Securing the Universal Postal Service

Responsefrom SLG Economics Ltd

including a proposal for a

New Approach to Postal Regulation

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Background: SLG Economics Ltd

SLG Economics Ltd is an economics consultancy set up by Stephen Gibson specialising in the provision of regulatory and competition policy advice to regulators, regulated companies and governments. Stephen Gibson is a recognised expert in this field with over 20 years applied regulatory and competition economics experience in the postal, rail, telecoms, broadcasting and radio-spectrum sectors - 10 years of which have been in the postal sector from both sides of the regulatory fence. Stephen has from 2007 until recently been Chief Economist and Director of Economic Policy at Postcomm – the former independent regulator for postal services in the UK and so is intimately acquainted with the details of postal regulation. He has also been Principal Economist at Ofcom, Head of Economics at Network Rail and Economist and Competition Policy Analyst at Royal Mail.

Stephen Gibson has published articles on postal economics and rail economics in leading academic books and journals. He is an Honorary Lecturer in microeconomics at Birkbeck College, part of London University and Visiting Lecturer at London's City University on their MSc in Regulation and Competition.

This paper is SLG Economics Ltd's response to the proposals set out by Ofcom on 20 October 2011 to regulate the postal sector from April 2012 onwards. It is not confidential.

Executive Summary: SLG Economics' Proposals - a New Approach to Postal Regulation

SLG Economics proposes that Ofcom:

- **Provides greater clarity** over what they will do with the detailed monitoring information they will receive from Royal Mail and **develop structured thresholds** to indicate when regulatory action is appropriate;
- **Safeguards business affordability** to ensure that it does not end up securing the provision of a universal service at **unaffordable**, geographically uniform prices; and
- Supplements the proposed efficiency incentives with **greater oversight of Royal Mail's senior management incentives** to provide a powerful incentive towards cost efficiency and quality of service improvement rather than price increases.

Ofcom's proposals

Ofcom proposes deregulation and removal of price controls on Royal Mail for a 7 year period subject to three safeguards:

- a detailed regulatory monitoring regime;
- a 45-55p cap on second class stamp prices;
- an obligation to provide access to competitors at inward mail centres.

These safeguards are aimed at returning Royal Mail to financial stability by allowing it to increase its prices at the same time as incentivising it to become more efficient, through a combination of the threat of reintroduction of price controls and the preservation of upstream competition.At the same time Ofcom is seeking to safeguard vulnerable customers by capping the price of a basic postal product.

Ofcom's proposed safeguards

Detailed Monitoring Regime

Ofcom proposes a very prescriptive monitoring regime including detailed separate accounts and product profitability information.Much of this information will not be published for commercial confidentiality reasons and will rely on Ofcom having the resources and desire to undertake significant analysis of this large data set on a regular basis. There is very limited explanation in Ofcom's document of the type of analysis that Ofcom are planning to undertake of this data set or what levels / thresholds would cause them to take regulatory action. Given that this is the primary safeguard for customers and competitors in a sector where Royal Mail is dominant or super-dominant in most of the markets in which they operate, SLG Economics believes that a more structured approach is appropriate.

SLG Economics' Proposal

SLG Economics recommends the use of 'warning signs' (orange lights) and 'calls to action' (red lights), based on key thresholds for particular elements, ratios etc. For example to assess cost orientation of pricing, Ofcom might start to be concerned (orange light) if product profits were more than X% of product costs and consider enforcement action if they were more than Y% of product costs. Ofcom would set a range of such monitoring thresholds and regularly report on whether any / how many had been breached by Royal Mail and the action they had taken / were proposing to take to reassure customers and competitors that the problem would be corrected.

A 45-55p Cap on Second Class Stamp Prices

The current price of second class stamps is 36p, before April 2011 it was 31p. Ofcom's 'safeguard' will ensure that second class stamps rise by no more than **25% to 53% next year**.This would be a**45% to 77% price rise in stamp costsover two years** - at a time when inflation is running at around 5% and average pay increases are below 2%. This does not appear to be much of a safeguard for vulnerable residential customers.

Affordability

Ofcom also argues that if prices are affordable for residential customers they will be affordable for businesses customers – this argument does not appear to hold water. While ensuring vulnerable residential customers can afford postal prices ensures that all residential customers can afford postal prices, it does not ensure that all business customers can afford postal prices. An average residential customer spends around 40p per week on postage, a business customer however could spend significantly more – often hundreds or thousands of pounds in a week. A typical small mail order business or E-bay trader might well spend 20-30% of their total costs on postage and have profit margins of 10-15%. A 50% price rise would wipe out their profit margin making postage 'unaffordable' to that business.

SLG Economics believes that Ofcom is at risk of failing its primary duty - to secure the provision of a universal service at **affordable**[1], geographically uniform prices. By failing to consider research into business affordability and the impact on businesses of unconstrained price rises **Ofcom may end up securing the provision of a universal service atunaffordable, geographically uniform prices.** Ofcom therefore needs to make proposals to safeguard business affordability alongside residential affordability.

End-to-end Competition

Ofcom recognise that end-to-end competition can bring benefits to customers through a greater range of services, more choice, innovation and lower prices. It can also benefit the universal service through increased efficiency incentives particularly in Royal Mail's downstream processing and delivery functions where modernisation and cost reduction have been slowest and most difficult for Royal Mail to achieve. However Ofcom are also concerned that such competition may use arbitrage opportunities to put the universal service at risk.

Ofcom's proposal is to require an operator to give advance notice of their intention to provide or expand the scope of their end-to-end activities under a Section 41 notification condition and to assess such competition on a case by case basis against their duties.

[1] Article 12 (first indent) "prices shall be affordable and must be such that **all users**independent of geographical location, and, in the light of specific national conditions, have access to the services provided". The definition of 'User' in Article 2(17) is "any natural or legal person benefiting from postal service provision as a sender or an addressee". This implies the inclusion of commercial corporations, businesses and government departments as well as private individuals.

Unfortunately Ofcom's proposal rather ducks the question of how Ofcom would regulate end-to-end competition were it to emerge. As a result this reduces even further the likelihood of it emerging (given the risk to operators that they will spend time and resources developing proposals that will then be blocked by the regulator) and further weakens the efficiency incentives on Royal Mail. There is a danger that Ofcom will allow only unviable business models or those which do not provide any efficiency incentive benefits for the universal service.

SLG Economics believes that Ofcom needs to give further guidance on its regulatory approach to end-to-end competition.In particular it should consider criteria similar to those used in the rail regulatory regime for assessing whether to allow open access train operators to compete with franchised train operators – for example preventing entry where the proposed business model is primarily abstractive[2] or considering whether the benefits of entry are likely to outweigh the costs.

Efficiency incentives

Ofcom recognises the risk that without a price cap to constrain them Royal Mail may simply raise prices to improve profitability rather than making efficiency savings. Unfortunately under Ofcom's proposals there isn't much to stop Royal Mail doing exactly that:

- Ofcom's threat to reimposeprice caps is if Royal Mail fail to improve efficiency does not appear to be very credible. Given the government's desire to privatise Royal Mail, it is very unlikely that Ofcom would then reimpose price caps on Royal Mail before or immediately after privatisation- having previously promised to remove them and having set up a long term regulatory framework which only included a price cap as an affordability safeguard for vulnerable residential consumers.In any case this is simply a threat to reintroduce a measure that they claim has failed to incentivise efficiency in the past;

- the cap on second class stamp prices at 25% to 52% above the current price is more of an attempt at an affordability safeguard for residential customers than an efficiency driver;

- with competition accounting forless than 1% (around 0.3%) of end-to-end mail and given the uncertainty in the marketplace, and given Ofcom's lack of proposals for the regulation of end-to end competitors, competition cannot be relied upon to drive Royal Mail's downstream efficiency improvements.

As a result there is a very real danger that Royal Mail will seek the 'easy' route to profitability through higher price rises rather than cost cutting and that this ends up

[2]Where the whole basis of the competing business model is to capture revenue from the universal service without any compensating benefits.

exacerbating existing long term decline / e-substitution and leads to an on-going downward spiral of price rises and volume decline. This is particularly the case where Royal Mail managers are rewarded based on short term profitability rather than long term cost efficiency and quality incentives.

A New Approach to Postal Regulation: A Proposal from SLG Economics

There is one important incentive that Royal Mail has reacted to over the current control period that Ofcom have not considered. Royal Mail senior managers have a three year Long Term Incentive Plan (LTIP) as part of their remuneration package which pays out very large bonuses. Adam Crozier received £1.57 million, Ian Duncan received £880,000, Alan Cook received £768,000 and Mark Higson received £1.012 million from the 2007-2010 LTIP scheme[3], other senior Royal Mail managers also received very generous six figure LTIP bonuses.

The basis of the LTIP performance awards were not aligned with the regulatory incentives or the company's financial viability or long term sustainability. They were instead based on Return on Total Assets (ROTA) – a measure of short term profitability. The company's performance against the ROTA targets set in the LTIP plans was (unsurprisingly) very good – in all three years of the plan Royal Mail exceeded the 'On Target' level and in 2009-10 exceeded the maximum level - resulting in a maximum Company Award of 37.5% in that year as set out in Table 1.

Table 1: Royal Mail ROTA Targets, Achievement and LTIP Award

	2007-8	**2008-9**	**2009-10**
On Target	2.1%	8.2%	8.6%
Maximum	5.1%	12.0%	11.0%
RM Achievement	3.9%	10.1%	11.3%
Company LTIP Award	32.5%	30.6%	37.5% (maximum award)

Source: Royal Mail Report and Accounts 2008-09 and 2009-10

In addition there was a multiplying factor of 1.76 for cumulative ROTA performance of 26.1% over the three years.

These results show that if the senior management of Royal Mail are appropriately incentivised they can ensure that the company delivers against specific targetsand that these personal incentives are likely to override or at least severely compromise the efficacy of other regulatory incentives if the two are in conflict or misaligned.

[3] SLG Economics analysis of Royal Mail Annual Report and Accounts 2009-10

UK Regulatory precedent for regulation of management incentives

There is also clear UK regulatory precedent in the rail sector for a regulator approving a regulated company's management incentive plan.Network Rail's Licence requires Network Rail (NR) to obtain approval from the Office of Rail Regulation (ORR) for NR's management incentives.These focus on a delivery objective, an outperformance objective and an accountability and transparency objective which are aligned with ORR's regulatory objectives for the rail sector. In a letter to the Chairman of Network Rail's remuneration committee on 30 April 2010, the Chief Executive of ORR wrote:

"We remain of the view that a properly constructed management incentive plan plays a part in driving your senior managers to achieve and out-perform both your regulatory and business requirements which are aligned with the progress needed to achieve a successful railway."

On 3 March 2011 the Chief Executive of ORR wrote again to the Chairman of Network Rail's remuneration committee that:

"Your proposed decisions on remuneration must also demonstrate how you have taken account of ORR's assessments of the company's performance (early June each year) and efficiency improvement (in mid July each year) and how any underperformance has been reflected in your decisions. You must set out how your management incentive plan and your decisions have reflected any penalties imposed on the company by ORR or the courts."

SLG Economics'Proposal

SLG Economics therefore proposes that Ofcom should supplement the efficiency incentives in their current proposals with greater regulatory oversight of Royal Mail's senior management incentives. This should be at the level of setting high-level objectives (along similar lines to the ORR regime) rather than detailed scrutiny of personal objectives or bonuses - which would lead to micromanagement. It should ensure that Royal Mail managers' personal objectives are aligned with and supportive of the regulatory objectives for the company and that they provide a powerful incentive towards cost efficiency and quality of service improvement rather than price increases.

SLG Economics Ltd
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Annex: SLG Economics Ltd's comments on Ofcom's analysis

Ofcom's analysis of a price cap for Royal Mail

Ofcom considers that the previous price cap regime is not appropriate since it was aimed at preventing excessive profits while profits have been negative rather than excessive. Ofcom should be aware that price cap regimes are aimed at preventing excessive prices rather than excessive profits. Indeed economic regulators have generally been prepared to see regulated companies making very large profits – if these are as a result of outperforming their efficiency targets or growing their businesses more quickly than expected - without considering such profits "excessive".

Ofcom also considers the example of the extra £100m allowed price rise in April 2011 as evidence that the 2006 price control did not work and that the allowed price rise weakens efficiency incentives. However the 2006 price control was only planned to last until April 2010 and therefore was not planned to allow sufficient funds to meet the on-going and unpredicted extra cash demands of the pension deficit for an extra two years. The extension of the price control for two additional years due to the Hooper Review and the 2009 Postal Service Bill was at least partly to blame for weakened efficiency incentives and meant that when faced with financial difficulties Royal Mail was not reopening an existing price cap, but making a bid for extra cash in a one year extension to a price control. Ofcom's analysis of the efficiency incentives of the previous price cap should recognise that the 2006 price control was extended twice with significant uncertainty about the on-going regulatory situation on both occasions as this will have significantly affected the incentives on Royal Mail.