Securing the Universal Postal Service

MCF Response to Ofcom Consultation Technical Annexes

A report by SLG Economics Ltd

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Background and Introduction

On 20th October 2011 Ofcom published their consultation document 'Securing the Universal Postal Service' in which they set out their proposals for the regulatory regime for the postal sector from April 2012 when the current regime expires. The consultation document included detailed technical annexes on regulatory financial reporting and access and attached a consultancy report by Deloitte on regulatory accounting guidelines. The MCF has asked SLG Economics Ltd[i] to provide a technical annex to their response that outlines their views on the three Ofcom annexes.

Executive Summary

The MCF propose that Ofcom:

- **Use a 70% of adjusted FAC minimum headroom** as a safeguard for individual contracts;
- **Use the premium access price** as the transfer price for D+1 mail rather than the standard access price;
- **Provides greater clarity** over what they will do with the detailed monitoring information they receive from Royal Mail and **develop structured thresholds** to indicate when regulatory action is appropriate;
- Use **nested EPMU** to allocate overheads;
- Consider the threshold for Ofcom taking on a dispute to ensure that the dispute resolution process is effective in resolving zonal access disputes.

Margin/price squeeze and Headroom protection

Section 7 of Annex 7 discusses Ofcom's proposals on margin squeeze (which they refer to as 'price squeeze') and the headroom protection.

Ofcom concludes that reliance on competition law alone is unlikely to be sufficient to address the risk to competition from a price squeeze. Ofcom believes that setting a headroom with reference to Long Run Incremental Costs (LRIC) provides the correct signal signals for entry and investment and that in the long term there should be a minimum of a LRIC margin between Royal Mail's access price and the equivalent retail price. However, given the lack of robust LRIC data they propose using a Fully Allocated Cost (FAC) margin with the following adjustments:

- Upstream FAC is calculated as end-to-end FAC less the equivalent access FAC;
- Costs that are non-incremental to upstream activities are excluded including: allocation of central overheads (approx 5-10% upstream FAC) and exceptional costs;
- Including a reasonable rate of return of 5-10% of revenue;
- Further adjustments where there is evidence of non-equivalence that cannot be addressed through operational changes.

The test would cover the services that are included in the scope of the current headroom protection (second class Mailsort and Walksort letters and large letters).

In addition to this average headroom across all protected services they propose a minimum headroom of 50% of adjusted FAC for individual contract prices. The control would be reviewed after 18-24 months with the expectation of moving to a monitoring regime based on LRIC by 2014-15 subject to provision of appropriate data.

MCF response

Ofcom have provided very little justification for the 50% of adjusted FAC safeguard on individual contracts. It does not appear to be based on detailed analysis by Ofcom (apart from noting that overheads account for 25% of Royal Mail's FAC in 2010-11, they suggest that it "strikes an appropriate balance" between allowing Royal Mail to compete and protecting other operators).

MCF analysis (which may be included in individual members' responses) suggests that LRIC is likely to be a minimum 60% of FAC. Many of the costs which Royal Mail might wish to categorise as fixed could be variable in the long run given changes to Royal Mail's operational processes and significant (i.e. incremental rather than marginal) changes in volume. For example in the long run faced with a CEO and senior management team focussed on reducing costs in reaction to a major loss of volume, many overheads which might be fixed in the short term and to small volume changes could be reduced to well below the currrent level of 25% of FAC.

Postcomm has previously estimated LRIC at 60% of FAC and Ofcom have not provided any extra information to move from that estimate. The MCF believe that Ofcom should 'err on the side of caution' in estimating this proportion given that until Royal Mail develops a LRIC costing model any number is likely to be a 'guestimate' and the risks of regulatoty failure in choosing too low a number which could severly damage or wipe out postal competition are greater than using too high a number which would be part of a transition from the current headroom to a LRIC based headroom.

The MCF members have to cover their total fully allocated costs when competing with Royal Mail's upstream bulk business – for many of whom this is their only product. Allowing Royal Mail to price down to LRIC across their 2nd class bulk upstream products and 50% of adjusted FAC on individual contracts would give them a major advantage over competitors. This would significantly reduce the competitive pressure on Royal Mail, reducing the efficiency incentives from competition which Ofcom rightly see as an important safeguard within their proposed regulatory framework. It would also put at risk the benefits that Ofcom has rightly recognised customers have gained from competition such as lower prices, greater choice and increased innovation including day certain and hybrid mail services and improved management information to customers and it would increase the risk of regulatory failure disrupting the market.

The MCF believe that in setting the headroom Ofcom should deliberately 'aim high' i.e set a percentage of FAC that they believe to be slightly above where the actual percentage lies. Using this approach would give Royal Mail a positive incentive to develop LRIC costing quickly – something they have delayed doing for over 5 years so far. If there is any chance that the FAC percentage is lower than the actual LRIC number, there is a strong risk that Royal Mail will continue to delay producing LRIC data in order to benefit for longer from a weaker regulatory constraint. Therefore the MCF believes that as a safeguard and as an incentive on Royal Mail, Ofcom should set the minimum headroom for individual contracts at 70% of adjusted FAC.

Transfer pricing

Ofcom propose that when calculating a transfer price across Line B, the price of a comparable reference access product is used. If there is an operational or activity difference between the downstream services to be transfer priced and the comparable reference access product, the FAC of the operational or activity difference is estimated and added to the reference product price with a 10% mark-up added on for an operating margin on the extra costs incurred.

Ofcom have proposed that transfer prices for D+1 retail products should be calculated using the standard access product price rather than the premium access price. This is because Ofcom were concerned that the premium access prices were significantly higher than standard prices (even taking account of cost differences). This would shift profitability between USO products and downstream services. Ofcom argue that the higher premium price could have reflected willingness to pay, however the very low take up of the premium service suggests that the price may be higher than willingness to pay and given the operational similarities between the handling of first and second class mail during inward processing and delivery, the standard class price is more appropriate. They also argue that the price relativities between D+1 and D+2 may reflect the impact of historic *ex ante* regulation rather than costs or willingness to pay.

MCF Response

The MCF believe that the the appropriate transfer price for D+1 mail is the premium access price. The use of standard rather than premium access price as the transfer price for D+1 services is not consistent with Ofcom's overall principle of equivalence which requires "*available open market or regulated prices of externally provided products and services (where appropriate comparable products and services exist) to be used as the basis of transfer prices*"[1].

As Ofcom says, this principle allows it to understand on a consistent basis the relative profitability and cost orientation of Royal Mail products, prevent anti-competitive behaviour and promote effective competition. It also assists in ensuring that transfer prices are non-discriminatory between Royal Mail's internal use of these services and the use of comparable services by external customers. The profit margin in external prices is shaped by the commercial and regulatory factors in the market, if transfer prices are based on the external prices of equivalent products then those transfer prices will incorporate the relevant margin built into the external price and avoid the need for regulatory judgement to determine the appropriate margin. In this way the principle of equivalence seeks to ensure that transfer prices reflect the relevant commercial and regulatory environment in the same way as corresponding external prices. The principle of equivalence explicitly recognises that regulated as well as commercially set prices should be used as the basis for transfer pricing, therefore the fact that the relativities between D+1 and D+2 may reflect the impact of historic *ex ante* regulation is not a reason for not following the principle.

For First Class retail services Ofcom have sought to justify their proposal to use a standard access tranfer price on grounds (that price may be above willingness to pay and that price may not reflect downstream costs) which they have not sought to apply to other products (they have not for example considered whether transfer prices across Line A, should or

[1] Annex 6 – Regulatory Financial Reporting, Paragraph 1.133

should not use the prices of externally provided products and services) and have used a justification which does not relate to the principle of transfer pricing equivalence.

Premium access does have significant additional costs compared to standard access. It is delivered to the mail centre at midnight when Royal Mail are already busy managing their own peak mail flows while standard access is delivered in the late mornings when mail centres are much quieter. This means that Royal Mail incurs additional capacity costs and also higher staff unit costs (from night-time allowances) to handle premium access compared to standard access. Royal Mail's first class retail products are also delivered into IMCs during the night and processed overnight alongside premium access products in order to be delivered the following morning. Therefore the processing of Royal Mail's first class retail service is more similar to premium access services than it is to standard access services. To ensure equivalence of access for first class products the transfer price should reflect this.[2]

The use of the premium access price as a transfer price would ensure that that transfer prices were non-discriminatory between Royal Mail's internal use of these services for its own first class retail services and the comparable D+1 retail services offered by other operators.

If Royal Mail was paying the same price for its downstream services as its competitors then it would be forced to optimise its operations perhaps releasing capacity and leading to a more efficient use of limited resources. It would also provide a strong incentive on Royal Mail to set the price of premium access at a level closer to the standard access price (plus the addition operational costs involved) which would be more cost orientated and ensure more equivalent access arrangements between Royal Mail's first class retail products and other competitors' next day products. In addition, using a premium access price as a transfer price would transfer revenue from upstream to downstream services, potentially lowering the access price for all mail.

Ofcom monitoring of Royal Mail performance

Ofcom proposes separate regulatory accounts consisting of (i) annual and quarterly income statements to EBIT level (ii) annual balance sheets showing operational assets and working capital and (iii) annual cash flow statements showing operating cash flows. These would be produced for: upstream USO products, upstream non-USO products, downstream services and end-to-end only products. They also propose product profitability splits within the separate accounts to assess the relative profitability of different types of products.

[2] Similarly, were Royal Mail to introduce different retail and access prices for different types of mail (financial, direct mail etc), the transfer price for their retail financial mail or retail direct mail products should reflect the respective financial and direct mail access prices - even though the downstream operational processes are identical and are currently offered as one product.

Royal Mail would be required to publish the following regulatory reports:

- Annual audited and quarterly unaudited income statements and annual balance sheets and operating cash flow statements for the Reported Business and four separate reporting entities;
- Annual audited and quarterly unaudited income statements for universal service amd non-Mails products;
- Annual audited and quarterly unaudited product profitability statements for access, Relay and PAF.

Ofcom are proposing to keep the first two sets of quarterly reports confidential to ensure the methodologies are properly embedded and understand any seasonal variations in the information.

MCF Response

Ofcom's proposals will provide a large body of data on Royal Mail's financial and operational performance. Proper monitoring will rely on Ofcom having the resources and desire to undertake significant analysis of this large data set on a regular basis going forward. There is very limited explanation of the type of analysis Ofcom proposes to carry out, what levels / thresholds would cause them concern or their response if an issue or issues are raised by the analysis. Given that Ofcom is relying heavily on monitoring Royal Mail's data as the primary safeguard for customers and competitors with few additional constraints on Royal Mail's dominant and super-dominant position in most of the postal market in which they operate, a more structured approach is required to reassure customers and competitors.

The MCF believes that the use of warning signs (orange lights) and 'calls to action' (red lights) – based on key thresholds for particular elements, ratios etc should be used to bolster Ofcom's monitoring safeguard. For example Ofcom might start to be concerned (orange light) if profits on a particular product were more than X% of the product costs and consider enforcement action (red light) if profits were more than Y% of product costs. Ofcom could then report on a regular basis whether any / how many of the thresholds had been breached and on any action they had taken / were proposing to take. This would reassure customers and competitors that the problem had been considered and hopefully addressed. A similar warning system might be used where there are concerns that prices are set too low.

Allocation of Overheads

Ofcom considers whether overheads should be allocated using a non-nested Equi-Proportionate Mark-up (EPMU) approach or a nested EPMU approach. They recognise that the nested EPMU approach would provide a more accurate representation of costs and that such a change would be material or close to material (more than 1%), however they balance this against the extra processing costs and time (increasing quarterly processing by 2 days) that Royal Mail claim nested EPMU would require. On balance they consider nested EPMU as appropriate.

MCF Response

Pipeline costs make up around 15% of total FAC and allocating these costs correctly to upstream or downstream activities could make a difference to individual product costs (and therefore prices). The MCF agree with Ofcom that more accurate costing using nested EPMU will provide better cost allocation and improve the quality of Royal Mail's costing data allowing Ofcom to better monitor Royal Mail performance and prevent anti-competitive behaviour as well as promote cost-orientated pricing.

Zonal Access

Ofcom propose to set a 'fair and reasonable' pricing obligation on Royal Mail and to propose guidance on changing the structure of zones, moving postcodes between zones and maintaining equivalence and cost orientation with other prices. These would be implemented via Ofcom's dispute resolution process in the event that Royal Mail could not agree proposed changes with its customers.

MCF Response

While Ofcom's dispute resolution processes once engaged operates to a tight timescale, Ofcom require a high threshold before it is satisfied that the parties are in dispute and that there are no other way to resolve the issue. There is a risk that Royal Mail could use this to draw out a dispute for an extended period before Ofcom become engaged in the dispute resolution process. Ofcom should therefore consider the threshold for taking on a dispute in this area to ensure that the dispute resolution process is effective in resolving zonal access disputes.

SLG Economics Ltd on behalf of The Mails Competition Forum
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[i] SLG Economics Ltd is an economics consultancy set up by Stephen Gibson specialising in the provision of regulatory and competition policy advice. Stephen Gibson is a recognised expert in this field with over 20 years applied regulatory and competition economics experience - 10 years of which have been in the postal sector from both sides of the regulatory fence. Stephen has until recently been Chief Economist and Director of Economic Policy at Postcomm, 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 and Visiting Lecturer at City University on their MSc in Regulation and Competition.