its own explicit efficiency targets. This position is welcome. However, as an alternative the regulator is endorsing the efficiency savings which underpin Royal Mail's current business plan. Therefore in monitoring the extent to which Royal Mail becomes more efficient, Ofcom will monitor whether it achieves the efficiency savings projected in the business plan. This is a cause of serious concern for the union.
46. We question the achievability of Royal Mail's efficiency targets which it is currently struggling to meet, in many cases because these have been ill thought through and are unrealistic. We therefore question a regulatory model based upon such foundations. We would not like to see Ofcom choosing to change the direction of regulation on the basis of Royal Mail's failure to meet the targets in its business plan. Ofcom needs to monitor efficiency based on realistic and achievable goals. It is also important to recognise that efficiency is more complicated than simply meeting targets. Efficiency must not mean reducing costs at the expense of service standards.
47. We would like to see an open debate about the meaning of efficiency in Royal Mail. The debate has too often been muddled, with the implication being that employees are not working well enough and that Royal Mail compares unfavourably to its competitors. Employees at Royal Mail are working hard to implement change and are enduring increasing workloads and the strains of a more physical job as the length of deliveries grows. We need to be realistic about what can be achieved and ensure that efficiency projections are valid.
48. We would like to see greater emphasis on innovation at Royal Mail. The company must become more innovative if it is to secure a future for itself and the UK postal industry. We welcome the announcement of the relaxation the notification requirements on new products and product changes and will respond to this consultation separately. We are further encouraged by a growing focus on the innovation of new products and services in Royal Mail's business plan. Unfortunately it has taken a long time for the business to reach this point. We believe an excessive focus on cost cutting and competition on price alone has also stifled innovation.
49. The regulator must look beyond deregulation to stimulate innovation and consider how it can be positively promoted and encouraged, using what regulatory tools are available. It is crucial that confidence in the postal industry is rebuilt. To achieve this we need a clearly articulated



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and positive vision of a future for Royal Mail and for postal services in the UK. This vision must be facilitated by the regulator and supported by employees and stakeholders alike.

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21 December 2011