

Annex

Review of the regulation of Royal Mail: CFH Response

Question 1: Do you agree that the evidence summarised in Section 4 and set out in more detail in the annexes to this consultation does not support the imposition of (i) further price controls on parts of Royal Mail's business or (ii) efficiency targets? Please state your reasons and provide evidence to support your view.

No, if anything the evidence presented by Ofcom would appear to counter this view.

Firstly, as stated at various points throughout Section 4, the Universal Service and Royal Mail are now financially stable and are making a commercial rate of return.

Ofcom repeatedly points out that this is at the lower end of the 5-10% EBIT margin that is the measure Ofcom deems appropriate for a commercial rate of return, and Ofcom goes on to use this point, towards the end of Section 4, as justification for not imposing either efficiency targets or price controls on Royal Mail.

This does not appear to follow from the evidence laid out by Royal Mail for several reasons:

1. Royal Mail has reduced the efficiency of its own delivery network

As was stated at 4.65 Analysis Mason have found that voluntary changes to delivery processes made by Royal Mail have reduced the flexibility of Royal Mail's costs in line with short term volume declines, for example the use of Royal Mail's foot network for parcel delivery was a major contributing factor in reducing cost flexibility.

Equally the pay deal reached with the CWU in January 2014 has resulted in Royal Mail being committed to a less flexible, full time workforce except in exceptional circumstances as well as significantly above inflation pay rises, amounting to 9.06% over three years. When staff costs make up roughly 68% of Royal Mail's costs this behaviour is not only inexcusable but is also illogical. While we understand that Royal Mail, at times, has a fractious relationship with its union, we do not feel this excuses the level of these increases in the face of rising prices and poor efficiency gains.

2. Royal Mail have not achieved efficiency potential

All of the analysis obtained by Ofcom shows that Royal Mail has not achieved its efficiency potential by any measure. Ofcom mentioned at 4.57 that the potential efficiency gains for delivery offices is around 10% in gross hours, whereas the average achieved is 5.8% since 2010/11.

Furthermore the spread of efficiency gains across different delivery offices shows that Royal Mail has not yet achieved network wide improvements to the base level of efficiency despite the current regulatory framework having been in place for four years.

Also, as mentioned previously, the fact that Royal Mail have made changes to their delivery network that have reduced its cost flexibility, as opposed to improving it, indicate that Royal Mail is not adequately incentivised to consider efficiency and cost improvements by the current regulatory regime and is not even on a par with comparable national operators who have improved flexibility to deal with fluctuating postal volumes.

Instead consumers, especially those consumers using stamps which have faced the largest cost increases, are subsidising Royal Mails inefficiency.

3. Prices have increased substantially

While, according to Ofcom's analysis, prices have not been increased by as much as could be commercially sustained they have still risen by a substantial amount with USO letter and large letter prices increasing by approximately 34% since 2011.

These price rises are not only vastly more than the cost of wage rises, inflation or cost of materials but are simultaneously disguising underlying problems with cost management and causing irreparable damage to the postal services market.

In previous analysis¹ PWC have demonstrated that price increases made by the national postal operator have a direct and inverse effect on postal volumes. As such we believe that Royal Mails price increases have been a major factor driving e-substitution and postal volume declines and as such postal volume decline should not be considered a valid argument for allowing complete pricing freedom.

4. Pricing freedom has not resulted in a strong EBIT margin

Despite the substantial price increases discussed previously and the adoption of large pension deficits by central government Royal Mail have still not achieved an EBIT margin of above 5.6% demonstrating that pricing freedom alone has not driven behaviour in Royal Mail that allows it to increase its profitability above the lower end of the acceptable EBIT margin as proposed by Ofcom.

Further improvements can only come from efficiency and under the current framework Royal Mail has:

- Reduced the cost flexibility of its delivery network
- Increased prices by, on average, approximately 30% across all services
- Committed to less flexible payment contracts with above inflation pay rises; and
- Not achieved the potential efficiency gains or even industry standard cost flexibility identified by Ofcom or its analysts

¹<http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf>

We do not see any way in which these results can be interpreted as demonstrating that the current regulatory framework is adequately driving efficiency incentives.

Question 2: Do you agree that the regulatory framework should remain in place until March 2022 following the anticipated completion of Ofcom's review by the end of 2016-17? Please state your reasons and provide evidence to support your view.

No.

As discussed above the framework does not currently provide adequate efficiency drivers to ensure Royal Mail achieves a financially viable USO in a sustainable way i.e. not just driven through increased prices.

Given that Royal Mail, mainly through pricing freedom, has managed to achieve an EBIT margin that leads Ofcom to find that the USO is financially stable, the focus now should be on controlling price increases to the benefit of consumers and driving additional margins through efficiency gains.

However while the current framework has been marginally successful in securing the financial viability of the USO we feel it has utterly failed to achieve Ofcom's secondary objective, under the Communications Act 2003 and the Third Postal Directive, of increasing competition to the benefit of consumers.

In fact in the May 2016 document Ofcom repeatedly mentions that it does not see any substantial end to end competition arising whilst ignoring the fact that this has resulted, in a large part, from a regulatory regime that does absolutely nothing to foster competition and little to protect it.

We find it greatly concerning that following the exit from the market of the only substantial competition to Royal Mail, largely as a result of pricing uncertainty created by Royal Mail, Ofcom has not only been seen to do very little about Royal Mail's behaviour but has also suggested that the framework that allowed this to happen is working fine.

Following on from this Ofcom have then gone on to suggest that competition is unlikely to arise in the UK in the foreseeable future, but has taken no steps to address this issue, despite the fact that the Universal Service is considered to be financially stable.

As an end to end competitor in the UK, we feel that Ofcom provides very limited support and no protection to competition from a powerful and occasionally hostile incumbent monopolist. The fact Ofcom has proposed the removal of the current PCOP regime, one of the few protections remaining for end to end competitors, is very concerning and signifies either unwillingness or an inability by Ofcom to support competition in the UK.

We have seen numerous abuses of the PCOP regime by Royal Mail despite the enshrinement of the regime in regulatory conditions and we see no situation where weakening of the current meagre protections for competition will benefit the postal services industry.

Further information and evidence is provided in the attached Confidential Annex 1 at sections 1 and 2 and Confidential Annex 2.

Question 3: Do you agree that the analysis summarised in Section 4 and set out in more detail in the annexes to this consultation accurately reflects the UK postal market? Please state your reasons and provide evidence to support your view.

We mainly agree with Ofcom's analysis however we feel that there are some issues with this analysis:

1. Firstly the analysis ignores the key issue of metered items being considered single piece USO items
2. Secondly the prospect of end to end entry has been analysed in isolation of the impact of the 2012 regulatory regimes impact on competition
3. Thirdly Ofcom's conclusion that the regulatory regime is achieving its aims does not appear to be supported by the facts

1. Metered Items as Part of the USO

As we have raised in previous consultation responses we do not feel that Metered Items fit within the requirements of a Universal Service product as defined by the Postal Services (Universal Postal Service) Order 2012.

Article 7 of the Postal Services Order requires that collections for letters that are part of the "end to end services at affordable prices" (defined in Schedule 1) are collected 6 times a week, Monday to Saturday. Collections from franking Post Boxes only take place Monday to Friday, on Saturday the user would have to take their items directly to the Post Office.

Franking Post Boxes are also significantly less available than standard Post Boxes. This would not be an issue except that franking mail cannot be placed in normal Post Boxes, immediately demonstrating that the collection of the service is not as ubiquitous as standard Universal Service products.

Article 8 of the Postal Services Order requires that "end to end services at affordable prices" are provided:

- a) at affordable prices determined in accordance with a public tariff which is uniform throughout the United Kingdom;
- b) on fair and reasonable terms; and
- c) every day on which a collection is required by article 7.

To address these points one at a time:

- a) While the prices are clearly affordable, as they are a long way below the current stamp prices, we would argue that the "tariff" is effectively not uniform. Royal Mail's tariff, i.e. the

cost of the postal service, may be uniform however this does not take account of the fact that in order to access the service customers must either purchase or lease a franking machine, the cost of which varies depending on the commercial abilities of the company negotiating the contract. Equally maintenance and consumable costs will also vary depending on the commercial organisation used and potentially on the volume of letters sent via the franking machine (especially in the case of consumables). See section 1.1 on Franking Costs below.

- b) It could be argued that terms of lease and/or maintenance (both of which are required to use franking services) which prevent a customer from easily switching to other cheaper or more beneficial services for, potentially, several years are not fair and reasonable.
- c) As discussed before franked mail does not appear to be collected in accordance with Article 7.

Finally, the definition of “end to end services at affordable prices” (see Schedule 1 of the Postal Services Order 2012) requires that such services are “single piece”.

Single Piece means a postal service for the conveyance of an individual postal packet to the addressee, for which the price per postal packet is not subject to any discounts related to:

- a) the number of postal packets sent in connection with the person who paid for the service;
- b) the positioning or formatting of text on the postal packet;
- c) the use of markings which facilitate the use of machines to sort postal packets;
- d) presortation into geographical areas for delivery; or
- e) the purchase of any other conveyance of the same or any other postal packet.

While franking conforms to most of these requirements we would argue that it does not conform to either ss. c) or e) for the following reasons.

Ss. c) requires that no discount is received for the use of markings which facilitate the use of machines to sort postal packets. Through its Mail Mark product Royal Mail makes additional discounts available for franking users that apply the Mail Mark barcode to their mail items. The purpose of this barcode is to facilitate sortation through Royal Mails machines, hence the additional discount, and is in clear contravention of ss. c).

Ss. e) requires that no discount is acquired for the purchase of the conveyance of additional postal packets. Franking requires that a user tops up their franking machine with credit. This credit is not easily removed and can only be used to purchase the conveyance of additional postal packets meaning that the discount acquired through franking is only achieved through this commitment.

The above would appear to indicate that franking is not a Universal Service product within the limits of the Postal Services Order 2012 and should not be designated as such.

1.1 Franking Costs

At 4.83 Ofcom states the following in regards to Bulk Mail Products “In line with the definition of ‘single piece service’ in the Universal Service Order, we have defined single piece letters and large letters as those where the price per item is not discounted on the basis of volume... bulk letters and large letters are subject to discounts relating to volume...these services are not included in the universal service and are used by businesses which send large volumes of mail”.

Metered mail products cannot be used in isolation of franking machine contracts nor the purchase of the associated service contracts and the required sundries (namely ink ribbons).

As a result there is effectively a volume related discount when using franking services, as demonstrated below:²

Franking Costs			
Item	Cost Per Item	No. Of	Actual Cost
Monthly Machine Lease	13.95	12.00	£167.40
Annual Maintenance Calculated at 5% of Annual Lease	8.37	1.00	£8.37
Ribbon Ink 3600 items (2000 impressions/ribbon)	25.00	1.80	£45.00
Ribbon Ink 2400 items (2000 impressions/ribbon)	25.00	1.20	£30.00
Ribbon Ink 1200 items (2000 impressions/ribbon)	25.00	0.60	£15.00
Cost of Franking (2nd Class) in pence	0.40		
Number of Letters Sent 2nd Class Per Annum	3,600	2400	1200
Additional Cost Per Item (2nd Class)	0.06	0.09	0.16
Actual Cost Per Item (2nd Class)	0.46	0.49	0.56
Total Cost	1660.77	1165.77	670.77

2. Impact of the 2012 Regulatory Regime on Competition

² This ignores top up surcharges which some franking machine companies charge

Ofcom has itself highlighted the failure of the current regime to foster competition, one of the aims of the Third Postal directive that was enacted by the PSA 2011.

4.84 - Overall, we find that Royal Mail remains a near monopolist facing relatively limited competitive constraints in relation to both single piece and bulk letters and large letters. At first glance there does not appear to be a material change in the actual level of competition that Royal Mail has faced since 2012 (as even at the peak of Whistl's delivery operations, Royal Mail was delivering over 98% of all letter volumes). However, following Whistl's exit from end-to-end letter delivery in 2015, we consider the prospect of a significant rival operator to Royal Mail starting end-to-end letter delivery operations in the future has diminished. In this sense, we consider the constraints on Royal Mail in letters and large letters are weaker than they were in 2012 when the prospect of end-to-end entry and expansion was more credible.

Given the position of Royal Mail as a near monopolist in these areas and the lack of any meaningful competition, as well as the exit from the market of Whistl and the substantial price rises across all Royal Mail Products since 2011, we feel it is clear that the current regulatory regime has only achieved half of Ofcom's aims. The universal service is secure but this has been to the detriment, if not effectively subsidised by, the consumers whom Ofcom is supposed to protect.

This is most clearly demonstrated by the price rises across USO letter products. Since 2011 across all USO Letter and Large Letter products prices have increased by roughly 34%³.

In a market with effective competition acting as a proper pricing constraint either these price rises would not have happened or customers would have had the option to switch to viable alternative delivery offerings.

Instead, in place of viable alternative end to end delivery offerings, customers are moving away from post and towards online services.

4.86 It is likely that Royal Mail does face some constraints, particularly given the on-going decline in single piece volumes due to e-substitution. However, the competitive constraints it faces are unlikely to prevent it from profitably raising prices for single piece letters and large letters. Nevertheless, following the significant price increases in 2012 (for example, stamp letter prices increased by circa. 30% and 40% for First and Second Class respectively), Royal Mail has not raised prices as much as our analysis suggests it could have profitably sustained. There may, however, be factors other than competitive constraints such as political pressure, concern about negative publicity and our monitoring regime which have limited Royal Mail's incentives to raise prices further. While that may be the case, it does not affect our assessment of the competitive constraints which Royal Mail faces in respect of single piece letters and large letters.

This point appears to ignore the fact that a substantial influence on Royal Mail's pricing was the intervention by Ofcom following Whistl's withdrawal from the market and the signal from Ofcom that Royal Mail could not do whatever it pleased with pricing. Following Ofcom's intervention it appears that Royal Mail's price increases slowed substantially.

³ See Annex 2

It also does not address the issue that a key driver behind e-substitution is high postal prices and that RM has brought about some of the decline through rising postal prices.

Equally while RM hasn't pushed prices as high as it could have the –lack of competitive constraint on prices has still resulted in substantial price rises and a negative effect on consumers. If not directly through their purchase of stamps then indirectly from increased prices from other service providers and potentially through increased costs of local governance and other areas where there are drivers other than cost for sending mail.

The lack of competition is in part brought about by poor protections for competition within current regime i.e. lack of pricing controls, lack of transparency of individual contractual negotiations (making enforcing controls such as the headroom test difficult), evidential thresholds and the relatively slow speed of enforcement.

3. Conclusions do not appear to be supported by the facts

At 4.102 Ofcom suggest that Royal Mail have not increased prices and profitability at the expense of efficiency gains. This is despite that fact that Ofcom's own analysis shows that Royal Mail is not achieving the efficiency gains it could be achieving, is not performing to the industry standards that are being met by other international postal operators and has reduced the cost flexibility, whilst increasing the cost, of its own workforce.

Furthermore Royal Mail has increased costs across USO letter products by roughly 34% whilst also using its networks to deliver increasing parcel volumes, which have a higher per item value and have helped to mitigate lost value through letter volume decline, and is still only achieving the lower end of a 5-10% EBIT margin range.

These results do not appear to support Ofcom's conclusion that the current framework and market conditions provide sufficient incentives to drive Royal Mail towards making efficiency gains to achieve profitability in place of price rises.

At 4.105 Ofcom states that the maintenance of a financially sustainable Universal Service and maintaining current competitive arrangements for bulk mail are essential to ensure the best outcomes for consumers.

While we agree with this statement in principal it does not appear to go far enough. In terms of the Universal Service we would propose that this should be both financially sustainable and **efficient**. Royal Mail does not appear to have done enough to ensure that it is meeting industry standards of efficiency and consumers appear to be carrying this burden.

As stated previously Royal Mail has only achieved the bottom end of the acceptable EBIT margin despite substantial prices increases so the focus should now be on improving efficiency.

In terms of competition we do not feel that the current regulatory framework has done anything to foster competition in the market place. Though we support all competition, access competition is

not able to exert sufficient competitive constraints on Royal Mail due to its reliance on Royal Mail's network.

The inability of this regulatory framework to support, foster and protect end to end competition is one of its greatest failings and should be given greater emphasis in light of both the exit of Whistl from the market and the financial sustainability of the USO.

We do not feel that the current regulatory framework can achieve this and further to this do not feel that a regulatory framework that achieves only half of its aims can be described as achieving the best outcomes for consumers.

If Ofcom feel that certainty in the market place is essential then providing a regulatory framework with adequate safeguards for competition to prevent repeats of the situation that drove Whistl to exit the market would create greater stability than continuity of the existing framework.

Finally we feel that the constant referral to lower price rises than Royal Mail could "profitably sustain" is not helpful. As Royal Mail have achieved a reasonable commercial rate of return without achieving the required efficiency gains it is clear that this has been done at the expense of the consumer. As the universal service is clearly not under threat Ofcom should not be looking at the profitability of Royal Mail above and beyond this threshold but should instead be focussing on improving competition in the market for the benefit of consumers.

Question 4: Do you agree with our proposal not to amend the Universal Service Order or the DUSP conditions to include tracking as standard on First and Second Class single piece parcels? Please state your reasons and provide evidence to support your view.

Yes.

CFH supports Ofcom's reasoning.

Question 5: Do you agree with our proposal to retain the safeguard cap in its current form? Please state your reasons and provide evidence to support your view.

Yes, competition has not developed sufficiently in this area of the market to provide independent constraints on Royal Mail and the Safeguard Cap is yet to constitute a restriction on Royal Mail's pricing freedom.

This would appear to indicate that the Safeguard Cap is adequate in its current form.

Question 6: Do you agree that we should amend the USPA Condition so that it is clear that access operators cannot be required to accept general terms and conditions that include shorter notification periods than those provided for under USPA 7?

Yes, however we fundamentally agree with other conclusions Ofcom draws in Section 6, predominantly regarding:

1. the 2013 Access Contract and Royal Mails Contractual Power: and
2. Ofcom's assessment of Royal Mail's consultations process

1. The 2013 Access Contract and Royal Mail's Contractual Power

At 6.13 Ofcom feels it necessary to state that no Access users were forced to move to the 2013 contract. We feel that this conclusion can only be drawn if commercial reality is completely ignored. The pricing differential between the contracts, though relatively small in the beginning, was set to increase over the coming months/ years and any Access user who remained on the, legally sounder, old contract would find themselves at an immediate, substantial and growing commercial disadvantage.

In reality there was not any option for any Access user who wished to remain competitive on prices but to move to the new contract.

CFH chose to remain in the old contract as we received strong legal advice against moving to the 2013 contract given the potential risk it could pose to our end to end operations. Following on from this, and as explained in more detail at Confidential Annex 1, we were then subject to an increasing differential price with no apparent justification for such increases.

If commercial negotiation were possible then companies such as ours would not have been forced to accept commercially disadvantageous prices in order to retain an acceptable level of legal protection and certainty.

Furthermore Ofcom states at 6.13 that the contract was offered following a consultation. The 2013 contract received significant criticism during this process, a process that was deemed so severe by the industry that the Working Access Group (WAG) was formed in order to ensure that negotiations were conducted as fairly as possible, and substantial concerns were raised by many Access contract holders.

Many of these criticisms were ignored in the final drafting of the contract and the consultation process appeared to have little influence on the end result.

2. Ofcom's Assessment of Royal Mail's Consultation Process

The access contract consultation was not unusual but was instead indicative of the way in which Royal Mail operates its consultation process.

Royal Mail often presents the results of consultations as a consensus reached by a genuine process when in reality the original positions presented by Royal Mail are often so unworkable as to be thoroughly rejected by the industry. Royal Mail then presents less extreme positions which are less objectionable and presents this as industry consensus and successful consultation.

The example of Mailmark given by Royal Mail at 6.41 is a perfect example of this process at work. For example, one of the "customer improvements" was to halve the surcharge rate after proposing an unworkably high per item rate and receiving very strong customer backlash. If such a rate was based on genuine estimates of the increased costs incurred by Royal Mail as a result of non-conforming items it is not clear how this could be so easily halved unless the original position was not intended to be accepted.

We do not believe that Royal Mail's consultation process has ever reflected the needs of its customers but is simply an exercise designed to provide a veneer of legitimacy.

If a regulatory prescribed consultation process were to be followed this may assist Stakeholders in situations where they felt their concerns were being ignored and may assist them in bringing disputes.

Finally at 6.47 Ofcom states that Stakeholders can bring disputes to Ofcom where agreement can't be reached. Aside from the cost of this process in terms of both time and money we do not feel that Ofcom has demonstrated any willingness to assist in commercial disputes between Royal Mail and Stakeholders.

In our previous experience Ofcom has cited a lack of "consumer harm" as a factor that would prevent a dispute being taken up. This does not appear to indicate that Ofcom would be willing to assist Stakeholders where a fundamentally commercial dispute has arisen with Royal Mail.

Question 7: Do you agree with our proposal to amend the scope of Essential Condition 1 to cover untracked letter and large letter mail, and single piece universal service parcels, and to remove the remaining universal service products from the scope of the Essential Condition 1?

Yes.

Question 8: Do you agree with the proposed streamlining revisions to Essential Condition 1, including the removal of the Mail Integrity Code of Practice, as drafted in Annex 13?

Yes. However we have not found the MICOP requirements onerous and they provide a good baseline for monitoring performance.

Question 9: Do you agree that the proposed drafting of Essential Condition 1 including relevant definitions accurately capture our intended objectives and the intended operators and mail types?

Yes. The changes to the definitions clear up some ambiguity in definitions from previous regimes. We feel a threshold of 250k items is appropriate for ensuring that local end to end operators with a small coverage area but potentially important local contracts are covered by the regulations.

Question 10: Do you agree with the proposed revisions to Consumer Protection 2, including the removal of the PCOP code and agreement, as drafted in Annex 13?

No.

We feel that the PCOP code and agreement offer a fundamental protection to end to end competition in the UK. As stated earlier we do not feel that we would be able to negotiate adequate terms on a commercial basis with Royal Mail and as such would lose all of the protection that PCOP provides us.

At present there are very few protections for end to end competitors within the current framework and we feel that the PCOP code is the foremost of these as it requires that Royal Mail return items to our network within a reasonable time and at a reasonable price and not forward these items to recipients for a surcharge cost.

Equally it ensures that important items that end up in the Royal Mail network accidentally are returned to us promptly to allow us to handle these as required.

Additional evidence and reasoning is provided in Confidential Annex 1 and 2

Question 11: Do you agree that the proposed drafting of CP 2 including relevant definitions accurately capture our intended objectives and the intended operators and mail types?

We feel that the updated definitions improve CP2 and removing references to Code Identifiers is also makes sense.

However we feel very strongly that the removal of the Postal Common Operational Procedures Code would have a hugely negative impact on end to end competition in the UK and would further harm the prospects of meaningful end to end competition.

Given the lack of end to end competition in the UK anything which makes the competitive environment less secure is hugely concerning.

Question 12: Do you agree with our proposal to amend the scope of Consumer Protection Condition 3 so that it retains a minimum requirement for all postal operators, and that additional requirements in relation to redress and reporting would apply to Royal Mail as the universal service provider only?

Yes.

The minimum standards seem appropriate to non USO providers who rarely have reason to use the POSTRS ADR scheme.

Question 13: Do you agree with our proposed drafting of Consumer Protection Condition 3 given our proposal to only apply the additional requirements set out in CP 3.3 in relation to redress and reporting to Royal Mail as the universal service provider?

Yes. We support the reasoning of Ofcom.

Question 14: Do you agree with our proposal to revoke Consumer Protection Condition 5?

Yes.

Question 15: Do you agree with our proposal to remove the one-month notification period for price decreases to Royal Mail's universal service products and services?

No.

We would agree with a reduced notice period.

For competitors of Royal Mail a price decrease without notice could have huge effects on the ability of competitors to respond to Royal Mail's price changes and we feel it is appropriate that competitors are given some notice of price reductions in order to allow them to react.

Question 16: Do you agree with our proposal to reduce the advance notice period for specified collection times to one month (reduced from three months)?

Yes

Question 17: Do you agree with our proposal to remove the advance notice period for latest delivery times (currently at three months)?

Yes

Question 18: Do you agree with our proposed restructuring and drafting of Designated Universal Service Provider Conditions 1.10.1 and 1.10.2, and the removal of Designated Universal Service Provider Conditions 1.10.3?

Yes