



Royal Mail Access Pricing Review

Proposed amendments to the regulatory framework
Annexes 1 to 8

Consultation

Publication date: 2 December 2014

Closing Date for Responses: 24 February 2015

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Annex 1

Responding to this consultation

How to respond

- A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made **by 5pm on 24 February 2014**.
- A1.2 Ofcom strongly prefers to receive responses using the online web form at <http://stakeholders.ofcom.org.uk/consultations/rm-access-pricing/>, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.
- A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email steven.ball@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.
- A1.4 Responses may alternatively be posted to the address below, marked with the title of the consultation.
- Steven Ball
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.
- A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

- A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Steven Ball on 020 7981 3379.

Confidentiality

- A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

- A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at <http://www.ofcom.org.uk/terms-of-use/>

Next steps

- A1.11 Following the end of the consultation period, Ofcom intends to publish a statement in mid 2015
- A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: <http://www.ofcom.org.uk/email-updates/>

Ofcom's consultation processes

- A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.
- A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Graham Howell, Secretary to the Corporation, who is Ofcom's consultation champion:

Graham Howell
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA

Tel: 020 7981 3601

Email Graham.Howell@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

- A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.
- A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.
- A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.
- A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at <http://stakeholders.ofcom.org.uk/consultations/consultation-response-coversheet/>.
- A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing Name/contact details/job title

Whole response Organisation

Part of the response If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name

Signed (if hard copy)

Annex 4

Consultation questions

A4.1 Below is a summary of the questions in this consultation

Consultation question 1: Do you agree with Ofcom's analysis of the case for intervening as proposed in this section?

Consultation question 2: Do you think the options of doing nothing and of imposing a price control on the level of Royal Mail's prices are not appropriate or proportionate?

Consultation question 3: Do you agree with our approach to focus on existing Royal Mail zones to develop our response to the threats to end-to-end competition? If not, please set out your reasons?

Consultation question 4: Is our proposed approach to the definition of 'Zones' appropriate?

Consultation question 5: Do you agree with our proposals regarding Zonal charges address our competition concerns? If not, please explain why.

Consultation question 6: Do you agree with the proposed weighted average rule? If not, please explain why.

Consultation question 7: Do you agree with our assessment of and proposed approach towards tolerances and profile surcharges on national contracts? If not what alternative would you propose?

Consultation question 8: Do you agree that it is appropriate to prohibit non-Zonal sub-national pricing plans at this time? If not please state your reasons.

Consultation question 9: Do you agree that the appropriate measure of cost in relation to our proposals is Zonal FAC by format? If not please state your reasons.

Consultation question 10: Do you agree with our proposal to use historic cost data rather than forecast data? If not please state your reasons.

Consultation question 11: Do you agree that we should require Royal Mail to use the 2012/13 ZCM, subject to a power for Ofcom to specify by direction that a different model be used? If not please give your reasons.

Consultation question 12: Do you have a view on the appropriate volumes to use as weights in the weighted average rule? Please provide reasons for your view.

Consultation question 13: Do you agree that it is appropriate to use format level volumes as the weights in the 'weighted average rule'? If not please give your reasons.

Consultation question 14: Do you agree with our proposal that the legal instrument implementing our proposed regulatory changes will come into force six months after the publication of the final Statement on this review? If not please give your reasons.

Consultation question 15: Do you agree with the proposed scope of our review of the Zonal costing methodology to take place following the publication of our Statement? Are there any other issues that it would be appropriate to consider as part of the review?

Consultation question 16: Do you consider that there is a need for a structured compliance process with respect to the proposed remedies? If so, why and what would be the value of such a process, if not why not?

Consultation question 17: If we were to establish a compliance process what form should it take?

Consultation question 18: Do you consider there is are reasons we should extend the access obligation to the crown dependencies? If so please state your reasons.

Consultation question 19: Do you agree that our proposals are likely to address the concerns we have identified? Are there ways that Royal Mail could take action which would undermine the effectiveness of our proposals?

Consultation question 20: Do you agree with our assessment of the impact of our proposals? If not, please explain why.

Consultation question 21: Do you agree with our proposals, if not please explain why?

Consultation question 22: does the way in which we have drafted the proposed modified access condition appropriately reflect the proposals and in particular do you find it sufficiently clear? In your response, you should suggest alternative wording if you have drafting concerns.

Question 23: Which of our proposed two alternative definitions of 'Relevant Postal Services' discussed above do you prefer and what are your reasons for your preference?

Question 24: Do you agree with our proposal to base the concepts related to the concept and definition of 'Zones' on Royal Mail's own methodology (as referred to above)? If not, please explain in detail why.

Question 25: Do you have any comments on our proposed new concepts and their definitions discussed in this Annex?

Question 26: Do you have any comments on our proposed corrections to the USPA Condition discussed in this Annex that are unrelated to our proposed new remedies in USPA 2.1A, USPA 6A and USPA 6B (and their associated new expressions)?

Question 27: Do you agree with our thinking and proposals for the rounding (decimal places) to assess compliance with our proposed new remedies in USPA 6A and USPA 6B? If not, please explain in detail why.

Annex 5

Impact of end-to-end competition

- A5.1 This Annex sets out in more detail what we consider to be the likely impact of competition in bulk mail delivery in the UK.
- A5.2 In doing so, we consider the benefits and risks of the kind of competition we are seeking to promote through modifications to existing access regulation. We compare these benefits and risks to the counterfactual we consider the likely alternative to our proposed interventions, that is Royal Mail operating as a near monopolist in bulk mail delivery.
- A5.3 We consider both the direct impacts on bulk mail delivery and the potential indirect impacts on related services, most notably USO mail.
- A5.4 This Section is structured as follows:
- First, we summarise our analysis of the potential benefits and risks of end-to-end competition in previous Ofcom publications;
 - We then set out the scenarios we use to assess the benefits and risk of end-to-end competition; namely a scenario in which entry occurs in selected areas of the UK in response to modifications to existing access regulation compared to a situation in which Royal Mail is a near monopolist in bulk mail delivery;
 - Next we discuss the potential benefits and risks of competition in bulk mail delivery, relative to the counterfactual. We consider potential benefits in the context of different types of efficiency gains that could bring benefits for consumers, such as, lower prices. We then consider the possible risks, including the potential for duplication of fixed assets as well as ‘cherry picking’ and related arbitrage opportunities;
 - Finally we apply the above benefit/risk analysis to assess the impact of competition in bulk mail delivery on other relevant mail products, primarily USO mail.
- A5.5 Overall, we provisionally conclude that competition from an end-to-end entrant is likely to lead to net consumer benefits relative to a situation in which Royal Mail acts as a monopolist in bulk mail delivery, as long as we design any modifications to access regulation appropriately. We do not consider such competition poses an immediate threat to the financial sustainability of the USO, and consider it has the potential to result in significant spill-over efficiency benefits for the delivery of USO mail. On balance, in the circumstances, we consider it appropriate to place weight on the need for the universal service to be provided efficiently and therefore the need to preserve the prospect of end-to-end competition, albeit recognising the risk that such benefits may not materialise until beyond the timeframe for which we are in a position to foresee the overall financial position of the universal service.

Analysis of benefits and risks of end-to-end competition in previous Ofcom publications

A5.6 In our October 2011 Consultation, we set out the benefits and risks of competition in postal services generally, identifying the following potential benefits from competition:

- Efficiency incentives on Royal Mail - with firms competing to meet the needs of customers, competitive pressures can help promote efficiency by enhancing the internal incentives of organisations to cut costs which may lead to lower prices;
- Increased innovation - with an increased number of firms competing to meet the needs of customers, firms will have an increased incentive to innovate. An innovating firm may gain market share at the expense of non-innovating firms; and
- Direct benefits for customers - customers may benefit from lower prices and improved customer service for services relative to those that would be offered in the absence of competition.¹

A5.7 We noted there were potential risks from competition. In particular, we observed that introducing competition to a network monopoly environment would lead to static inefficiencies, e.g. the duplication of deliveries to the door, duplication of sortation capacity. We said that if competition involved duplication of fixed network costs, it could increase the overall cost of production. In this case, we said the question for Ofcom was whether the dynamic benefits created by competition would outweigh these static inefficiencies.

A5.8 We said that the backdrop of a declining market exacerbated these issues, as Royal Mail would be exposed to volume and revenue reductions not just from the declining market but also from competition. We noted that if Royal Mail were unable to react sufficiently to competitive pressures it could lose revenues and volumes to such an extent that it endangered the provision of the universal service.²

A5.9 We then considered the specific benefits and risks from end-to-end competition. We noted the potential for end-to-end competition to incentivise efficiency improvements in Royal Mail's delivery network, noting particularly the potential for these benefits to be spread more widely across Royal Mail's delivery network (e.g. efficiencies in processing bulk mail services could be used to reduce the cost of processing universal services). We also considered there was the potential for end-to-end competition to encourage innovation, which could help the financeability of the USO by helping to increase or at least maintain the usage of mail. Finally we noted the potential for end-to-end competition to provide direct benefits to consumers through lower prices and improved consumer services (albeit noting that to the extent that such competition was focussed in certain areas only, the majority of customers would need to continue to use Royal Mail for the items that the end-to-end operators could not deliver).

A5.10 We found end-to-end competition also posed significant risks. We noted the potential revenue impact on Royal Mail was significant, particularly given the size of

¹ October 2011 Consultation, *Securing the Universal Postal Service: Consultation*, 20 October 2011, <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf>, paragraph 7.4.

² October 2011 Consultation, paragraphs 7.5 - 7.7.

the access market and the potential for an entrant to gain these volumes. We noted the USO obligation on Royal Mail to deliver everywhere at the same price creates opportunities for arbitrage whereby an entrant could target lower cost areas and under-cut Royal Mail, who would be obliged to charge a higher price in these areas (although we noted the potential for this risk was reduced if not completely eliminated by Zonal access charges). Finally we noted that an alternative operator could gain a competitive advantage by offering a lower quality service than Royal Mail is allowed to provide under its USO obligation to deliver six days a week. However, we said this kind of entry could still lead to benefits for consumers if it represented efficient entry.

A5.11 As a result, we said that the net effect of end-to-end competition would depend on the form of such competition.³

A5.12 In our March 2012 Statement, we concluded:

“End-to-end competition could potentially provide both costs and benefits to the universal service. On the one hand it would remove business from Royal Mail, challenging its already weak financial position, and, in this sense, might affect the sustainability of the universal service. On the other hand, it potentially increases the incentives on Royal Mail to reduce cost, innovate and focus on customer service. The effect of end-to-end competition on the provision of the universal service will depend on the entrant’s plans and the circumstances which the market and Royal Mail finds itself in at the time. We therefore plan to assess end-to-end competition on a case by case basis.”⁴

A5.13 In this Consultation, we consider the potential benefits and risks of competition identified in the October 2011 Consultation and the March 2012 Statement in relation to the bulk mail delivery market as well as to the USO, where these previous publications were concerned primarily with the net impact on the USO.

Scenarios used for assessment

A5.14 In order to assess the likely impact of competition in bulk mail delivery through modifications to access regulation, we compare the outcomes under two alternative scenarios:

- Scenario 1: Competition from an end-to-end entrant - Royal Mail faces competition from an end-to-end entrant operating its own network in selected areas of the country; and
- Scenario 2: Counterfactual - Royal Mail faces no competition in bulk mail delivery (actual or potential).

³ October 2011 Consultation, paragraphs 7.13-7.22.

⁴ March 2012 Statement, *Securing the Universal Postal Service - Decision on the new regulatory framework: Statement*, 27 March 2012, <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>, paragraph 1.53.

Scenario 1: Competition from an end-to-end entrant

- A5.15 In the first scenario, we assume that we implement modifications to existing access regulation, which support entry by an end-to-end operator in selected areas of the country.
- A5.16 A potential entrant will decide whether or not to roll-out its own delivery network in a particular area by comparing the costs at which it could self-supply with Royal Mail's access charge. Where it can self-supply more cheaply, entry is likely to occur. Thus the geographic scope of entry and the nature of the entrant's costs in entry areas will depend on the structure and level of access charges set by Royal Mail.
- A5.17 We do not anticipate entry occurring on a national scale. There are some less densely populated and more remotely located areas (e.g. certain rural areas) where entry is unlikely to occur, even if Royal Mail chooses to set access charges with a relatively high mark-up over its own costs. Royal Mail's incremental costs of bulk mail delivery are likely to be significantly lower in these areas than those of an entrant by virtue of the fact it is already required to deliver USO mail in these areas. Delivering bulk mail to these areas involves relatively small additional cost to Royal Mail, whereas an entrant would need to recoup its fixed costs over bulk mail volumes only.
- A5.18 We therefore assume an entrant will have significant presence in the London and Urban Zones, and is also likely to cover those parts of the Suburban and Rural Zones that are served by the delivery centres that also cover more densely populated areas. However, our analysis is not specific to a particular pattern of network coverage and instead considers the benefits and risks of competition more generally from an entrant with sub-national coverage.
- A5.19 The incentives for Royal Mail to respond to competition will also depend on the way in which it is able to react through changes to its access charges and retail prices. This will clearly be affected by the nature of access regulation in place.

Scenario 2: Counterfactual

- A5.20 In the counterfactual scenario, we assume that Royal Mail is a monopolist in bulk mail delivery. This scenario is based on our understanding that at present, no competing operator to Royal Mail in the bulk mail delivery has achieved the required minimum scale to make it worthwhile operating a competing end-to-end network.⁵ As such, a competing operator would probably be better off exiting bulk mail delivery completely, rather than remaining as a small-coverage partial-entrant.
- A5.21 Under this scenario, Royal Mail would still face indirect constraints on its behaviour in wholesale delivery. These constraints would arise from the potential for switching by customers at the retail level, either to alternatives to bulk mail (such as electronic communications), by reducing the amount of bulk mail they send, or dropping out of the market altogether.
- A5.22 We assume Royal Mail would continue to face direct competition in the upstream activities in this scenario (i.e. competition from access operators in bulk mail collection and upstream processing). However, we assume it would no longer face

⁵ We note that we believe that this issue could be resolved by implementing modifications to existing access regulation which would support entry and potentially allow competing end-to-end operators to expand to reach this minimum scale.

the threat of entry into bulk mail delivery. This is because we consider that if Whistl abandons its plans to enter bulk mail delivery, no other operator is likely to consider entry at a later date.⁶ In this respect, the counterfactual scenario we consider differs from the status quo, where the threat of entry is likely to act as an additional constraint.

Impact of competition in bulk mail delivery

A5.23 This sub-section looks at the direct impact of the kind of end-to-end competition in bulk mail delivery that is likely to emerge through modifications to existing access regulation (i.e. excluding any impact on related services such as USO mail). We consider the potential benefits and then the potential risks of such competition, before reaching a provisional conclusion on the likely overall balance of these effects.

Benefits of competition in bulk mail delivery

A5.24 In general, rivalry between firms tends to provide strong incentives for all types of efficiency, resulting in better market outcomes for consumers such as lower prices, higher quality and a wider range of services offered. In particular, competition can incentivise improvements in the following dimensions of efficiency (the first two are sometimes grouped as static efficiency):

- Productive efficiency – ensuring there is no inefficiency or waste in production so that goods are produced as cheaply as possible, i.e. costs of production are minimised;
- Allocative efficiency – ensuring that the right combinations of goods and services are produced given the tastes and preferences of consumers, i.e. prices are aligned to marginal or incremental costs; and
- Dynamic efficiency – improvements which occur over time as investment and innovation, for example arising from increased competition, result in the development of new goods and services, and technological advances that make the production of current and future goods and services less costly.⁷

A5.25 Below we analyse the expected benefits of competition in the specific context of competition in bulk mail delivery. For each dimension of efficiency, we discuss in detail:

- The theoretical framework supporting the tendency for competition to incentivise efficiency gains in this area; and
- How we expect these incentives to operate in the context of bulk mail delivery.

⁶ See paragraph 4.22

⁷ Dynamic efficiency can be related back to productive and allocative efficiency, e.g. investment in a process innovation that reduces costs enhances productive efficiency and investment in an innovative new service valued by consumer enhances allocative efficiency. But it is often helpful to identify it as a third type of efficiency, emphasising the incentives to invest and innovate and the development of competition, even if there is potential for overlap with the other two types of efficiency.

Allocative efficiency

Theoretical framework

- A5.26 Competition tends to put downward pressure on the retail price that a provider can charge when compared with a monopoly scenario. As a result, prices tend to be more closely aligned to costs under competition and allocative efficiency is improved.
- A5.27 Even a monopoly provider will face some degree of constraint on its pricing. This constraint comes from the fact that consumers will tend to purchase lower quantities at higher prices, either because they can switch to substitute products outside of the market or because they could just cease purchasing altogether. The more sensitive consumer demand is to such changes in price, the lower will be the mark-up over cost: even when the market is supplied by a monopolist.
- A5.28 When there is more than one provider supplying the market, the same constraints apply as in the monopoly scenario. In addition, each firm will face the further constraint that consumers now have the option to switch to an alternative provider within the same market. Consumers' willingness to do so is typically much greater than it is to switch to substitutes outside of the market or to stop consuming, particularly when competing providers offer a product very similar in its innate characteristics.
- A5.29 Competing providers will therefore have an incentive to undercut one another (subject to recovering their costs) in order to attract customers away from their rivals and grow market share. As a result, constraints on prices will tend to be stronger when there is more than one provider in the market.⁸

Application to bulk mail delivery

- A5.30 Bulk mail delivery services are wholesale services which are used, in conjunction with upstream activities such as collection and sortation, to provide a bulk mail service to retail users. The demand for wholesale delivery services is therefore derived from the retail demand for bulk mail services.
- A5.31 In the absence of competition in delivery services, operators wishing to provide a retail service to end users will have no alternative to purchasing wholesale delivery services from Royal Mail. Under this scenario, access charges may increase from current levels. Since charge control regulation was removed in 2012, Royal Mail has operated under the threat of end-to-end entry and expansion. Setting higher access charges would tend to make entry more attractive in a greater number of areas, which Royal Mail has clear incentives to avoid. If this threat of entry were to disappear for the reasons outlined above, any constraint this threat of entry has placed on Royal Mail's access charges will also disappear and they may increase from current levels, putting upward pressure on retail prices.
- A5.32 There will nonetheless be constraints on the prices Royal Mail can charge for its delivery services. These constraints arise from the fact that any increase in the price of a wholesale input is likely to be reflected, at least in part, in an increase in the retail price. This is particularly true in the context of wholesale delivery services,

⁸ See, for example, Motta (2004), *Competition Policy: Theory and Practice*, p.41-44; and David Begg, Stanley Fischer, Rudiger Dornbusch (2000) *Economics*, Sixth Edition, McGraw-Hill, p. 141-143.

which constitute the large majority of the cost of providing a retail bulk mail service.⁹ In addition, Royal Mail is subject to a margin squeeze condition, which means that it would need to increase its own retail prices by a similar order of magnitude as any increase in access charges.

A5.33 An increase in the retail price of bulk mail is likely to lead to consumers switching to alternatives, notably e-communications, and/or reducing the volume of bulk mail they send. We recognise there is a trend of shifting away from standard bulk mail services to e-communication and that this may act as some constraint on Royal Mail's prices, even in the absence of competition. However, the evidence we have seen suggests this trend is being driven primarily by non-price factors.¹⁰ For the purpose of assessing the strength of constraints from e-substitution on Royal Mail's retail prices, we are interested in how changes in Royal Mail's prices are likely to affect this trend.

A5.34 In the short-term, it is unlikely that changes in Royal Mail's retail prices would have any material effect on the rate of e-substitution. Evidence suggests that bulk mail customers who can easily switch to e-communication may have already switched, while the remaining customers are likely to face some barriers. For example, 18% of UK households, and a considerably higher proportion of older households, do not have access to the internet.¹¹ According to PwC, 42% of consumers who do not use internet banking state that the main reason is concern over security. PwC adds that 34% of consumers who receive financial statements by post do so to keep paper records (as a means to provide proof of address).¹² In addition, around 30% of the non-statement mail sent by financial services companies is difficult to substitute due to regulation (e.g. the requirement for a 'wet' signature) or the delivery of a physical item (e.g. a credit card).¹³

⁹ See paragraph 3.17 of the 2013 end-to-end Guidance.

¹⁰ First, Royal Mail's internal documents projected that e-substitution would occur independently of changes in relative prices. It provided projections of e-substitution from 2013/2014 to 2016/2017 and estimated that e-substitution lie in the range [3<] of total mail volumes per annum depending on the application type. See Document 52, *Mail Volumes and Revenue Trends Report and Business Plan 2014 Projections*, p.487. Second, Ofcom Business Postal Tracker shows that those business customers that expect a decrease in their mail volume believe that it will be due to: i) an increase in the use of e-mails (60%); and ii) the use of other new digital communication methods (16%). See Ofcom, *Business Postal Tracker*, p.1762, 7 June 2014, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2014apr1/Ofcom_Business_Postal_Tracker_Y2_data_tables.pdf. Third, one study estimates that between 2008 and 2011 multimedia competition (mainly e-communications) was responsible for 5.8% of the decline of letter traffic growth on average per annum over the four years independently of changes in the price of mail. See Jarosik et al., *Letter traffic demand in the UK: some new evidence and review of econometric analysis over the past decade*, Published in "Reporting the Postal Sector in the Face of Electronic Competition", edited by Crew and Kleindorfer, Elgar Publishing, 2013. Another study states that e-substitution is driven by both structural and price factors, however "the expected structural decline appeared to dominate the price effect in a five-year horizon". See Veruete-McKay et al., *Electronic Substitution and postal price elasticities: a customer market approach*. Published in "Reporting the Postal Sector in the Face of Electronic Competition", edited by Crew and Kleindorfer, Elgar Publishing, 2013.

¹¹ Communication Markets Report 2014, Figure 4.17, p.262. For adults that are 75 years old or more, internet take-up is only 32%. For adults who are between 65 and 75 years old, take-up is 67%

¹² PricewaterhouseCoopers, *PwC – The Outlook for UK mail volumes to 2023*, 15 July 2013, <http://www.royalmailgroup.com/sites/default/files/The%20outlook%20for%20UK%20mail%20volumes%20to%202023.pdf>. This document has been prepared by PricewaterhouseCoopers for Royal Mail Group, p.22, p.36

¹³ This is consistent with Veruete-McKay et al. (2013) who argue that "as the postal price increases [in the long run], business senders of physical mail look at alternative communication channels to

- A5.35 In the longer-term, we expect changes in Royal Mail's retail price to affect the trend to e-substitution to a greater extent, however the degree is still uncertain.
- A5.36 Overall, we consider that constraints from e-substitution are likely to be relatively limited, at least in the foreseeable future. Indeed, we consider it possible that these longer term trends could even put upward pressure on retail prices in the absence of competition. To the extent these declines in volume are driven by longer term trends rather than by movements in retail price, Royal Mail could face incentives to increase retail prices to (at least partially) offset this reduction in revenue.
- A5.37 Under competition, Royal Mail's choice of mark-up will be constrained by two additional considerations, over and above those constraints which would apply if it operated as a near monopolist in delivery.
- A5.38 Firstly, the mark-up it chooses when setting access charges will affect the scale of entry, with a higher mark-up making entry on a greater scale more likely. This is because, for a given cost base, an entrant would find it more cost-effective to self-supply in marginal areas when access charges are higher. The greater the number of areas an entrant chooses to self-supply, the greater the volume loss Royal Mail will experience as a result of entry. This will tend to encourage Royal Mail to set lower access charges to limit the scale of entry.
- A5.39 Once entry has occurred, Royal Mail's access charges will be indirectly constrained by competition with the entrant at the retail level. Following entry, Royal Mail will compete with an entrant who is self-supplying delivery services in selected areas at a cost equal to or below Royal Mail's own access charge, and purchasing the remainder of its delivery requirements from Royal Mail at a price equal to Royal Mail's access charge. Thus, the entrant's average delivery costs will be equal to or lower than the average charge faced by other operators (including Royal Mail's own retail arm).
- A5.40 The entrant is likely to use this cost advantage to offer a lower retail price to end users in order to increase its share of the retail market. If other operators are not able to respond by cutting their own retail prices, they will lose volumes to the entrant. The volumes switched could be significant, even for small differences in price, because retail users are willing to switch between operators for small price differentials.¹⁴ Where retail volumes are switched from an operator who uses Royal Mail's delivery service exclusively to the entrant, Royal Mail will see a reduction in volumes of its wholesale delivery service.
- A5.41 This indirect constraint from retail level switching is likely to be relatively strong. We understand the scope for access operators to match an entrant's retail price by reducing their margins is limited given that they operate under small margins.¹⁵ The scope for Royal Mail to reduce its own upstream margins is limited further by the margin squeeze condition we have put in place.¹⁶ As a result, most of any reduction in retail price to mitigate retail level switching to an entrant will need to come from a reduction in access charges.

establish with their customers. In the short term, however, not all business senders will be able to switch their customers of electronic channels, so the substitution is relatively small".

¹⁴ For example, in its June 2014 Submission on end-to-end, Royal Mail states that - "To date, competitive tenders have been fought and won over upstream price differentials as low as [redacted] per item". Royal Mail's June 2014 Submission, paragraph 4.6.2.

¹⁵ For example, Whistl told us that its access business operates under small margins with an EBIT figure of [redacted] of total revenue (slide 8 of Whistl Presentation to Ofcom on 20 January 2014).

¹⁶ For the details of the margin squeeze condition, see March 2012 Statement, paragraph 10.154.

- A5.42 Royal Mail is likely to face strong incentives to mitigate volume loss to the entrant, both in influencing its entry decision and in competing at the retail level once entry has occurred. These incentives come from the fact Royal Mail's delivery network exhibits significant economies of scale. Losing volumes to an entrant would entail a loss of profitability not just on the volumes no longer sold to the entrant but also through the increase in unit cost of supplying remaining volumes.¹⁷
- A5.43 Of course, Royal Mail may also choose to respond to these constraints by reducing its cost base rather than simply accepting a lower mark-up. We consider this potential reaction in relation to incentives for productive efficiency below.
- A5.44 Overall, we consider the constraints on Royal Mail's mark-up on its delivery services are likely to be considerably greater under competition from an end-to-end entrant compared to a scenario in which it operates as a monopolist. Although we recognise Royal Mail's current margin on access services is relatively low (around 5%),¹⁸ we do not consider this to be the relevant counterfactual. Instead, we consider that if the threat of entry and expansion by Whistl were to disappear, Royal Mail may set a higher mark-up than it sets today – particularly if the removal of this constraint means Royal Mail is able to off-set some of the likely reduction in future revenues resulting from longer term volume trends by increasing prices. In addition, we note Royal Mail's current low mark-up may reflect in part productive inefficiencies rather than strong competitive constraints, and we consider this possibility in more detail in the sub-section below.
- A5.45 Given the volumes of mail sent by bulk mailers, even small price changes could have a significant overall impact on costs to bulk mail customers.¹⁹ This suggests that the stronger constraints on Royal Mail's retail pricing under competition are likely to lead to significant welfare gains for these customers. In addition, if bulk mail customers, such as banks, experience a reduction in the cost of sending bulk mail, we expect that part of this gain may be passed on to their users in the form of lower prices and/or higher quality of service.

Productive efficiency

Theoretical framework

- A5.46 Productive efficiency is maximised when a good or service of a given quality is produced using the most cost efficient set of inputs and technologies.
- A5.47 A monopoly operator will clearly face some incentives to reduce costs. For a given retail price, the ability to produce the same volume of output at a lower cost will increase overall profits. By passing some of the cost reduction onto retail prices, the monopolist may be able to increase profits further still by encouraging greater consumption.
- A5.48 However, these incentives may not be particularly strong given the weaker constraints acting on the monopolist's retail price compared to a more competitive market. As a result of its ability to charge a higher retail price, it will face weaker

¹⁷ [§<]. We consider that if Royal Mail did not have the pricing freedom to set strategic access charges (which would be limited following implementation of our proposed Zonal access charges remedy), Royal Mail would probably respond to competition by lowering its wholesale access charges and subsequently retail prices.

¹⁸ Ofcom calculations based on Royal Mail's published regulatory accounts.

¹⁹ Bulk mail accounts for around 7.2bn items per year meaning, for example, a 1p change in retail prices could impact costs of sending bulk mail by as much as £72m.

incentives to engage in cost-reducing activities and may be prepared to accept a lower mark-up over a higher cost base than it could in theory achieve. Where there is separation between ownership and control, shareholders will lack any benchmark against which to assess its management, and may be able to exert less effective control as a result. This can give rise to higher costs when managers have incentives to pursue goals other than profit maximisation (e.g. sales maximisation).

- A5.49 Under competition, the stronger constraints acting on the retail price that competing providers can charge will by themselves reduce the scope for firms to accept a higher cost base. In addition, competing firms will face strong incentives to reduce their costs relative to their rivals. Doing so will allow them to under-cut their rival's retail prices by an amount their rivals cannot match, gaining share from rivals while still covering their own costs. The scope for managerial slack will also be reduced under competition as shareholders will be able to benchmark their managers' performances to other competitors in the industry.²⁰
- A5.50 We recognise that, in industries with high fixed costs and low marginal cost, such as bulk mail delivery, there may be upward pressure on total industry costs as a result of competition, despite the stronger incentives for individual operators to minimise their own costs. We consider this issue separately below under the potential risks of competition (see paragraphs A5.77-A5.90). In this sub-section we focus on how competition creates more incentives for productive efficiency.

Application to bulk mail delivery

- A5.51 As set out above in relation to allocative efficiency, Royal Mail acting as a monopolist would still face some constraints on its retail price. These same constraints, along with the incentive to maximise profits, are likely in turn to provide some stimulus to cost reduction.
- A5.52 It is possible that some of these constraints will increase over time, providing greater pressure for Royal Mail to realise cost savings in the future- even as a monopolist. In particular, the potential for e-substitution to increase over time in response to relative price changes may put pressure on Royal Mail to reduce retail prices and, through this, create incentives for Royal Mail to realise productive efficiency gains. However, as set out above, the likely impact and timing of this effect remains unclear.
- A5.53 On the other hand, as mentioned above, constraints on Royal Mail's prices are likely to become more limited if threat of competition from an end-to-end entrant goes away. To the extent the disappearance of the threat of competition lifts some of the current constraint on retail prices, it will also reduce the pressures on Royal Mail to take measures to lower its costs. A lack of competitive constraint in the future would also be likely to increase Royal Mail's ability to off-set some of the impact of declining volumes on profitability with increases in retail price, reducing the extent to which the longer term trends towards e-communication alternatives are likely to act as a spur to efficiency.
- A5.54 If Royal Mail were instead to face competition from an end-to-end entrant, it would face the same incentives to reduce its costs as in the monopoly scenario. In addition, it would face further incentives to reduce costs from the desire to restore

²⁰ See, for example, Motta (2004), *Competition Policy: Theory and Practice*, p.45-51; and Jean Tirole, "The Theory of Industrial Organization", 2003, p.34-50 and p.75-76.

lost profitability and the need to compete with the entrant at the retail level to prevent further volume loss.

- A5.55 We noted above that in the entry scenario, Royal Mail would face a constraint on its access charges through the impact they have on the entrant's decision regarding where to self-supply. Although Royal Mail would be likely to find it more attractive to cut access charges through a reduction in costs rather than a reduction in margin, entry is likely to occur relatively soon after any modifications to existing access regulation are implemented. As such, it is unlikely to be able to implement efficiencies on the required scale in time to affect the entry decision. Once roll-out has occurred, it is less likely to be able to influence the decision to self supply through further adjustments to its access charges as the entrant will have incentives to recoup investment costs by putting volumes through its network.
- A5.56 Nonetheless, this constraint may still provide impetus to cost reduction. To the extent that Royal Mail's mark-up over existing cost is constrained by the desire to limit the scale of entry, it is likely to look to restore its margin by implementing cost reductions as soon as it can.
- A5.57 Following entry, Royal Mail may lose a material proportion of its volumes to the end-to-end entrant. As Royal Mail's ability to increase access charges will be constrained by competition with the entrant, it will be strongly incentivised to realise efficiency gains to recover some of its lost profitability.
- A5.58 Competition with the entrant at the retail level is also likely to provide strong incentives for cost reduction. As set out above, the entrant is likely to have lower average delivery costs than operators exclusively using Royal Mail's network. This will put downward pressure on Royal Mail's mark-ups in the short term, but in the longer term, it creates a strong incentive to match the entrant by reducing cost base rather than mark-up.
- A5.59 Competition with the entrant is likely to act as a continued impetus to cost reduction. Once in the market, the entrant will face incentives for productive efficiency improvements of its own as a result of competition with Royal Mail.
- A5.60 We expect that any reduction in costs resulting from productive efficiency improvements would then likely to be passed through, at least in part, to bulk mail customers in the form of lower retail prices. This is likely to lead to welfare benefits for bulk mail users and potentially also their customers.
- A5.61 We note that Royal Mail has stated that it is already doing everything it can to improve efficiency.²¹ It argued in its June 2014 Submission that end-to-end competition does not contribute to the already strong incentives on Royal Mail to seek greater efficiency across its business. Instead, it stated that lower workload in Royal Mail's delivery network, combined with a constrained ability to reduce hours, tended to reduce productivity.²²
- A5.62 We recognise that end-to-end competition will lead to loss of volumes for Royal Mail, putting some upward pressure on its unit costs in the absence of any off-setting efficiency initiatives. We discuss this pressure in more detail below. However, we do not agree with Royal Mail that end-to-end competition does not contribute towards incentives for efficiency improvements.

²¹ Royal Mail's June 2014 Submission, p.24.

²² Royal Mail's June 2014 Submission, p.16.

- A5.63 As noted above, Royal Mail has operated under the threat of end-to-end entry and expansion since charge control regulation was removed in 2012. We consider that competition, including the threat of entry and expansion in bulk mail delivery, is a central part of what currently contributes to the incentives for Royal Mail to improve its efficiency (as we had assumed it would be in our March 2012 Statement). There are clear benefits to Royal Mail adopting an efficiency programme in response to this threat of competition as it reduces the attractiveness of entry by signalling that Royal Mail may have the potential to compete more aggressively on price in the future. Delivering efficiency improvements also reduces the scope for entry to occur as it requires any potential entrant to have a lower cost base in order to compete successfully against Royal Mail. If the threat of entry and expansion in bulk mail delivery were to disappear completely for the reasons set out above, any impetus that the threat of competition currently provides to efficiency would lessen. As set out above, the reduced constraint on retail price if the threat of end-to-end competition were to go away may also lead to lower incentives for efficiency relative to current levels. We consider it is important to maintain the pressure on Royal Mail to realise further efficiencies in its delivery network, and see end-to-end competition as a key element of this pressure.
- A5.64 In addition, while Royal Mail stated in its submission that end-to-end competition would not result in any additional efficiency incentives, in meetings and presentations with Ofcom it has shared detailed plans to respond to competition. [redacted].
- A5.65 Overall we consider incentives for productive efficiency would be stronger under competition than they would be if the threat of entry and expansion in bulk mail delivery were to disappear. We consider Royal Mail will respond to these stronger incentives by realising efficiencies at a faster rate than it would under the counterfactual.

Dynamic efficiency

Theoretical framework

- A5.66 Dynamic efficiency refers to the extent to which a firm introduces new products or processes of production, and will be maximised when providers face strong incentives to invest in cost-efficient technology, improve the quality of their current services, and to innovate by launching new and better products that consumers value.
- A5.67 Monopolist providers are likely to face lower incentives to innovate than firms facing some degree of rivalry. This is because competition tends to push firms to invest in improving their products and processes in order to improve their competitive position relative to their rivals.
- A5.68 The relationship between competition and innovation is not straightforward as too much competition, in certain contexts, may also reduce the incentives to invest by reducing the potential returns to innovation. However, although the theoretical and empirical research on the precise nature of the link between market structure and innovation is not conclusive, this literature does tend to support the view that the

complete absence of competition is worse for dynamic efficiency than markets exhibiting some degree of rivalry.²³

Application to bulk mail delivery

- A5.69 Under the monopoly scenario, Royal Mail will face some incentive for dynamic efficiency gains. Declining letter volumes and the increased availability and penetration of e-communications may provide some incentive for Royal Mail to respond to changing user needs by developing products and services that better reflect customer demand. It may also have incentives to invest in cost-reducing technologies as a result of these same pressures, although these incentives may be more limited for the reasons set out in relation to productive efficiency above (i.e. the lesser constraints on its retail price meaning it may accept a reduction in mark-up rather than explore cost-reducing options).
- A5.70 The incentives for dynamic efficiency will be stronger under competition, as Royal Mail will face incentives to adapt to changing user needs not just to counteract longer term trends of e-substitution but also to prevent the erosion of its market share to the entrant. As competition is likely to lead to more pressure on mark-ups, Royal Mail is likely to face stronger incentives to respond to declining letter volumes by investing in cost-reducing technologies. In addition, the presence of a competing delivery operator in the market may lead to greater improvements in dynamic efficiency relative to the monopoly scenario because there are more operators exploring different ways of doing things.
- A5.71 Below we consider the potential for product innovation and process innovation in the bulk mail delivery market in turn.
- A5.72 Product innovation relates to the range and quality of goods/services offered, whether they are new or improved versions of the existing goods/services. An example of product innovation is Royal Mail's Mailmark service,²⁴ recently launched to keep Royal Mail's service offering in line with Whistl's leading tracking services for non-premium bulk mail.
- A5.73 Improved choice allows consumers to better match their preferences with expenditure, which means that consumers are more likely to be able to select a product that offers the right balance between price and quality for them. This is likely to have a positive impact on consumer welfare. In addition, innovation may lead to new opportunities for mail to add value to bulk mail customers through the creation of new products and services.
- A5.74 Process innovation relates to the implementation of new or improved production processes in terms of the delivery network or technology used. An example of this could be investing into the new sorting machines which have higher levels of efficiency, or replacing manual tasks with automated processes which reduce the transit time and costs of delivery.
- A5.75 Process innovation is likely to be a very important aspect of a competitive postal market. This is because the delivery of mail is based on a multitude of interconnected processes, which means improving individual processes or

²³ See, for example, Motta (2004), *Competition Policy: Theory and Practice*, Cambridge University Press. p.55-p.57

²⁴ Mailmark service was launched by Royal Mail in February 2014 and allows tracking of items within the Royal Mail network, raising of issues (such as issues regarding the address of delivery), and confirmation of delivery.

coordination between them could yield significant cost savings for postal operators (and potentially subsequent benefits to consumers). This is consistent with the view expressed by ECORYS that competitive pressure encourages postal companies to increase investments in (new) business development, new (sorting) technologies, new IT systems and other supporting systems, alliances and joint ventures.²⁵

- A5.76 Overall, we consider there is potential for dynamic efficiency improvements in bulk mail delivery to lead to benefits for consumers. The incentives for such improvements will be stronger under competition from an end-to-end entrant than under the counterfactual.

Risks of competition in bulk mail delivery

Cost duplication

Theoretical framework

- A5.77 In industries with high fixed costs (i.e. costs that do not vary with output levels), average costs of production are lower when output is higher - a feature commonly referred to as economies of scale.
- A5.78 It is clear from the above that competition provides incentives for efficiency, putting downward pressure on prices and encouraging firms to minimise costs and invest in improving their services and production processes over time. However, in industries where firms incur significant fixed costs and experience economies of scale as a result, it is not necessarily the case that increasing competition will lead to overall efficiency gains.
- A5.79 Instead, the duplication of fixed costs by competing operators may put upward pressure on average industry costs as the total cost base for each operator is spread over a smaller volume of output than it would be with fewer operators in the market. This loss in productive efficiency may be sufficient to offset the other efficiency gains from competition, depending on the significance of the lost economies of scale compared with the benefits of competition.
- A5.80 An extreme example is that of natural monopoly, where economies of scale are so significant relative to the total size of the market that production costs can only be minimised if one firm serves the whole market. In this scenario, a monopoly may be a more efficient outcome (from the perspective of society as a whole) than competition even from a single rival. However, in the absence of regulation, it would not necessarily lead to better outcomes for consumers given the lack of constraint the monopolist would face when setting prices.²⁶

Application to bulk mail delivery

- A5.81 Bulk mail delivery depends on a network of large-scale labour and machinery to sort and deliver mail, which results in a relatively high proportion of total costs being fixed. If our access proposals are successful in supporting entry, they are likely to result in some duplication of these fixed costs in areas where entry occurs. This is

²⁵ ECORYS 2005 report, *Development of competition in the European postal sector*, July 2005, http://ec.europa.eu/internal_market/post/doc/studies/2005-ecorys-final_en.pdf, page 122.

²⁶ See, for example, David Begg, Stanley Fischer, Rudiger Dornbusch (2000), *Economics*, Sixth Edition, McGraw-Hill, Chapter 19.

in turn likely to lead to some increase in total industry costs - at least until such time as any efficiency improvements are made in response to entry.

- A5.82 The extent of this upward pressure on industry costs will depend on the number of areas the entrant chooses to enter as well as the efficiency of the entrant. The greater the number of areas in which the entrant chooses to roll out, the greater the duplication of fixed costs and the greater the potential increase in industry cost. Clearly, the less efficient the entrant, the greater the increase in industry cost.
- A5.83 There will also be offsetting factors putting downward pressure on costs as a result of entry. In the first instance, we expect competition to lead to greater pressure on prices than under the counterfactual. As a result, we also expect volumes to be larger under competition than they would otherwise be (as lower prices relative to the counterfactual would be likely to result in a slower rate of volume decline). Thus while total industry costs may increase, the effect on average cost is less clear because we expect that higher total costs would be spread over a larger volume base.
- A5.84 More significantly, we set out above the reasons for believing that Royal Mail would be subject to greater incentives for efficiency improvements under competition relative to the counterfactual. In the medium term, we would expect Royal Mail to act on these incentives, putting downward pressure on industry costs.
- A5.85 The overall effect on industry costs will clearly depend on the balance of these effects.
- A5.86 We recognise that any increase in industry cost will represent a loss of efficiency from the perspective of society as a whole. However, we place significant weight on the incentives created by competition for efficiency improvements over time, particularly given the importance that Royal Mail continues to improve the efficiency of its delivery network.²⁷ Competition would also create stronger incentives for Royal Mail to pass any gains from such improvements onto consumers in the form of lower prices, increasing the likelihood that efficiencies are realised in a way that benefits consumers. As a result, we consider the dynamic efficiency gains from competition are likely to outweigh any loss of productive efficiency.
- A5.87 Nonetheless, we would clearly want to minimise the impact of any short term loss of efficiency resulting from entry, and particularly any adverse effect this may have on consumers. We consider both effects can be mitigated through appropriate regulation.
- A5.88 The overall loss of short term efficiency will be smaller the more efficient the entrant. Regulation will tend to promote more efficient entry if operators face access charges that reflect the differences in costs incurred by Royal Mail when providing delivery services to different areas. Charges that reflect this underlying pattern of Royal Mail's delivery costs will tend to encourage operators to self-supply in areas where their own costs are relatively low compared with Royal Mail's, which is likely to reduce any adverse impact of entry on industry costs. It will also reduce the scope for entry in response to arbitrage opportunities rather than on the basis of genuine competitiveness (see below), again acting to reduce any adverse impact on industry cost.

²⁷. [✂]

- A5.89 Moreover, consumers would only be adversely affected by a loss of productive efficiency if it were to put upward pressure on retail prices. In this respect, we note that entry will only occur if an entrant can use self-supply in the areas it chooses to enter in order to offer a lower price to customers at the retail level. The immediate effect of entry will therefore be to put downward pressure on retail prices- even if total industry costs are higher.
- A5.90 Overall, we recognise there is likely to be some duplication of fixed costs and that this will lead to an increase in industry cost, at least in the short term. However, the alternative to this involves monopoly prices and limited incentives for efficiency improvements. We consider competition would act as a strong constraint on prices, expanding the market and creating incentives for Royal Mail to realise efficiencies on a greater scale and more quickly than it otherwise would, putting downward pressure on industry costs and encouraging Royal Mail to pass these benefits onto consumers. We consider these dynamic benefits are likely to outweigh any short term loss of productive efficiency given the importance that Royal Mail continues to make efficiency improvements to its delivery network and the incentives created by competition to pass the benefits of these improvements onto consumers. We also consider we can mitigate the extent of any loss of short term efficiency, as well as the impact this may have on consumers, through appropriate regulation.

Arbitrage opportunities

Theoretical framework

- A5.91 The introduction of competition into markets previously supplied by a single monopolist can lead to problems created by arbitrage, particularly if the incumbent is subject to regulation.
- A5.92 At the retail level, these problems can arise if new entrants are able to target the industry's more profitable customers (i.e. those that can be served at lower cost), leaving the incumbent with a higher proportion of less profitable customers than it served before. This can put upward pressure on the incumbent's average cost base, leading to higher prices for the less profitable customers.
- A5.93 This problem is more likely to arise where there are significant differences in the cost of serving different customer groups and the incumbent is required by regulation to serve all customers at a uniform retail price. Opening up this kind of market to competition can create arbitrage opportunities whereby entrants are able to target cheaper to serve customer groups, quickly winning share from the incumbent who is constrained in its ability to offer a better deal to cheaper customers by virtue of the uniform price requirement.
- A5.94 Similar concerns may apply when an incumbent is subject to a minimum quality of service requirement, as an entrant can target those customers who do not value a higher quality of service by offering a lower quality, lower price service which the incumbent will be unable to match.
- A5.95 Problems of arbitrage can also arise when regulation applies at the wholesale level. For example, a requirement on the incumbent to provide access to its network at a uniform price may create opportunities for arbitrage if the cost of providing access varies to a material degree (e.g. by type of service provided or by time of day). An operator purchasing network access from the incumbent could then choose to purchase services selectively, obtaining more expensive services at the regulated uniform price. This may be attractive for an entrant if it were then able to use access

to these subsidised services to gain an advantage when competing at the retail level. This advantage would not reflect genuine competitiveness on the part of the entrant but rather the fact that the incumbent was effectively subsidising access to its network. It would be likely to lead to worse outcomes for consumers by putting upward pressure on the incumbent's cost base, which would be reflected in a higher access price over time.²⁸

Application to bulk mail delivery

A5.96 Royal Mail has enjoyed a monopoly position in the provision of bulk mail services until recently. As the Universal Service Provider, it is subject to a number of regulatory requirements at both the retail and wholesale level. We therefore recognise the potential for entry to occur in response to arbitrage opportunities.

A5.97 In its June 2014 Submission, Royal Mail argues that a combination of its Universal Service obligations and the regulatory requirement for it to provide Downstream Access (DSA) for D+2 (and later) services creates scope for 'cherry picking' arbitrage by an entrant across three dimensions: areas of coverage, delivery frequency and type of mail.²⁹

A5.98 We consider it possible to design any modifications to the access regime in such a way as to avoid the potential for this kind of arbitrage. In summary, this is because:

- An entrant will be unable to gain an artificial cost advantage by rolling out its network selectively as long as the entrant faces charges which reflect the costs incurred by Royal Mail in providing access services in non-entry areas;
- There is no requirement on Royal Mail to deliver bulk mail at a particular frequency (or level of service). The fact Royal Mail is unlikely to respond to entry by offering a less frequent (or otherwise lower quality) bulk mail delivery service reflects the fact there are significant economies of scope from delivering bulk mail and USO mail over the same network; and
- An entrant will be unable to gain an artificial cost advantage by focussing on particular types of bulk mail as long as Royal Mail is able to set charges for different types of mail on a different basis.

A5.99 We now consider these points in more detail.

A5.100 In relation to the potential for geographic 'cherry picking', we recognise that delivery in different areas is associated with materially different costs, and that entry is likely to occur in selected areas only. We also recognise that Royal Mail is required to provide access services in areas where an entrant chooses not to roll out its own network.

A5.101 However, an entrant would only be able to gain an artificial advantage by entering in selected areas if it were able to obtain access services in non-entry areas at subsidised prices (e.g. because access services were subject to a uniform price

²⁸ For a summary of literature on this in the context of the postal industry, see Hill and Robinson (Royal Mail Group), 2005, Establishing Non-Uniform Access Prices in the UK. Published as Annex 10 of Royal Mail's Response to Postcomm's initial proposals for the 2006 price and service quality review.

²⁹ Royal Mail's June 2014 Submission, p.i and p.33.

requirement). Entry in this case would effectively be paid for by Royal Mail, who would see an increase in its average cost base without any corresponding increase in average access charges. Such entry would be unlikely to be in the interests of consumers as it would not reflect genuine competitive advantage on the part of the entrant and would put upward pressure on Royal Mail's costs.

- A5.102 These problems will not arise as long as an entrant faces Zonal access charges that reflect Royal Mail's delivery costs in different Zones. When this is the case, an entrant would need to pay higher charges for Royal Mail's access services if it chose not to enter in areas associated with a higher cost to Royal Mail and would therefore not be able to gain an artificial advantage by selectively entering in this way. Royal Mail would not be disadvantaged from providing access services to the entrant in higher cost areas because it would receive a higher access charge.
- A5.103 Entry would only be a profitable strategy in this scenario if an operator were able to self-supply in entry areas at a cost below the relevant Zonal access charge. This would limit entry to those operators who had a genuine source of competitive advantage over Royal Mail in the areas they chose to enter, either in terms of the cost of self-supplying delivery, the mark-up they were prepared to accept on their own delivery services or both. We note this point was recognised by Royal Mail itself when establishing non-uniform access charges in the UK. In particular, it quoted Panzar (2002) as saying that the problem of inefficient entry would not occur in response to mandating unbundled access as long as "the prices charged to all services and market segments were subsidy free."³⁰
- A5.104 In addition, we note that it is not necessarily the case that an entrant rolling out its own network selectively will focus on the areas that are low cost for Royal Mail. It may well be the case that an entrant faces relatively lower costs in areas where Royal Mail faces relatively higher costs due to differences in the way they operate their networks. For example, Whistl's business model for end-to-end involves a focus on the London area [§<].
- A5.105 With regard for the potential for arbitrage in relation to frequency of service, we recognise that Royal Mail is subject to a Universal Service obligation to provide collection and delivery services for USO mail six days per week. However, there is no such requirement on Royal Mail for the frequency of delivery of bulk mail. Royal Mail nonetheless chooses to deliver bulk mail six days per week, presumably because there are significant economies of scope in using the same delivery network for both bulk mail and USO mail.
- A5.106 An entrant into bulk mail delivery is likely to face incentives to offer a less frequent service than Royal Mail. Doing so would enable it to consolidate volumes over fewer deliveries, thereby benefitting from economies of scale. We do not consider this to be an artificial cost advantage because there are no regulatory requirements that would prevent Royal Mail from reducing the frequency of its own bulk mail delivery service in response to entry. We recognise Royal Mail is very unlikely to act on this freedom because it would mean giving up the significant economies of scope it currently enjoys in using the same delivery network for both USO and bulk mail. However, this suggests that the cost advantages Royal Mail enjoys from using its USO network for the delivery of bulk mail exceed the cost advantages from operating a bulk mail delivery service on a less frequent basis. The USO requirement is therefore likely to confer a net cost advantage on Royal Mail when

³⁰ Hill and Robinson (Royal Mail Group), 2005, Establishing Non-Uniform Access Prices in the UK, p.5.

competing with an entrant in bulk mail delivery rather than placing Royal Mail at a competitive disadvantage.

- A5.107 Finally, in relation to the types of mail offered, we do not consider it to be arbitrage for an entrant to focus on certain types of mail. We recognise some types of letter are likely to be easier to handle than others (for example, mail that is presented in a particular way). It may well be the case that an entrant chooses to focus on easier to handle types of mail and uses Royal Mail's access service for the remainder. However, as long as Royal Mail remains free to reflect the higher costs of handling this type of mail by setting higher charges for these services, an entrant will not gain an artificial advantage by purchasing these services from Royal Mail rather than supplying them itself.
- A5.108 Overall, we do not consider that the USO or the access regime, as long as any modifications to this regime are appropriately designed, create scope for entry to occur in response to an arbitrage opportunity. Instead, we consider any modifications to the existing access regime can be designed in such a way as to ensure entry will only occur where an operator has a genuine source of competitive advantage over Royal Mail. This will be the case as long as any modifications ensure: (i) an entrant purchasing access services on a selective basis faces access charges that reflect Royal Mail's costs of providing access services in different Zones and (ii) Royal Mail remains free to set different access charges for different types of mail.

Provisional conclusion on the impact of competition in bulk mail delivery

- A5.109 We consider that Royal Mail is likely to face greater constraints on its retail prices and access charges if it is exposed to competition from an end-to-end entrant compared to a situation in which it is a monopoly provider of bulk mail delivery. In particular, we consider competition would act as a strong constraint on prices, expanding the market and creating incentives for Royal Mail to realise efficiencies on a greater scale and more quickly than it otherwise would, putting downward pressure on industry costs and encouraging Royal Mail to pass these benefits onto consumers.
- A5.110 We recognise that competition will result in some duplication of fixed assets and that this may put upward pressure on industry costs- at least in the short term.
- A5.111 However, we consider the dynamic benefits of competition are likely to outweigh any short term loss of productive efficiency this entails, given the importance of Royal Mail continuing to make efficiency improvements in its delivery network and the incentives created by competition to pass the benefits of these improvements onto consumers. We also consider we can mitigate the extent of any loss of short term efficiency, as well as the impact this may have on consumers, through appropriate regulation.
- A5.112 We also recognise the potential for entry to occur in response to an arbitrage opportunity rather than genuine competitiveness. However, we consider that as long as an entrant faces charges that reflect the cost to Royal Mail of providing access services in different Zones, and as long as Royal Mail remains free to set different access charges for different types of mail, the scope for such opportunities will be limited.
- A5.113 As a result, we provisionally conclude that, as long as we design access regulation appropriately, competition in bulk mail delivery is likely to lead to net benefits for

consumers (i.e. the benefits of competition are likely to outweigh the associated risks).

Impact of competition in bulk mail delivery on the USO

- A5.114 In this sub-section, we consider the potential spill-over effects of competition in bulk mail delivery on USO mail.
- A5.115 On the benefits side, these primarily relate to spill-over gains from the greater incentives for productive and dynamic efficiency outlined above.
- A5.116 The potential for such gains arises from the fact that bulk mail and USO mail are delivered over the same network. As a result, any efforts by Royal Mail to reduce the costs of bulk mail delivery and/or to invest in improvements in bulk mail delivery services/processes will also impact USO mail delivery costs and services/processes. As explained above, Royal Mail has stronger incentives to minimise costs and invest in developing products and/or processes in response to competition in bulk mail delivery.
- A5.117 At the same time, we are aware that competition in bulk mail delivery is likely to have an impact on Royal Mail's overall profitability. It is likely to reduce the profits Royal Mail makes from this line of its business - even if it is able to implement the kind of cost efficiencies we expect to be incentivised by competition. In addition, due to the common costs between USO mail and bulk mail we recognise that a decline in the downstream volume will put an upward pressure on cost for all downstream products including USO mail. As a result, it is possible there are some scenarios in which the introduction of bulk mail delivery competition could threaten the financial sustainability of the USO in the longer term.
- A5.118 For the purposes of this review, we have satisfied ourselves that there is no immediate threat to the USO from competition in bulk mail delivery. We also consider there is potential for such competition to lead to efficiency improvements in the delivery of USO mail.
- A5.119 However, both the potential benefits and costs of bulk mail competition depend on the extent of roll-out by any entrant (which will in turn depend on the access charges Royal Mail chooses to set) and its ability to win market share - all of which are currently unknown. In addition, there are a number of other factors likely to have a greater impact than end to end competition on Royal Mail's overall profitability in the long term that are currently uncertain (most notably the impact of parcels and future pension costs).
- A5.120 It is therefore not possible to state definitively that promoting competition in bulk mail delivery will provide a net benefit in relation to the universal service. However, as set out above we do not consider that the provision of the universal postal service is under threat. On balance, in the circumstances, we consider it appropriate to place weight on the need for the universal service to be provided efficiently and therefore the need to preserve the prospect of end-to-end competition, albeit recognising the risk that such benefits may not materialise until beyond the timeframe for which we are in a position to foresee the overall financial position of the universal service.
- A5.121 We do not consider that in so doing, we are creating any risk to the ongoing provision of the universal service. Ofcom monitors the sector continuously and will be carrying out a more detailed review of issues which may affect the longer term

financial sustainability of the USO (pensions, parcels and Royal Mail's efficiency). We therefore consider that we are in a position to identify and react to any emerging threat to the universal service promptly.

Overall provisional view

- A5.122 In light of our analysis above, we consider competition from an end-to-end entrant is likely to lead to net consumer benefits in the bulk mail market relative to a situation in which Royal Mail acts as a monopolist in bulk mail delivery, as long as we design our modifications to access regulation appropriately. We do not consider such competition poses an immediate threat to the financial sustainability of the USO, and consider it has the potential to result in significant spill-over efficiency benefits for the delivery of USO mail. On balance, in the circumstances, we consider it appropriate to place weight on the need for the universal service to be provided efficiently and therefore the need to preserve the prospect of end-to-end competition, albeit recognising the risk that such benefits may not materialise until beyond the timeframe for which we are in a position to foresee the overall financial position of the universal service.
- A5.123 These findings are consistent with our assessment of competition set out in the October 2011 Consultation and March 2012 Statement, which found that end-to-end competition offered significant benefits for efficiency but risked duplication of fixed assets and cherry picking, concluding that the balance of benefits would depend on the type of competition that emerged. We consider we can influence the type of competition that emerges through our design of any modifications to access regulation and would only implement modifications that promoted entry which led to net benefits for consumers.

Annex 6

Proposed modifications – detailed drafting issues for the USPA Condition

Introduction

- A6.1 The purpose of this Annex is to explain our thinking on certain detailed drafting issues for our proposed remedies discussed in the main body of this Consultation mainly related to the concept and definition of ‘Zones’. Like our proposed remedies, these proposed concepts and definitions are included in the statutory notification for our proposed modifications to the USPA Condition, which is published in Annex 9.
- A6.2 We note from the outset that the key concepts and their definitions used in our proposed remedies (especially the concepts of ‘Core Charge’ and ‘D+2 Access Service’) are discussed in the main body of this Consultation. We do not repeat them in this Annex, but we signpost below where we deal with such concepts and definitions in this Consultation.
- A6.3 We also note that, in a few minor places, our proposed modifications to the USPA Condition discussed in this Annex include drafting issues which do not arise from our proposed main remedies, but instead concern minor errors in the USPA Condition which we have identified in the course of our review. While they are not directly related to our proposed main remedies, we consider that it is clearly appropriate for us to take this opportunity to propose these corrections.
- A6.4 We invite stakeholders to provide us with their comments on the detailed drafting issues discussed in this Annex via response to the consultation questions set out at the end of this Annex. In particular, if stakeholders have suggestions on certain drafting points, we would like to receive their detailed reasons for them, including explanations on any practical matters that might arise from our proposed modifications. To assist stakeholders, we have included a marked-up consolidated version of the USPA Condition in its entirety, showing our proposed modifications in highlighting, in Schedule 2 to the notification published in Annex 6. We will discuss below our proposed modifications as they appear from the top to the bottom in Schedule 2.

New: ‘Business Density’ (USPA 1.3 (d))

- A6.5 We deal with this concept below in relation to the concept of ‘Zones’.

New: ‘Core Charge’ (USPA 1.3 (e))

- A6.6 We deal with this key concept and its definition in the main body of this Consultation.

New: specific types of Core Charges, ‘C₁’, ‘C_N’ etc. (USPA 1.3 (f) to (j))

- A6.7 We deal with these key concepts and their definitions in the main body of this Consultation.

New: 'D+2 Access Service' (USPA 1.3 (o))

A6.8 We deal with this key concept and its definition in the main body of this Consultation.

Correction: 'D+2 and later than D+2 Letters and Large Letters services' (currently, USPA 1.3(h); new USPA 1.3(p))

A6.9 We have noticed from the existing definition of 'D+2 and later than D+2 Letters and Large Letters services' in USPA 1.3(h) that it, firstly, omitted a reference to the words 'Letters and Large Letters' immediately after the word 'deliver'. The references to those nouns after the verb were clearly intended by our original decision in 2012 as the intended subject-matter and scope of D+2 Access. Secondly, we have noticed a typographical error in the definition of 'D+2 and later than D+2 Letters and Large Letters services' in USPA 1.3(h) in that it ends with a full stop instead of a semi-colon.

A6.10 We therefore propose to modify this definition as follows (with the specific proposed changes highlighted):

*“**D+2 and later than D+2 Letters and Large Letters services**” means retail services that aim to deliver **Letters and Large Letters** two working days (or later) after collection from the sender, also known as a day C service, or later.”*

New: 'Delivery Office' (USPA 1.3 (q))

A6.11 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Delivery Point' (USPA 1.3 (r))

A6.12 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Delivery Point Density' (USPA 1.3 (s))

A6.13 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Downstream Large Letters Unit FAC' (USPA 1.3 (v))

A6.14 We deal with this concept and its definition in the main body of this Consultation. We use this concept in the specific types of FAC for large letters that we have defined and use in the proposed new remedy in USPA 6A.2.

New: 'Downstream Letters Unit FAC' (USPA 1.3 (w))

A6.15 We deal with this concept and its definition in the main body of this Consultation. We use this concept in the specific types of FAC for letters that we have defined and use in the proposed new remedy in USPA 6A.2.

New: specific types of FAC, 'FAC_l', 'FAC_{ll}' etc. (USPA 1.3 (x) to (ee))

A6.16 As noted above, the specific types of FAC for letters and large letters that we have defined are used in the proposed new remedy in USPA 6A.2. We also deal with these key concepts and their definitions in the main body of this Consultation.

New: 'Financial Year' (USPA 1.3 (ff))

A6.17 We only use this concept once in our proposed modifications, namely in defining the concept of the '2012/13 Zonal Costing Model'. We make reference to that the latter concept in defining the concepts of 'Downstream Letters Unit FAC' and 'Downstream Large Letters Unit FAC'. We deal with these key concepts and their definitions in the main body of this Consultation.

New: 'Geographic Postcode Sector' (USPA 1.3 (gg))

A6.18 We deal with this concept below in relation to the concept of 'Zones'.

New: 'London SSCs' (USPA 1.3 (gg))

A6.19 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Mailing Item' (USPA 1.3 (ll))

A6.20 We propose to use this concept for several of our new concepts and we also make reference to 'Mailing Items' in our proposed remedies themselves. We propose to define it as follows:

"(ll) "Mailing Item" means either a Letter or a Large Letter;"

A6.21 The concepts of 'Letter' and 'Large Letter' are already defined in the USPA Condition (see current USPA 1.3(l) and (m)).

New: 'Mails Characteristics Survey' (USPA 1.3 (mm))

A6.22 We propose to use this concept for our concept of 'London SSCs', which discuss below in relation to the concept of 'Zones'.

New: 'Minimum Posting Requirements' (USPA 1.3 (nn))

A6.23 We deal with this concept and its definition in the main body of this Consultation. We refer to it in our proposed definitions of 'Profile Requirements' and 'Zonal Access Contract'.

New: 'National Access Contract' (USPA 1.3 (oo))

A6.24 We deal with this concept and its definition in the main body of this Consultation. We refer to it in our proposed new remedies in USPA 2.1A and USPA 6B.

New: 'Non-Geographic Postcode Sector' (USPA 1.3 (pp))

A6.25 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Postcode' (USPA 1.3 (qq))

A6.26 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Postcode Sector' (USPA 1.3 (rr))

A6.27 We deal with this concept below in relation to the concept of 'Zones'.

New: 'Profile Requirements' (USPA 1.3 (ss))

A6.28 We deal with this concept and its definition in the main body of this Consultation. We refer to it in our proposed definitions of 'D+2 Access Service', 'Profile Surcharges' and 'Zonal Access Contract'.

New: 'Profile Surcharges' (USPA 1.3 (tt))

A6.29 We deal with this concept and its definition in the main body of this Consultation. We refer to it in the definition of 'D+2 Access Service'.

New: 'Relevant Postal Services' (USPA 1.3 (eee))

A6.30 We use this concept of 'Relevant Postal Services' in defining the specific types of volumes (e.g. V_{IA} , V_{IA} etc., see USPA 1.3(ppp) to (www)) relevant to our proposed new remedy in USPA 6B. We have set out for consultation two alternative definitions of this concept. They are presented to reflect our invitation to stakeholders to comment on the alternatives for the weights to be used in the formula set out in that proposed new remedy, which link the national charge with zonal charges.

A6.31 We discuss the policy and economic issues associated with this choice in Section 6 of the main body of this Consultation. In that discussion, we note that the two options for weightings are:

- total mail volumes in each zone for letters and large letters (that is including USO, Royal Mail bulk mail and Access mail); and
- Royal Mail bulk mail and Access mail in each zone.

A6.32 In our proposed definitions of the specific types of volumes, we refer to the volume of 'Letters' or 'Large Letters' in a given zone that form part of the 'Relevant Postal Services' for that zone. Such 'Letters' or 'Large Letters' volume references therefore serve to narrow down the scope of postal services relevant for our proposed new remedy. However, for reasons discussed in Section 6, we consider that there is a choice of alternative definitions for the concept of 'Relevant Postal Services'.

A6.33 The first option is:

*“(eee)“**Relevant Postal Services**” means all of the following postal services—*

(i) products and/or services provided by the universal service provider for the purpose of complying with its universal service obligations imposed by or under any designated USP condition; and

(ii) products and/or services provided by Royal Mail other than those products and/or services falling within (i) above,”

- A6.34 This option is intended to capture all mail processed by Royal Mail, both USO mail (referred to in (i) of this definition) and the remainder of its mail (referred to in (ii) of this definition) which we understand, at least with respect to Letters/Large Letters, consists of Royal Mail Bulk mail and Access mail.
- A6.35 We should note that we are referring in sub-paragraph (ii) of this definition to ‘Royal Mail’ (instead of ‘the universal service provider’, as in sub-paragraph (i)) because, although they are both referring to the same entity, we wish to avoid any possible ambiguity in using the expression of ‘the universal service provider’ such that this would suggest to capture only the products and/or services provided by Royal Mail acting in its capacity as the universal service provider. That is not our intention. Our proposal is here to capture all products/services provided by Royal Mail.
- A6.36 The second option is:
- “(eee)“**Relevant Postal Services**” means the postal services comprising all products and/or services provided by Royal Mail other than those products and/or services provided for the purpose of complying with universal service obligations imposed by or under any designated USP condition,”*
- A6.37 The difference between this option and the first option is that this second option excludes USO mail, but it similarly to the first option captures Royal Mail bulk mail and Access Mail.

New: ‘SSC’ (USPA 1.3 (jjj))

- A6.38 We deal with this concept below in relation to the concept of ‘Zones’.

New: ‘Standard Terms and Conditions’ (USPA 1.3 (kkk))

- A6.39 We deal with this concept and its amended definition in the main body of this Consultation.

New: ‘Tolerances’ (USPA 1.3 (nnn))

- A6.40 We deal with this concept and its definition in the main body of this Consultation. We refer to it in the definition of ‘D+2 Access Service’.

New: specific types of volumes ‘V_{1A}’, ‘V_{1A}’ etc. (USPA 1.3 (ppp) to (www))

- A6.41 We deal with these volumes and their definitions in the main body of this Consultation. We refer to them in our proposed new remedy in USPA 6B.

New: ‘Zonal Access Contract’ (USPA 1.3 (yyy))

- A6.42 We deal with this concept and its definition in the main body of this Consultation. We refer to it in our proposed new remedies in USPA 2.1A and USPA 6A.

New: 'Zones' (USPA 1.3 (zzz)) and associated concepts

The methodology used as a basis for our proposed concepts

- A6.43 An important feature of our proposed modifications is the concept of 'Zones'. We discuss in Section 5 our reasons why we consider it necessary and appropriate for access operators to be provided with D+2 Access in 'Zones'.
- A6.44 We have based this concept on the methodology that Royal Mail itself is using, and which it has used for some time, in mapping and allocating postcode sectors to so-called 'Zones'. Stakeholders should also be familiar with that methodology as it is set out by Royal Mail in its so-called 'ABC Costing Manual'³¹, a non-confidential version of which is available on Royal Mail Group's website.
- A6.45 Royal Mail states that its methodology explains involves two steps: *"First postcode sectors are mapped to non-London zones defined by reference to delivery point density and the proportion of business delivery points (and for London identified by reference to Standard Selection Codes (SSCs) and secondly postcode sector costs are mapped to zones."* Royal Mail adds that: *"Geographically, mail items are identified by their destination in terms of postcode (e.g. SE15 3UE), postcode sector (e.g. SE15 3), postcode district (e.g. SE15) and postcode area (e.g. SE). By contrast, zonal costs are recorded within Royal Mail by the costs of Inward Mail Centres, the local distribution of mail to delivery offices and the delivery offices themselves (preparation, walks). There is a link in that the postcode sectors fall within the delivery office's area and therefore can be associated with a delivery office and its Inward Mail Centre. Costs can then be allocated to postcode sectors within a delivery office either uniformly per item or taking account of geographic drivers that distinguish postcode sector costs within a delivery office."*³²
- A6.46 In its more detailed description of allocating postcode sectors to zones, we note that Royal Mail explains more broadly that: *"A postcode sector is allocated to London if the majority of volume for its SSC falls within the M25 (details in Section 8.4.2). The zonal allocation of PC sectors outside London is based on the delivery point density and the business density (details in Section 8.4.3)."*³³
- A6.47 We also note that Royal Mail uses the following definition of 'zones' in its Access Letters User Guide,³⁴ which definition summarises the methodology set out in the ABC Costing Manual:

"2. What is a Zone?"

We have analysed the c. 11000 Postcode Sectors in the United Kingdom and have allocated each of these to a Zone according to the criteria as per the table below.

Figure 99: Zone definitions

Zone	Definition
	Where DPD = Delivery Point density and BD = Business Density

³¹ This methodology is set out in Section 8.4 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1, http://www.royalmailgroup.com/sites/default/files/Costing_Manual_%202015-1.pdf

³² Section 8.1 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1.

³³ Section 8.4.1 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1.

³⁴ Access Letters User Guide for Inward Mail Centres, version 4, August 2014, available at: <https://www.royalmailwholesale.com/mint-project/uploads/337921591.pdf>

A (Urban)	<i>(BD >10% and DPD >500) or DPD >1000</i>
B (Surbuban)	<i>DPD <1000 >100</i>
C (Rural)	<i>DPD <100</i>
D (London)	<i>M25 Where the relevant 3 digit Standard Selection Code3 (SSC) is defined as "having more than 50% of their postal delivery volumes going to an area within the M25 boundary"</i>

A6.48 In the ABC Costing Manual³⁵, the methodology for the non-London zones is described as follows:

"For non-London zones, the following data sets are used:

i) The area in square kilometres for every "geographic" PC sector is sourced from Royal Mail using external mapping programs (notably Geoplan¹²). "Non-geographic" PC sectors have no area in square kilometres but can still have a physical geographic location point (e.g. PO boxes).

ii) The number of business and residential delivery points for all PC sectors (both "geographic" and "non-geographic", where the latter are PC sectors for large customers with customer-specific delivery by van, is sourced from Royal Mail's Address Management Unit (AMU) using the Postcode Address File (PAF).¹³

iii) Three-digit Standard Selection Codes and their mail volumes that sit within or overlap the boundary of the M25 are identified by Royal Mail using the MCS.¹⁴

The following methodology is used to allocate PC sectors to zones:

a) Geographic PC sectors with business address density (number of business addresses as a percentage of the total) greater than 10% and delivery point density per km² greater than 500, or delivery point density per km² greater than 1000 regardless of business address density are allocated to the Urban zone (excluding PC sectors allocated to the London zone).

b) Geographic PC sectors with a delivery point density per km² between 100 and 1000 are allocated to the Suburban zone (excluding PC sectors allocated to the London and Urban zones).

c) Geographic PC sectors with a delivery point density per km² less than 100 are allocated to the Rural zone (excluding PC sectors allocated to the London, Urban and Suburban zones).

d) All "non-geographic" sectors have an infinite delivery point density (as they have no area in km²) and are allocated to the London zone when in a London SSC, or otherwise to the Urban zone.

e) All sectors in PC areas GY, IM and JE (Guernsey, Isle of Man and Jersey) are allocated to the Rural zone."

³⁵ Section 8.4.3 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1.

Initial concepts: 'Postcode Sector', 'Postcode', 'Delivery Point' and 'Mailing Item'

- A6.49 It is clear from the above-mentioned methodology that the concept of 'Postcode Sector' is an initial concept that underpins how 'Zones' are defined and ultimately determined under Royal Mail's methodology. However, as we explain below, defining that concept means, in turn, that it is necessary to use (and define) ancillary concepts, such as 'Postcode' (to which 'Postcode Sector' refers). We therefore deal in the following with a number of initial concepts that need to be defined, before we deal with our proposed definitions of the 'Zones' themselves.
- A6.50 We note that Royal Mail has defined 'Postcode Sector' for the purposes of its standard Letters Access Contract (as published on Royal Mail Wholesale's website)³⁶ as *"the first three, four or five alphanumeric digits of an outward Postcode, which is used to identify a geographical area for Mailing Items to be delivered;"*.
- A6.51 We have therefore based our own proposed definition on that contractual definition:
- "(rr) "Postcode Sector" means the first three, four or five alphanumeric digits of an outward Postcode, which is used to identify a geographical area for Mailing Items to be delivered;"*
- A6.52 We have also based our definition of 'Postcode' on Royal Mail's contractual definition³⁷: *"an alphanumeric code owned and developed by us, and allocated by us, to identify a Delivery Point or group of Delivery Points;"*. Therefore, we propose to use the following definition:
- "(qq) "Postcode" means an alphanumeric code allocated by Royal Mail to identify the location of a Delivery Point or group of Delivery Points as recorded and published from time to time in the database known at the time this USPA 6A enters into force as the Postcode Address File (PAF[®])³⁸;"*
- A6.53 Given that the exact meaning of a postcode is capable of alteration by Royal Mail itself through its allocation of such codes, we consider it necessary to add reference to the PAF to make sure that Royal Mail can demonstrate its allocation of postcodes openly and objectively, something which is also required to ensure that the USPA Condition remains transparent.
- A6.54 In light of our proposed definition of 'Postcode', it is necessary, in turn, to define the concept of 'Delivery Point'. We have considered whether to use Royal Mail's contractual definition of this concept.³⁹ However, we consider it more appropriate to

³⁶ See Schedule 1 to General Access Terms and Conditions of Royal Mail's standard Letters Access Contract. See at: <https://www.royalmailwholesale.com/access-letters-contract>

³⁷ See Schedule 1 to General Access Terms and Conditions of Royal Mail's standard Letters Access Contract.

³⁸ Details and access to the PAF[®] are available at http://www.poweredbypaf.com/end-user/products/data-products/paf-raw-data/?gclid=CjwKEAjkf-gBRcd-b2m2aOo0EQSJABMeQDkiRseBYjQHrfopyZQ8wBT87X5c9hSJDjJCkatoqGsGBoCSurw_wcB. Free limited searches for customers who occasionally need to look up address details are available using the Postcode Finder and Address Finder at <http://www.royalmail.com/find-a-postcode>.

³⁹ Namely, *"Delivery Point a postal address (business or residential) to which we deliver Mailing Items"*: see Schedule 1 to General Access Terms and Conditions of Royal Mail's standard Letters Access Contract.

use an alternative formulation, which is consistent with how we have used a similar concept for the purpose of giving a direction under the designated USP condition.⁴⁰ We therefore propose the following definition:

*“(r) **“Delivery Point”** means any home or premises of any individual or other person in the United Kingdom; and any delivery point approved by OFCOM for the purposes of a designated USP condition,”*

A6.55 We note that our (and Royal Mail’s) definition of ‘Postcode Sector’ refers to ‘Mailing Items’. We note that the latter is defined by Royal Mail in its contract⁴¹ as “a *Letter or Large Letter*”. As already explained above, we propose to define ‘Mailing Item’ as meaning either a ‘Letter’ or a ‘Large Letter’, which concepts are already defined in the USPA Condition.

The non-London zones (and associated concepts)

A6.56 To reflect Royal Mail’s above-mentioned methodology for the non-London zones, we propose to define these three non-London zones (together with the London zone) as follows:

*“(zzz) **“Zones”** means the following four geographical areas into which the United Kingdom is divided into for the purposes of this USPA Condition—*

*(i) **“Zone A (Urban)”** means the area comprising all—*

(1) Geographic Postcode Sectors which—

(A) have both a Business Density of more than 10% and a Delivery Point Density of more than 500; or

(B) have a Delivery Point Density of more than 1,000 (irrespective of the Business Density),

but excluding Postcode Sectors falling within the meaning of Zone D (London); and

(2) Non-Geographic Postcode Sectors, but excluding Postcode Sectors falling within the meaning of Zone D (London);

*(ii) **“Zone B (Suburban)”** means the area comprising all Geographic Postcode Sectors which have a Delivery Point Density of between—*

(1) equal to (or more than) 100; and

⁴⁰ See Annex 1 to Ofcom’s Statement entitled *Direction relating to exceptions to the postal deliveries Universal Service Obligation and approval of alternative delivery points*, published on 18 December 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/post-deliveries-uso/statement/Statement_delivery_exceptions.pdf

⁴¹ See Schedule 1 to General Access Terms and Conditions of Royal Mail’s standard Letters Access Contract.

(2) *no more than 1000,*

but excluding Postcode Sectors falling within the meanings of Zone A (Urban) and Zone D (London), respectively;

*(iii) “**Zone C (Rural)**” means the area comprising all Geographic Postcode Sectors which have a Delivery Point Density of less than 100, but excluding Postcode Sectors falling within the meanings of Zone A (Urban), Zone B (Suburban) and Zone D (London), respectively;*

*(iv) “**Zone D (London)**” means the area comprising all Postcode Sectors allocated to one or more London SSCs,”*

A6.57 There is only one substantive difference between our proposed definition of ‘Zones’ and Royal Mail’s own methodology. Namely, under the latter methodology, “*all sectors in PC areas GY, IM and JE (Guernsey, Isle of Man and Jersey) are allocated to the Rural zone*”. However, we propose not to make reference to Channel Islands and the Isle of Man under our definition of ‘Zone C (Rural)’ because such a reference would in its effect impose requirements on Royal Mail in relation to these Islands. We explain in Section 6 our reasons why we consider it inappropriate to impose such regulation.

A6.58 It is further apparent from Royal Mail’s methodology that, in defining the non-London zones, it involves distinguishing between “geographic” and “non-geographic” postcode sectors. Our understanding from that description is that the essence of “geographic” postcode sector in this context is that it refers to a postcode sector that has a geographical area which can be measured in square kilometres. We therefore propose to define it as follows:

*“(gg) “**Geographic Postcode Sector**” means a Postcode Sector for which the denoted geographical area for Mailing Items are to be delivered can be measured in square kilometres (km²);”*

A6.59 We also propose to define a ‘Non-Geographic Postcode Sector’, having the opposite meaning to a ‘Geographic Postcode Sector’, as follows:

*“(pp) “**Non-Geographic Postcode Sector**” means a Postcode Sector other than a Geographic Postcode Sector, such as a physical geographic location point (e.g. PO boxes);”*

A6.60 In relation to allocating “geographic” postcode sectors to specific zones under the methodology, it is further necessary to use and define business (address) density and delivery point density, respectively. Our understanding of the meaning of these concepts as used in the methodology is reflected in the following respective proposed definitions:

*“(d) “**Business Density**” means the number of business addresses expressed as a percentage of total Delivery Points in the Postcode Sector in question; the expression “business addresses” means in this context addresses of places where organisations are situated as recorded and published from time to time in the database known at the time this USPA 6A enters into force as the Postcode Address File (PAF®);”*

(s) “**Delivery Point Density**” means the number of Delivery Points per square kilometre (km²);”

- A6.61 In relation to our proposed definition of ‘Business Density’, we issued a formal information request to Royal Mail asking how it defines the expression “business address” for the purpose of determining ‘business address density’, and what information and sources it uses to identify a “business address”.⁴² We consider that our proposed definition of ‘Business Density’ to be appropriate in light of Royal Mail’s response.
- A6.62 Using above-mentioned proposed defined concepts, we propose to define the three non-London zones (i.e. ‘Zone A (Urban)’, ‘Zone B (Suburban)’ and ‘Zone C (Rural)’ in accordance with Royal Mail’s own description in its above-mentioned methodology.

The London zone (and associated concepts)

- A6.63 Royal Mail’s approach to defining the London zone is, however, very different to defining the non-London zones. In that regard, we note that Royal Mail explains that its methodology is as follows:⁴³

“The London zone is the first to be defined. This uses the 3-digit Standard Selection Codes (SSCs) and their mail volumes that sit within or overlap the boundary of the M25, as identified by Royal Mail using the Mails Characteristics Survey (MCS, see the description in Annex F and in the ABC Costing Manual, section 5.1.1). The 3-digit SSC is used by large bulk mail customers for c120-way sortations. It often corresponds to a PC area (e.g. 108 to PA).¹¹ Each PC sector will map onto one and only one 3-digit SSC because

i) for each PC sector there is one and only one DO,

ii) for each DO there is one and only one 3-digit SSC.

(In 2012 there are 88 3-digit SSCs and around 1.3k DOs and 11k PC sectors in the UK.)

Following a review, for example from a change to the SSC definition, the 3-digit SSCs that have more than 50 percent of their mail volumes going to an area within the M25 boundary are allocated to the London zone. That allocation of 3-digit SSCs then determines the allocation of DOs and its PC sectors to the London zone.

The following detailed points are noted:

■ *An existing SSC can be renumbered within year for operational purposes and in this event the new SSC number is mapped to the same zone as the original number (i.e. London or non-London).*

■ *An existing SSC may be split within year. Where this happens in relation to non-London SSCs it has no effect on the mapping to*

⁴² Information request from Ofcom to Royal Mail dated 24 October 2014.

⁴³ Section 8.4.2 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1.

zones. Where this happens in relation to a London SSC, the mail to the two new SSCs continues to be allocated to the London SSC until the annual update is implemented.

■ Two existing SSCs may be combined within year. Where this happens the two original SSCs are retained until the annual update is implemented.

In practice the splitting and combining of SSCs has been rare and is driven by operational procedures. Hence the purpose of the above process is to allow operational procedures to be updated with minimal impact on the London zone definition within the same financial year.

¹¹ The Royal Mail Selection Files uses numeric coding which identifies each selection in a unique way. The first three digits identify the Residue/ Low Sort selection code, for example 125 is the Residue selection code for the CW, WA and WN postcode areas. This defines the area or Mail Centre to which it belongs. See also "User Guide for Marketing, Publishing and General Correspondence Products" Royal Mail 2012 at:

www.royalmailtechnical.com/rmt_docs/User_Guides_2012/Sorting.pdf "

A6.64 In light of this methodology, and in keeping with the usage of postcode sectors as a consistent reference point in determining specific zones, we understand that, in essence, the London zone comprises all postcode sectors allocated to one or more 'London SSCs'.⁴⁴ Accordingly, we propose to define the London zone as meaning:

"Zone D (London)" means the area comprising all Postcode Sectors allocated to one or more London SSCs,"

A6.65 It is therefore essential to define what is meant by a 'London SSC'. (We have already discussed our proposed definition of 'Postcode Sector' above.) We propose the following definition which, while capturing the key elements of the above-mentioned methodology, contains some specific features which we consider are necessary for reasons discussed below:

"(kk) "London SSCs" means—

(i) at the time USPA 6A enters into force, SSCs numbered 360, 362, 365, 369, 370, 374, 375, 376, 377, 378, 380 and 384; and

(ii) thereafter, if different from the SSCs referred to in (i) above, each and every SSC from time to time notified to OFCOM as having more than 50% of the volume of mail it receives to be delivered to Delivery Points located within the area the outer boundary of which is represented by the London Orbital Motorway (M25),

the expression "notified to OFCOM" means in this context that Royal Mail notifies OFCOM in writing showing to OFCOM's reasonable satisfaction that the SSC in question has (or, as the case may be, has no longer) the said percentage of delivery volume within the M25 identified from the results of the Mails Characteristics Survey

⁴⁴ We note that Royal Mail itself refers to the concept of a 'London SSC' when explaining its methodology for non-London zones: see point d) in section 8.4.3 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1. However, the 'London SSC' concept is not defined as such in that Manual.

and which percentage of volume has remained stable over a period of at least five consecutive months. OFCOM reserves the right to direct Royal Mail to include any SSC which OFCOM reasonably considers falls within the definition of London SSCs, and to exclude any SSC which OFCOM reasonably considers falls outside the definition of London SSCs.”

- A6.66 It is to be noted that the use of ‘Standard Selection Codes’ (SSCs) is an important feature that distinguishes the methodology used for the London zone from the methodology used for the non-London zones. It is therefore essential to firmly embed the ‘SSCs’ concept in the ‘London SSCs’ definition, together with the related traffic volume rule of SSCs “*having more than 50% of their postal delivery volumes going to an area within the M25 boundary*”.⁴⁵ That traffic volume rule is essentially what makes an SSC a ‘London SSC’ under the methodology.
- A6.67 We note that Royal Mail’s contractual definition⁴⁶ of the acronym ‘SSC’ is “*our three digit Standard Selection Code*,” and, in turn, the latter expression is defined in the contract as “*the unique numeric code that identifies the selections as used in the Access Selection Files*,”.⁴⁷ While we consider that it is appropriate to reflect this contractual meaning in our own proposed definition of ‘SSCs’, we consider that it is necessary to include some safeguards in the definition to ensure that Royal Mail is restrained in an appropriate manner in the way that these codes are identified for the purposes of how they apply to our proposed new remedies. In that regard, we note Royal Mail’s own explanation in the above-mentioned methodology, where it states that:

“...Each PC sector will map onto one and only one 3-digit SSC because

i) for each PC sector there is one and only one DO,

ii) for each DO there is one and only one 3-digit SSC.”

- A6.68 We therefore propose to capture the above matters and define an ‘SSC’ as follows:

“(jjj) “SSC” means a unique three digit numeric code used from time to time, as published in data files (known as the ‘Access Selection Files’ at the time that USPA 6A enters into force), by the universal service provider to enable the identification of Mailing Items sorted by Postcode into groups of Postcodes belonging to an individual Postcode Sector for which there is only one Delivery Office as ultimately identified by that numeric code,”

- A6.69 In defining an ‘SSC’, we propose to define a ‘delivery office’ as having the same meaning as it has for the purposes of the designated USP condition⁴⁸, namely:

⁴⁵ See Figure 99 of Royal Mail’s Access Letters User Guide, cited above.

⁴⁶ See Schedule 1 to General Access Terms and Conditions of Royal Mail’s standard Letters Access Contract.

⁴⁷ Royal Mail’s contractual definition of ‘Access Selection Files’ is “*data files controlled and made available by us which enables the sortation by Postcode of Mailing Items in to groupings which we call Selections, as described in Appendix C to the User Guide*,”.

⁴⁸ See, in particular, DUSP 1.1.2(l) of the so-called DUSP Condition, available at: <http://stakeholders.ofcom.org.uk/binaries/post120713/dusp1.pdf>

“(q) “Delivery Office” means an office managed by the universal service provider for the purposes of processing postal packets immediately prior to the activity of delivery to the addressee;”

A6.70 Having defined the meaning of an ‘SSC’, under the methodology it is then necessary to make reference to the above-mentioned traffic volume rule in order to define the concept of ‘London SSCs’. This is reflected in the second part of our proposed definition, where it provides:

“[...]

(ii) thereafter, if different to the SSCs referred to in (i) above, each and every SSC from time to time notified to OFCOM as having more than 50% of the volume of mail it receives to be delivered to Delivery Points located within the area the outer boundary of which is represented by the London Orbital Motorway (M25),”

A6.71 However, as seen from the first part of our proposed definition, we consider that it needs to expressly refer to the specific SSCs that, taken together, amount to the London zone at the time our proposed USPA 6A would enter into force. We understand from Royal Mail’s Access Selection Files that, at the time of publishing this Consultation, the following SSCs (with their respective postcode areas⁴⁹) constitute the London zone:

- SSC 360 – postcode area E;
- SSC 362 – postcode area IG/RM;
- SSC 365 – postcode area DA;
- SSC 369 – postcode area N;
- SSC 370 – postcode area EC/WC/W1;
- SSC 374 – postcode area W2-14;
- SSC 375 – postcode area HA/NW;
- SSC 376 – postcode area SL/UB/EC50;
- SSC 377 – postcode area SW;
- SSC 378 – postcode area KT/TW;
- SSC 380 – postcode area SE;
- SSC 384 – postcode area BR/CR/SM.

A6.72 Should we decide to adopt this definition following consultation, we intend to update these listed SSCs so that they are accurate as at the time we impose the revised USPA 6A.

⁴⁹ The postcode sectors falling within each SSC can be identified from the Access Selection Files themselves. It would be too lengthy for us to list all of the of relevant postcode sectors here..

- A6.73 We consider it is appropriate to have a list of specific SSCs to provide certainty as a starting point. This is linked with our proposed mechanism in the second part of the definition that Royal Mail from time to time notifies us of the actual SSCs forming part of the London zone after applying the above-mentioned traffic volume rule. This is because the identification of “SSCs that have more than 50 percent of their mail volumes going to an area within the M25 boundary are allocated to the London zone” is at Royal Mail’s operational discretion under the methodology. In particular, the methodology explains that the volumes are “as identified by Royal Mail using the Mails Characteristics Survey (MCS, see the description in Annex F and in the ABC Costing Manual, section 5.1.1)”.
- A6.74 However, the methodology also explains that it is not necessarily a factual question of Royal Mail simply identifying from the Mails Characteristics Survey whether the said 50% delivery volume within the M25 has occurred in relation to a particular SSC such that it should be treated as a London SSC. Rather, the operational discretion that Royal Mail still retains under the methodology in determining whether any changes should be made to SSCs in London is evident from the methodology itself where Royal Mail explains⁵⁰ that:
- “A full review and update of the postcode sector allocation to zones is undertaken using data from the second, fourth and sixth months of the financial year (May, July and September)¹⁰. Where the data shows that the mappings of existing PC sectors to zones or SSCs in London should be changed and that the change remains the same for the five months to September, Royal Mail updates the file with the new mappings. Where data shows that the mappings of existing PC sectors to zones or SSCs in London should be changed but that the change is unstable over the five months to September, or where the data does not show any significant change, Royal Mail does not update the file and the original mappings are retained. This ensures that changes to mappings are not driven by a single month’s data, and thereby seeks to provide some protection from any data volatility that might be present or become present in the data. The latest change in the mapping of postcode sectors to zones, along with the degree of instability over the 3 sample months, is shown in Annex E.”*
- A6.75 The application of our regulation cannot be subject to any operational discretion on Royal Mail’s part. It must be certain and transparent. We believe, however, that it is possible to retain key features set out in the above methodology by requiring Royal Mail to notify us in writing if it considers that any changes should be made to the SSCs listed above that provide the starting point. This is what we are seeking to achieve in sub-paragraph (ii) of our proposed definition for ‘London SSCs’.
- A6.76 In that regard, we also consider that it is appropriate that Royal Mail should carry the burden of showing to our reasonable satisfaction that the SSCs included in the London zone have 50% delivery volume within the M25 as identified from the results of the MCS and that this volume has remained stable over a period of at least five consecutive months. As seen from our above-mentioned proposed definition of ‘London SSCs’, we have reflected these matters in defining what we mean by the expression ‘notified to OFCOM’ used in this definition.

⁵⁰ Section 8.4.1 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1.

A6.77 Finally, we proposed to define the MCS concept as follows:

*“(mm) **“Mails Characteristics Survey”** means the survey carried out by Royal Mail from time to time in order to provide its business with information about the characteristics of mail, including volumes, in accordance with such rules, requirements or processes as OFCOM may direct by or under the USP accounting condition,”*

A6.78 While we understand that Royal Mail uses the MCS to check customers' compliance with commitments under the national price plans⁵¹, the MCS concept is not used in the standard Letters Access Contract as such. Nor is the MCS concept defined as such in ABC Costing Manual. However, we have based our proposed definition on Royal Mail's description of the MCS in the ABC Costing Manual⁵², particularly where it explains:

“Mails Characteristic Survey

In order to identify the characteristics of mail items, UKPIL makes use of the Mails Characteristic Survey (MCS). This is a survey which provides the business with a range of information about the characteristics of mail. The survey objective is to gather observations about the range of products UKPIL delivers in the UK. Data is collected from all Mail Centres and RDCs.

Every Mail Centre and RDC has one or more dedicated sampling staff that carry out the sampling in line with a daily sampling schedule. The sampling procedures are consistent across all sites, and as such, a statistically valid sample is obtained. Once items have been selected for the sample, the required observations are recorded locally and transferred electronically to the Traffic Volumes and Characteristics team.

Mail volumes posted by customers have different combinations of these characteristics listed above, and therefore need to go through different routes within the operational processes. For example, non business customers tend to post items with stamps while business customers typically use a prepaid or meter machine impression as the payment method. Mail volumes with stamps need to have the stamps cancelled, but the mail with meter impressions do not.

Mail volumes are grouped according to the defined routes, and these mail volumes are then handled the same way. This represents the flow of mail through the operational pipeline.”

A6.79 Our proposed MCS definition also makes reference to “such rules, requirements or processes as OFCOM may direct by or under the USP accounting condition” because we anticipate that we might have to adopt regulation to deal with the MCS as part of our review of the USPAC condition next year.

⁵¹ See document entitled ‘Quick Guide to the Pricing Plans (April 2013)’, as published on Royal Mail Wholesale’s website <https://www.royalmailwholesale.com/mint-project/uploads/105961180.pdf>

⁵² Section 5.1.1 of the ABC Costing Manual 2014-15, dated September 2014, version 2014-1.

New: '2012/13 Zonal Costing Model' (USPA 1.3 (aaaa))

A6.80 We deal with this concept and its definition in the main body of this Consultation.

New: re-numbering of list of definitions (USPA 1.3)

A6.81 As a result of our proposals to define above-mentioned new concepts under USPA 1.3, we propose to renumber sub-paragraphs of USPA 1.3 accordingly.

Correction: interpretation clause (USPA 1.4(d))

A6.82 We have noticed an unintentional omission of the expression 'USPA' immediately before the expression 'Condition' in the interpretation clause in USPA 1.4(d). We therefore propose to modify that clause as follows (with the specific proposed changes highlighted):

*"(d) the Interpretation Act 1978 (c. 30) shall apply as if **the this USPA Condition** ~~set out in this Condition~~ were an Act of Parliament."*

Correction: Requirement to comply with directions (USPA 2.3)

A6.83 We deal in the main body of this Consultation with our proposed modification to USPA 2, i.e. the proposed new remedy in USPA 2.1A. However, we have noticed an unintentional reference to "this Condition" in USPA 2.3, whereas it should have referred to "USPA 2".

A6.84 We therefore propose to modify USPA 2.3 as follows (with the specific proposed changes highlighted):

*"The universal service provider must comply with any direction given by OFCOM from time to time under this **Condition** USPA 2."*

Corrections: USPA 5 Requirement not to unduly discriminate and restriction on use of information obtained in connection with giving access

A6.85 Similarly to USPA 2.3 above, we have noticed an unintentional reference to "this Condition" in USPA 5.2, whereas it should have referred to "USPA 5". We therefore propose to modify USPA 5.2 as follows (with the specific proposed change highlighted):

*"In this **Condition** USPA 5, the universal service provider may be deemed to have shown undue discrimination if it unfairly favours to a material extent an activity carried on by it so as to place at a competitive disadvantage persons competing with the universal service provider."*

A6.86 We have also noticed a typographical error in the sub-paragraph numbering of USPA 5.4(c). We therefore propose to modify USPA 2.3 as follows (with the specific proposed changes highlighted):

"(c) the disclosure is to, or the use is by, a person who—

(iv)(i) is acting as an agent of the universal service provider for the provision of postal services to the person to whom access has been given and only for that purpose;

(v)(ii) is engaged by the universal service provider for the purpose of the universal service provider's business as a postal operator and has access to the information only for that purpose; and

(vi)(iii) is restricted by contract with the universal service provider from making any further disclosure or use of the information; or"

USPA 6A. Restrictions on pricing under a zonal access contract

- A6.87 While we deal with the proposed new remedy in USPA 6A in the main body of this Consultation, it is appropriate in this Annex to deal with our thinking on the number of decimal places to be used in complying with this remedy.
- A6.88 We are proposing that 2 decimal places should be used in assessing compliance.
- A6.89 Our reasoning for this illustrated by taking an example. If one assumes that the FAC in the urban zone was 20p and the FAC in suburban was 25p, then the ratio of the two would be $20/25 = 0.80$. Let us also assume that Royal Mail decides to set the charge for a particular service in the urban zone at 25p. It then needs to follow the ratio rule when setting the charge in the suburban area. If we were only to require the ratio of FAC to equal the ratio of charges to 1 decimal place, then Royal Mail could set charges such that the ratio of urban to suburban charges was anywhere between 0.75 to 0.84, i.e. Royal Mail could set the suburban charge between 29.76 to 33.33p and still be able to comply with our this remedy. Given the low margins in this industry, we consider this degree of flexibility (3.57p) is too large.
- A6.90 On the other hand, in requiring that the ratios are equal to 2 decimal places, the ratio of urban to suburban would need to be in the range 0.795 to 0.804 and the range for the suburban charges would thus be 31.09 to 31.15. We consider this is appropriate for competition purposes as it can not be used to undermine our remedy.

USPA 6B. Restrictions on pricing under a national access contract

- A6.91 Similarly to USPA 6A above, while we largely deal with the proposed new remedy in USPA 6B in the main body of this Consultation, it is appropriate in this Annex to deal with our thinking on the number of decimal places to be used in complying with this remedy.
- A6.92 In contrast to USPA 6A (for which we are proposing 2 decimal places), we consider that 1 decimal place is sufficient to assess compliance with USPA 6B. This is because compliance with USPA 6B would involve a different calculation from that in USPA 6A discussed above. It is easy to demonstrate that calculating to 1 decimal point leads to a margin of acceptable prices that vary by less than 0.1p..
- A6.93 We consider accuracy within 0.1p for the charge is sufficient and are not likely to give rise to a differentiation problem between users of national and zonal contracts. We therefore propose 1 decimal place for this remedy.

Correction: USPA 8 Quality of service

A6.94 We have noticed an unintentional reference to “OFCOM” (without underling) in USPA 8.1, whereas it should have been underlined as it is a defined term in PSA 2011.

A6.95 We therefore propose to modify USPA 8.1 by replacing “OFCOM” with “OFCOM”.

Correction: Table of terms defined in the PSA 2011 (at the end of the USPA Condition)

A6.96 We are proposing to amend the table of terms defined in the PSA 2011, which appear at the end of the USPA Condition, to correct a typographical error in referring to this condition and to insert certain terms that we are proposing to use in some of our proposed new concepts and their definitions.

A6.97 Specifically, we are proposing to correct this table as follows:

Table of terms defined in the Act

This table is provided for information and does not form a part of this USPA Ceondition. We make no representations as to its accuracy or completeness. Please refer to the Act.

<i>Defined term</i>	<i>Section of the Act</i>
<i>OFCOM</i>	<i>s.90</i>
<i>designated USP condition</i>	<i>s.36</i>
<i>postal network</i>	<i>s.38(3)</i>
<i>postal operator</i>	<i>s.27(3)</i>
<i>postal packet</i>	<i>s.27(2)</i>
<i>postal services</i>	<i>s.27(1)</i>
<i>universal service provider</i>	<i>s.65(1) and Schedule 9, paragraph 3</i>
<i>USP accounting condition</i>	<i>s.39</i>

A6.98 We should note, for the avoidance of doubt, that we have included this proposed amendment in Schedule 2 to the notification published in Annex 9, which Schedule shows a marked-up consolidated version of the USPA Condition in its entirety. We have not, however, included this proposed amendment in Schedule 1 to that notification because the table does not form part of the USPA Condition and it therefore does not require to be modified by notification.

Questions for consultation

Question 23: Which of our proposed two alternative definitions of ‘Relevant Postal Services’ discussed above do you prefer and what are your reasons for your preference?

Question 24: Do you agree with our proposal to base the concepts related to the concept and definition of ‘Zones’ on Royal Mail’s own methodology (as referred to above)? If not, please explain in detail why.

Question 25: Do you have any comments on our proposed new concepts and their definitions discussed in this Annex?

Question 26: Do you have any comments on our proposed corrections to the USPA Condition discussed in this Annex that are unrelated to our proposed new remedies in USPA 2.1A, USPA 6A and USPA 6B (and their associated new expressions)?

Question 27: Do you agree with our thinking and proposals for the rounding (decimal places) to assess compliance with our proposed new remedies in USPA 6A and USPA 6B? If not, please explain in detail why.

Annex 7

Sources of evidence

Introduction

We have noted throughout this Consultation the evidence we have relied upon in making the proposals we are consulting on and how we have relied upon that evidence. This Annex lists:

- the key legislation and other documents to which we have referred; and
- the main sources of that evidence.

While this Annex lists the main sources we have relied upon, the list is for convenience only and it is not intended to be exhaustive.

UK legislation

- The Competition Act 1998
- The Communications Act 2003
- The Companies Act 2006
- The Equality Act 2010
- The Postal Services Act 2011
- The Postal Services (Universal Postal Service) Order 2012 SI 2012/936, as amended by the Postal Services (Universal Postal Service) (Amendment) Order 2013, SI 2013/3108

EU legislation

- Directive 97/67/EC of the European Parliament and of the Council on common rules for the development of the internal market of Community postal services and the improvement of quality of service, as amended by Directive 2002/39/EC of the European Parliament and of the Council of 10 June 2001, Regulation (EC) No 1882/2003 of the European Parliament and of the Council of 29 September 2003 and Directive 2008/6/EC of the European Parliament and of the Council of 20 February 2008

Postcomm documents

- *Royal Mail's Price and Service Quality Review 2006-2010 - Licence modifications*, March 2006, <http://stakeholders.ofcom.org.uk/binaries/post/1383.pdf>
- *Royal Mail's Price and Service Quality Review 2006-2010: Licence Modifications Proposals*, March 2006: <http://stakeholders.ofcom.org.uk/binaries/post/1083.pdf>

- *Changes to zonal access pricing by Royal Mail – licence modifications: A decision by the Postal Services Commission*, 14 May 2009, <http://stakeholders.ofcom.org.uk/binaries/post/604.pdf>
- *The building blocks for a sustainable postal service: Access Review 2012 – Initial Proposals*, March 2011, <http://stakeholders.ofcom.org.uk/binaries/post/1813.pdf>
- *The building blocks for a sustainable postal service: Initial proposals for regulatory safeguards*, April 2011, <http://stakeholders.ofcom.org.uk/binaries/post/1885.pdf>
- *The building blocks for a sustainable postal service: Initial proposals for regulatory safeguards – Annex C - Zonal Access*, April 2011, <http://stakeholders.ofcom.org.uk/binaries/post/1890.pdf>

Ofcom documents (excluding research)

- *Statutory Duties and Regulatory Principles*, <http://www.ofcom.org.uk/about/what-is-ofcom/statutory-duties-and-regulatory-principles/>
- DUSP Regulatory Conditions imposed by Ofcom, <http://stakeholders.ofcom.org.uk/post/conditions/>
- *Better Policy Making - Ofcom's approach to Impact Assessment*, 21 July 2005, <http://www.ofcom.org.uk/about/policies-and-guidelines/better-policy-making-ofcoms-approach-to-impact-assessment/>
- *Postal regulation: Transition to the new regulatory framework – Statement*, 29 September 2011, <http://stakeholders.ofcom.org.uk/binaries/consultations/postal-regulation/statement/statement.pdf>
- *Securing the Universal Postal Service: Consultation*, 20 October 2011, <http://stakeholders.ofcom.org.uk/binaries/consultations/securing-the-postal-service/summary/condoc.pdf>
- *Securing the Universal Postal Service - Decision on the new regulatory framework: Statement*, 27 March 2012, <http://stakeholders.ofcom.org.uk/consultations/review-of-regulatory-conditions/statement/>
- *Regulatory Accounting Guidelines*, 27 March 2012, <http://stakeholders.ofcom.org.uk/binaries/consultations/regulatory-reporting-framework/statement/annex2.pdf>
- *Modification to the control preventing Royal Mail margin squeeze: Statement – Removal of unrecoverable VAT from the calculation of downstream costs in USPA6.4*, 26 February 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-margin-squeeze/statement/Statement_on_modification_to_USPA6.pdf
- *Modification to the Royal Mail margin squeeze control: Statutory Notification of change to USP Access Condition 6*, 26 February 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/royal-mail-margin-squeeze/statement/Change_to_USPA_6_Statutory_Notification.pdf

- *End-to-end competition in the postal sector: Ofcom's assessment of the responses to the draft guidance on end-to-end competition*, 27 March 2013, <http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/statement.pdf>
- *End to end competition in the postal sector, Final guidance on Ofcom's approach to assessing the impact of the universal postal service*, 27 March 2013, http://stakeholders.ofcom.org.uk/binaries/consultations/e2e-guidance/statement/E2E_Guidance.pdf.
- *Direction relating to exceptions to the postal deliveries Universal Service Obligation and approval of alternative delivery points*, 18 December 2013. http://stakeholders.ofcom.org.uk/binaries/consultations/post-deliveries-uso/statement/Statement_delivery_exceptions.pdf
- *Updating the Regulatory Reporting Framework- Statement USP Accounting Condition*, 27 January 2014, <http://stakeholders.ofcom.org.uk/consultations/regulatory-reporting-framework/statement/>
- *Ofcom Competition and Consumer Bulletin*, 21 February 2014 http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01122/
- *Annual monitoring update on the postal market - Financial year 2013-14*, 2 December 2014, <http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/>
- *Review of End-to-End Competition in the Postal Sector*, 2 December 2014, <http://stakeholders.ofcom.org.uk/post/end-to-end-statement/>

Research (Ofcom and others)

- Internet Citizens, 5 November 2013, <http://stakeholders.ofcom.org.uk/binaries/research/telecoms-research/Internet-Citizens-Report.pdf>
- Business Postal Tracker, Year 2 data tables, 7 June 2014, http://stakeholders.ofcom.org.uk/binaries/research/statistics/2014apr1/Ofcom_Business_Postal_Tracker_Y2_data_tables.pdf
- The 2014 Communications Market Report, 7 August 2014, <http://stakeholders.ofcom.org.uk/market-data-research/market-data/communications-market-reports/cmr14/uk/>
- Annual monitoring report on the postal market – Financial year 2013-14, [2 December 2014], <http://stakeholders.ofcom.org.uk/post/monitoring-report-13-14/>

Ofcom information requests

We have issued a series of statutory notices under section 55 and Schedule 8 of the Postal Services Act 2011, requiring various persons to provide specified information as set out in the notices. For the purposes of this work, we have also reused some information that was originally obtained for other purposes, including under s.26 of the Competition Act 1998.

These have been recorded as such in the list below. These information requests and the responses we received are listed below.

- Information request of 2 June 2014 covering specified information about D+2 access mail to Royal Mail.
 - Response of 13 June 2014 from Royal Mail.
 - Response of 18 June 2014 from Royal Mail.
 - Response of 23 June 2014 from Royal Mail.
 - Response of 27 June 2014 from Royal Mail.
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Annex 8

Glossary and defined terms

Term	Definition
2013 end-to-end Guidance	Ofcom's Guidance dated 27 March 2013 entitled <i>End-to-end competition in the postal sector – Final guidance on Ofcom's approach to assessing the impact on the universal postal service</i> .
2013 end-to-end Statement	Ofcom's Statement dated 27 March 2013 entitled <i>End-to-end competition in the postal sector – Ofcom's assessment of the responses to the draft guidance on end-to-end competition</i> .
The 2013 access contracts	The access contracts agreed between access operators and Royal Mail in 2013, namely those including the price plans known as NPP1, APP2 and ZPP3.
ABC Model	Activity Based Costing Model, which is the costing system that Royal Mail uses to allocate the costs recorded in the General Ledger, together with any sources of data (where necessary), to its products, through an intermediate step of allocating activity costs.
Access	Allowing other companies operating in the postal market, or other users of postal services, to use Royal Mail's facilities for the partial provision of a postal service. Access to Royal Mail's postal facilities could in principle be at any point in the pipeline, though in our regulations we require access at the inward mail centre.
C9 contracts	The access contracts agreed between access operators and Royal Mail which used UK Mail's agreement for access with Royal Mail in 2004 under Condition 9 of Royal Mail's licence as their basis.
CA 2003	The Communications Act 2003
CDA	Customer Direct Access, a form of access contract between a user of access services and Royal Mail.
Citizens	Defined in section 3(14) of the CA 2003 as meaning all members of the public in the United Kingdom.
Competition Act	The Competition Act 1998.
Communications matters	Defined in section 3(14) of the CA 2003 as meaning the matters in relation to which Ofcom has functions

Consumers	Defined in section 405 of the CA 2003 as meaning persons to whom the service, facility or apparatus is provided, made available or supplied (whether in their personal capacity or for the purposes of, or in connection with, their businesses); persons for whose benefit the service, facility or apparatus is provided, made available or supplied or for whose benefit persons falling within paragraph (a) arrange for it to be provided, made available or supplied; persons whom the person providing the service or making the facility available, or the supplier of the apparatus, is seeking to make into persons falling within paragraph (a) or (b); or persons who wish to become persons falling within paragraph (a) or (b) or who are likely to seek to become persons falling within one or both of those paragraphs. Consumers in a market for a service include, where the service is a postal service, addressees.
Costing Manual	The document containing Royal Mail's detailed description of the National Costing Methodology and the Zonal Costing Methodology and identifying all sources of data, and all supporting empirical data used for assumptions, used in these Methodologies. Part of the Costing Manual is published.
D+2	A retail postal service that aims to deliver two working days after collection, also known as a day C service.
D+2 Access	Access to Royal Mail's postal network at the IMC for the purposes of providing D+2 and later than D+2 Letters and Large Letters services.
Downstream	The activities of sortation in the Inward Mail Centre and delivery of mail items from the Inward Mail Centre to the final destination.
Downstream access	Access to Royal Mail's postal network at the point of entry to an Inward Mail Centre or at any point in the postal chain after that.
EBIT	Earnings Before Interest and Tax, namely revenue less all the costs of products and services provided before the deduction of interest and tax, also referred to as operating (loss) or profit.
End-to-end operators	Operators other than Royal Mail that provide a postal service from collection to delivery without using Royal Mail's postal network (usually only in some parts of the country).
EIA	Equality impact assessment
FAC	Fully Allocated Costs, which is a costing methodology, in which all costs (including overheads) are allocated to the outputs of the process.
Frontier Report	The document entitled <i>Designing a zonal pricing access regime</i> , Frontier Economics, September 2014
General access condition	A regulatory condition that Ofcom may impose under section 50 of the PSA 2011, which requires a postal operator to give

	access to the operator's postal infrastructure or any service within the scope of the universal service that it provides, and/or to maintain accounting separation.
Inward Mail Centre (IMC)	The part of a Royal Mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre's catchment area) of mail received from the upstream part of Royal Mail's network, or from other postal operators etc., to the final addresses take place.
Letter/Large Letter	A Letter is any item up to 240mm in length, 165mm in width and 5mm in thickness, weighing no more than 100g. A Large Letter is any item larger than a Letter and up to 353mm in length, 250mm in width and 25mm in thickness, with a maximum weight of 750g.
LDC	A private equity fund, wholly-owned by Lloyds Banking Group plc.
Locally Equally Efficient Operator ("LEEO")	An end-to-end operator with costs as low as Royal Mail's LRIC in areas it plans to enter.
LRIC	LRIC is a measure of costs that takes the service in question as the relevant increment of output over which to measure costs. LRIC does not include a contribution to common costs.
March 2012 Statement	Ofcom's Statement dated 27 March 2012 entitled <i>Securing the Universal Postal Service – Decision on the new regulatory framework</i> .
MCS	Mails Characteristics Survey, which is a survey conducted by Royal Mail of product types and volumes within the mail traffic of the Reported Business.
National Geographic Posting Profile (NGPP)	The national geographic mix of a customer's mail items. Under the national access contracts a geographically uniform price is charged to access customers, as long as their mailings meet the geographic profile specified by Royal Mail
Outward Mail Centre (OMC)	The part of a Royal Mail centre in which the activities related to the processes of final sorting for delivery (in that mail centre's catchment area) of mail received from the upstream part of Royal Mail's network, or from other postal operators etc., to the final addresses take place. The upstream part of Royal Mail's network consists of the processes related to collection and distribution of mail.
October 2011 Consultation	Ofcom's Consultation dated 20 October 2011 entitled <i>Securing the Universal Postal Service - Proposals for the future framework for economic regulation</i> .
Pipeline	Stages involved in the production and distribution process of a good or service from the initiation of the process to the delivery of the final product. In postal services the pipeline refers to the stages from collection to delivery of a postal item.

Postal infrastructure	Both physical infrastructure (such as letter boxes) and infrastructure in non-physical form (such as information relating to postcodes or addresses or arrangements made with others for the provision of any service).
Postal operator	Defined in section 27(3) of the PSA 2011 as meaning a person who provides the service of conveying postal packets from one place to another by post, or any of the incidental services of receiving, collecting, sorting and delivering postal packets.
Postal service	Defined in section 27(1) of the PSA 2011 as meaning the service of conveying postal packets from one place to another by post, the incidental services of receiving, collecting, sorting and delivering postal packets, and any other service which relates to, and is provided in conjunction with, any of those services. According to section 27(2), the expression "postal packet" means a letter, parcel, packet or other article transmissible by post.
Postal network	Defined in section 38(3) of the PSA 2011 as meaning the systems and all the resources used by the provider for the purpose of complying with its universal service obligations (and, accordingly, includes arrangements made with others for the provision of any service)
PSA 2011	The Postal Services Act 2011
Pre-sorted	Describes where the sender has sorted its mailing items to a predetermined level before handing them to the operator.
Price Plans	The respective national and zonal pricing options which Royal Mail offers in relation to its agreements with other persons for D+2 Access. It includes the price plans known as 'National Price Plan One (SSCs)', 'Average/National Price Plan Two (Zones)' and 'Zonal Price Plan', respectively, as well as the price plans for D+2 Access that preceded these price plans from time to time (known as Condition 9 agreements, whether or not they remain in force).
Regulatory Accounting Guidelines (RAG)	Means the document so entitled and published by Ofcom (as amended from time to time) setting out such requirements as Ofcom may direct from time to time relating to the preparation, auditing, reporting and publication, of regulatory financial statements and other regulatory financial reports to be prepared and maintained by Royal Mail under the USPAC Condition.
Regulatory condition	Defined in section 28(2) of the PSA 2011 as meaning (among others) an USPA Condition and an USPAC Condition
Regulatory financial reports	The financial reports produced for Ofcom by Royal Mail in relation to the RAG; they include both the regulatory financial statements and additional financial reports produced by the Royal Mail as per the guidance in the RAG.
Regulatory financial statements	The income statements, balance sheet statements and cash flow statements produced by Royal Mail as per the guidance in

	the RAG.
Relevant markets	Defined in section 3(14) of the CA 2003 as meaning markets for any of the services, facilities, apparatus or directories in relation to which Ofcom has functions
Reported Business	The part of Royal Mail's UKPIL business that undertakes activities for the purpose of, or in connection with, the provision of USO and non-USO products, excluding the activities and products of ParcelForce International and Royal Mail Estates Limited. For the avoidance of doubt, the activities and products of the Reported Business shall be treated to include all the activities and products which fall within the scope of Royal Mail's National Costing Methodology as documented in the Costing Manual from time to time.
Royal Mail	Royal Mail Group Limited, whose registered company number in England and Wales is 04138203.
Royal Mail's June 2014 submission	Royal Mail's regulatory submission to Ofcom entitled <i>Direct Delivery: A Threat to the Universal Postal Service: Regulatory Submission to Ofcom</i> . This document was received by Ofcom on 19 June 2014. A non-confidential version was published on Royal Mail's website.
Royal Mail Wholesale	A business unit within Royal Mail Group that deals with access to Royal Mail Group's postal network.
SAC	Standalone cost
Sorted	Describes mail that has been sorted into geographical areas prior to being collected by the postal operator. Some postal operators call this type of mail 'pre-sorted'.
Standard Selection Code (SSC)	A numeric code used by Royal Mail to sequence addresses, identify selection breaks and match items to mailing bag labels.
Universal Service Obligation (USO)	The requirements to provide postal services which are contained in a designated USP condition imposed on the universal service provider by Ofcom under section 36 of the PSA 2011.
Universal Service Provider (USP)	Any postal operator for the time being designated by Ofcom as the universal service provider under the Postal Services Act 2011.
Unsorted	Describes mailing items handed to an operator which are not pre-sorted.
Upstream	The activities of collection, outward sortation (where necessary – pre-sorted mail may not require further outward sortation) and trunking.

User	Defined in section 65(1) of the PSA 2011 as including addressees and potential users
USO products entity	Has the meaning given to it as defined in Section 4 of the RAG.
USP access condition (USPA Condition)	A condition that Ofcom may impose under section 38 of the PSA 2011 that requires the universal service provider to give access to its postal network to other postal operators or users of postal services and/or requires the universal service provider to maintain accounting separation.
USP accounting condition (USPAC Condition)	A condition Ofcom may impose under section 39 of the PSA 2011 that requires the universal service provider to provide regulatory financial statements and information, and may from time to time direct the universal service provider to do one or more of the following: to maintain accounting separation; to comply with rules about the identification of costs and cost orientation; to comply with rules about the use of cost accounting systems; and to secure that compliance with those systems is audited annually.
Whistl	Whistl Limited (formerly TNT Post UK Ltd).
Whistl complaint	The complaint submitted by Whistl to Ofcom on 21 February 2014 regarding certain prices, terms and conditions offered by Royal Mail for access to certain letter delivery services (D+2 access).
Zones	The geographical zones into which Royal Mail divides the United Kingdom based on the density of delivery points and the proportion of business delivery points of postcode sectors, currently known as Zone A (Urban), Zone B (Suburban), Zone C (Rural) and Zone D (London).
Zonal Costing Methodology	The rules, procedures, methods, algorithms, assumptions and other processes used by Royal Mail for the purpose of assigning the costs of the Reported Business, which it incurs in the conduct of its business, to the products subject to regulation under the Postal Services Act 2011 where it sets geographically differentiated prices, wherever those rules, procedures, methods, algorithms, assumptions and other processes identify cost differentials between specific zones defined by Royal Mail in accordance with its obligations.
Zonal Costing Model (ZCM)	A model produced by Royal Mail that estimates downstream FAC unit costs by format for each Zone in accordance with the Zonal Costing Methodology.
Zonal Costing Rules	The requirements of the RAG in relation to the Zonal Costing Methodology.
Zonal tilt	The differential in Zonal charges for downstream services across different Zones.