"Securing the Universal Postal Service"

- **UK Mail Response to Ofcom October 2011 Consultation**
December 2011

Note: Throughout this document:
UKM = UK Mail
RM = Royal Mail
Consultation = Ofcom's October 2011 consultation on "Securing the Universal Postal Service"

Numbering used in referring to the Consultation is as per the paragraph and table numbering in the Consultation; "A1" indicates Annex 1, etc. Quotes from the Consultation are shown *in italics*

The contents of this response document only may be made public and attributed to UKM.

All information or comment provided by UKM to Ofcom other than in this document is confidential and is not to be published, otherwise disclosed outside Ofcom or attributed to UKM.
UKM has provided a separate, confidential annex to this response.

1. SUMMARY

Ofcom's proposals set out a regulatory regime that radically increases the commercial freedoms of RM and lasting for the next seven years.

This regime is intended to be consistent with Ofcom achieving its primary statutory duty, to ensure the financial sustainability of the universal service. But also to recognise Ofcom's other principal duty, to further the interests of users and promote effective competition.

Royal Mail is the only postal operator currently able to provide the universal service and will be designated as such by Ofcom. In order for provision of the universal service to be sustainable, RM must be more efficient than it is now. Indeed, Ofcom's duty on the universal service is for provision to become and to remain efficient.

But Ofcom's assessment clearly indicates that RM has not improved efficiency enough to sustain financeability of the universal service in the past and Ofcom expresses doubts that RM's business plan for the first part of the seven year regime is achievable.

There must then be a significant danger that RM will not achieve the efficiency needed to be consistent with Ofcom achieving its primary statutory duty.

Yet Ofcom proposes to allow RM complete pricing freedom (except 2nd Class stamped Letters), rather than to use an RPI-X type price control which has been the standard regulatory tool to drive efficiency improvement.

Instead, Ofcom proposes to safeguard the universal service in three ways: monitoring and reporting; price controlling one, basic RM service; and through the commercial pressures of competition.

UKM is far from convinced that these safeguards are sufficient or adequately robust, or that RM has the necessary *"intrinsic efficiency incentives"* to deliver a financially sustainable universal service.

UKM is concerned that RM will use pricing freedom to impose on a declining market a second successive year of large price increases. We believe, as do many other mail users, that such increases would 'snap any past elasticities' and lead to irreversible losses of mail use, mainly due to technological and systems investments becoming embedded.

Ofcom suggests that RM would not adopt such a short-term approach. But UKM is not as reassured by RM's 'good intentions' as Ofcom is, given that there is a strong, current political imperative to achieve privatisation of RM during 2013.

This is likely to emphasise a short-term revenue growth objective for RM (as a business and for its senior executives), at the potential expense of medium-term maintenance of the postal market, and endangering universal service provision. This is particularly so when large price rises in 2012 will have a more immediate impact on RM's finances than improved efficiency.

There is then a clear imperative for RM to focus on financial performance. UKM strongly supports the need to Ofcom to have all necessary regulatory financial reporting and for this reporting to be based on the relevant business activities.

However, the reporting Ofcom seeks is not yet in place, never mind delivering robust, consistent information with appropriate publication. So the monitoring which Ofcom proposes be one of its key safeguards in the absence of price control will not be effective until well after RM has been given pricing freedom.

Because of this, UKM does not believe there is the necessary basis for the significant deregulation and weakening of safeguards which Ofcom proposes for April 2012.

UKM strongly questions Ofcom's proposals to have no direct regulatory requirement for efficiency improvement by RM while allowing RM complete pricing freedom (everywhere but 2nd Class stamps) – and for this to be the expected regime for seven years.

UKM is particularly concerned with the reliance Ofcom places on the further development of competition to encourage RM to greater efficiency.

We strongly agree with Ofcom that competition has been a positive influence in the mail market and that access-based competition must be able to continue to develop, not just for the benefits it provides directly but also as a likely enabler of end-to-end competition.

But UKM does not believe Ofcom's proposals are robust enough to achieve the safeguard of competition, on which it seeks to rely.

UKM sees Ofcom's proposals as providing only a very narrow mandate for access (far narrower than under Postcomm and narrower even than the already existing access to Inward Mail Centres), while failing to provide the necessary protection from competition-eliminating margin squeeze by RM.

Ofcom proposes to abandon the established headroom protection in favour of reliance on competition law and reporting requirements. UKM explains below how both of these are flawed, especially as it is impossible to rely on reporting requirements which are not in place or providing reliable, consistent and published information.

Initially, Ofcom proposes to rely on a very vague and imprecise regime based on its current limited knowledge of FAC. Even that will be adjusted to some as yet unknown degree and applied across a basket of second class, bulk mail services.

But how Ofcom will check and monitor compliance with this regime is not specified and seems to rely on RM ‘demonstrating’ compliance based on forecasts with retrospective checking by Ofcom. Yet Ofcom has said nothing about what will cause it to consider RM is failing to comply, or how swiftly or in what way Ofcom will then act to stop any margin squeeze from continuing.

We strongly argue that the existing defined headroom protection against margin squeeze, which has served the market well for five years and which was re-confirmed as the justified approach by Postcomm less than a year ago, should continue. We can see no valid reason to change it in the rushed, imprecise and risky way which Ofcom proposes.

The following sections provide UKM’s comments on the Consultation and responses to the Consultation questions.

[UKM does not have any comments in response to Sections 2 Introduction or 3 Legal Framework]

4. Background and market context

UKM believes Ofcom has provided a good overview of the UK postal market and RM’s position, covering relevant aspects in a concise and informative way.

Ofcom reports a 40% decline in single-piece mail while bulk mail has declined by less than 5%. As the main development of competition has so far been in bulk mail, UKM believes this is illustrative of how competition has, by offering mail users choice and better value, acted to sustain the mail market from sharper decline. Even in single-item or small volume mail, UKM believes competition has already had some positive effect; for example feedback from users of hybrid electronic-to-physical mail services such as out imail service suggests that some 25% of items sent in this way would not have been sent were the service not available.

Ofcom also reports price increases since 2003 of over 75% for both First Class and Second Class stamped letters. UKM would add that access prices have increased by some 40% since 2004 (e.g. Access 1400 for a standard letter was 13.00p in April 2004 but 18.35p in May 2011).

Figure 7 shows RM’s operating profit had been improving and positive in 2008-09 and 2009-10 but reversed to a loss again in 2010-11. Given that the chart also shows the rate of volume decline was essentially the same in those three years, RM’s failure to maintain the profit improvement in 2009-10 would seem to show RM’s inability to maintain efficiency improvements.

UKM notes that Ofcom states:

> *"The cost reductions achieved by Royal Mail have been delayed when compared to its original modernisation plan and have as a result been insufficient to keep up with the pace of volume decline. This has brought the sustainability of the universal service into question."* [4.25]

so it is RM's own failure to achieve sufficient cost reductions which has threatened the sustainability of universal service provision.

In para 4.28, Ofcom comments that:

> *"the use of an "access headroom" control also guaranteed a significant margin within which access operators could compete"* [4.28];

UKM believes this might wrongly be taken to imply a protected profit margin for access operators, which is very clearly not the case.

Access headroom provides protection against margin squeeze by maintaining a difference between RM's retail prices and the corresponding access prices; it does not determine the profit margin available to access operators. In practice, mail users have captured most of this difference between RM retail and access prices through competition between access operators. In other words, access headroom has protected benefits for mail users, not access operators. (Please also see Confidential Annex).

5. <u>Financially sustainable universal service</u>

Q 5.1. Do you agree with the assumptions set out in paragraph 5.86?.

- *The integrated universal service network defines the appropriate boundaries of the business which is central to the provision of the universal service.*
- *Royal Mail's ability to execute and deliver on its business plan is of primary importance to the achievement of a financially sustainable universal service, and there remains significant downside risk to the delivery of the plan.*
- *A regulatory framework which provides sufficient safeguards against downside risk, coupled with the intrinsic efficiency incentives underpinned in Royal Mail's business plans, is likely to provide the best opportunity to deliver sufficient cost saving pressures.*
- *An indicative EBIT margin range of 5% to 10% is appropriate and consistent with the need for Royal Mail to earn a reasonable commercial rate of return commensurate with the level of risk within the business*

Ofcom's primary duty is to ensure provision of the universal service, and for such provision to become and remain efficient and to provide a reasonable commercial rate of return.

UKM very much agrees with Ofcom that achieving such sustainability can only be achieved by RM becoming more efficient, not through increased prices:

> *"Increased prices cannot be relied upon as a longer-term means of improving revenue as they will also inevitable exacerbate the decline in mail volumes. It is for this reason that we attach such importance to the considerable efficiency improvements that are likely to be necessary to reduce Royal Mail's costs. We consider that only by becoming more efficient and reducing costs will Royal Mail's revenues cover its costs, such that the universal service is financially sustainable in the long term."* [5.9]

Given this imperative to focus on costs, UKM strongly supports the need to Ofcom to have all necessary regulatory financial reporting and for reporting to be based on the relevant business activities.

UKM agrees that the universal service network is the appropriate business entity to monitor when considering the provision of the universal service. It would be illogical and inappropriate to extend the monitored entity beyond this. Doing so would bring in business activities which do not use the universal service network and which are not providing services that are part of or in the scope of the universal service.

In particular, UKM can see no valid reason for the 'reported business' scope of regulatory reporting to be aligned with the new UK Letters, Parcels & International division (UKLPI) created by RM for its 2010/11 statutory accounts. This amorphous division incudes activities, most notably parcels, which are not part of the universal service and which very largely do not use the universal service network.

UKM agrees with Ofcom that the correct regulatory reporting base is activities which RM previously called RM Letters.

However, the reporting Ofcom seeks is not yet in even in place, never mind delivering robust, consistent information with appropriate publication. Therefore UKM does not believe there is the necessary basis for the significant deregulation and weakening of safeguards which Ofcom proposes for April 2012, especially on protection from margin squeeze against access operators.

Ofcom has concluded that:

> *"Royal Mail's ability to execute and deliver on its business plan is of primary importance to the achievement of a financially sustainable universal service, and there remains significant downside risk to the delivery of the plan"* [5.86]

UKM cannot comment on this conclusion in a direct or evidenced way as much of the information on which Ofcom reaches this conclusion has been redacted from the Consultation.

However, UKM is concerned by two aspects of the consideration published by Ofcom: the reliance on RM improving efficiency and the reliance on increased prices.

Ofcom points clearly to the critical importance of RM improving efficiency but also questions the achievability of RM's plans:

> *"(RM's Restructuring) Plan therefore includes the continuation and acceleration of Royal Mail's modernisation programme which seeks to reduce operating costs in real terms in each year of the Plan at a rate which is comparable with the fastest rate of cost savings achieved by Royal Mail in recent years."* [5.20]
>
> *"we recognise that Royal Mail's ability to achieve the improvements in the plan is subject to significant risks*" [5.22]
>
> *"Figure 12… shows that delaying Royal Mail's modernisation has a material impact on its profitability and cash flow…, the graph shows that a 1% shortfall in efficiency against the base case has a material impact on Royal Mail's future profitability, potentially reducing profit by up to 50%."* [5.62]

Ofcom has also pointed to significant unknowns in respect of how the postal market may respond to further, large increases in RM prices. Such unknowns include the impact of e-substitution [5.40] and price elasticity [5.45] and Ofcom states:

> *"Royal Mail has assumed that price elasticity increases where there are high price rises. Given the lack of evidence for the size of this effect, Royal Mail has additionally used internal commercial judgments to assess the impact and adjust the results. On balance, our assessment is that the combined assumptions around e-substitution and price elasticity result in plausible central case for volume decline. However, Royal Mail has not directly modelled how the 2011-12 price rises or any future price rises may specifically impact the pace of e-substitution"* [5.46]

Of the two areas of risk, efficiency improvement and revenue generation from increased prices, Ofcom conclude that efficiency is the greater risk:

> *Based on our analysis, it appears that potential volume uncertainties in the individual customer segments present a lesser risk to Royal Mail's financeability than a failure to modernise sufficiently*. [5.58]

At the time of the large price increases in May 2011, major mail users warned of a step-change fall in mail volumes. To date, RM seems to believe those warnings have been unfounded. However, UKM is far from alone in believing that RM's complacency is premature and false; several large customers and trade associations have described how the lag in reacting to big price increases is now starting to work though, with an impact on volumes in the later part of 2011/12 and from the start of the new financial year. (Please also see Confidential Annex)

Already, mail users are describing the likelihood of a second, consecutive year of large price increases as 'snapping any past elasticities' and leading to irreversible losses of mail usage, mainly due to technological and systems investments becoming embedded.

In this context, UKM believes that the necessity for RM to achieve efficiency improvements is paramount and must be pursued as the key means to achieve financial sustainability of the universal service.

Because of this, UKM strongly questions Ofcom's proposal to have no direct regulatory mechanism to ensure efficiency improvement by RM while allowing RM complete pricing freedom (everywhere but 2nd Class stamps), and for this to be the expected regime for seven years.

UKM does agree with Ofcom that:

> *"Royal Mail's ability to execute and deliver on its business plan is of primary importance to the achievement of a financially sustainable universal service, and there remains significant downside risk to the delivery of the plan"* [5.86];

and that:

> *"A regulatory framework which provides sufficient safeguards against downside risk, coupled with the intrinsic efficiency incentives underpinned in Royal Mail's business plans, is likely to provide the best opportunity to deliver sufficient cost saving pressures*" [5.86]

But UKM is far from convinced that the safeguards proposed by Ofcom are sufficient or adequately robust, or that RM has the necessary "*intrinsic efficiency incentives*" to deliver a financially sustainable universal service.

Further, UKM does not agree with Ofcom's assessment of the commercial rate of return for universal service provision:

> *"On this basis, we have assumed a base case for an indicative return of 8% margin on these activities when considering our options for the future regulatory framework in Section 6. We have also used such indicative financeability benchmarks to assess plausible outcomes that indicate the financial sustainability of the universal service."* [5.83]

We agree with the analysis that under a return on regulatory capital (RAB) approach the consequent EBIT margin for Royal Mail would be around 5% - 6%.

This level of margin is more consistent with the margins achieved with comparator companies which operate in the UK. The analysis shown in the Cambridge Economic Policy Associates report (a supporting document to the Consultation) includes as comparators a number of overseas postal companies that operate in very different market environments. It is more directly relevant that the report shows EBIT margins for UK based comparators in the range 3.07% to 7.85%, with the majority of comparators in the 3% to 5% range.

On this basis we believe the target return should be in the range 5% - 6%, not 8% as Ofcom propose. If a level of EBIT margin target is set at the higher level there is a danger it will impose too high a requirement for over-stretching efficiency improvements and/or market-crushing price increases. (Please also see Confidential Annex)

6. Securing the provision of the universal service and protecting customers

6.1 Securing the provision of the universal service

Q 6.1: Do you agree with our proposal to impose a regulatory condition on Royal Mail to require it to provide the universal service as set out above?

UKM agrees and will respond to the forthcoming consultation on the text of the universal postal service order and the condition designating RM as the universal service provider.

However, UKM believes that Ofcom should, at the earliest opportunity, carry out a review of the requirements of the universal service as permitted by S34 of the Postal Services Act 2011 (PSA) and required to be carried out by S30(4) of the PSA.

6.2 Viability of a price control in the current context

Q 6.2. Do you agree that a price control is not an appropriate option at present for regulating Royal Mail's prices?

In April 2011, Postcomm consulted on options for regulation of universal services and access services, including an option for separate *ex-ante* price controls on universal services and on access products.

In considering the options, Postcomm supported this dual, *ex-ante* control and concluded:

> "*controlling external access services through a wholesale basket or downstream activity price control, when deployed in combination with a separate universal services control, can readily be structured and set at a level as to support the financial sustainability of the universal service. This*

> *approach would allow Royal Mail to increase the prices of universal and/or access services if this was needed to cover the relevant costs of the universal service network"* [7.41; "The building blocks for a sustainable postal service - Initial proposals for regulatory safeguards"]

UKM's response agreed (response was published by Postcomm).

In this Consultation, Ofcom has concluded (at some length, 6.25 – 6.61) that a conventional, RPI-X price control does not work in practice for the postal market or for RM.

UKM does not have the necessary regulatory experience, econometric expertise or knowledge of RM's finances to refute this conclusion; we have to acknowledge Ofcom's ability to reach this conclusion and recognise that Ofcom seems committed to this view.

However, this is a significant change from the position adopted by Postcomm, which had established almost a decade of regulating Royal Mail and for Ofcom to abandon any price controls (except 2nd Class stamps) seems a highly risky position.

Ofcom states:

> *"Royal Mail should be in a better position than the regulator to determine the quantum and structure of price increases required to return it to a sustainable financial position (although there is no guarantee absent a price control that its price increases would stop at this level). Royal Mail should also have the incentive to do this in a manner which is consistent with the ongoing and long-term health of the postal sector which, in turn, should help maintain the viability of the universal service"* [6.57]

UKM is not as reassured by RM's good intentions as Ofcom is, given that there is a strong, current political imperative to achieve privatisation of RM during 2013. This is likely to emphasise short-term revenue growth as the objective for RM (as a business and for its senior executives), at the potential expense of medium term maintenance of the postal market and endangering universal service provision.

This is particularly so when large price rises in 2012 will have a more immediate impact on RM's finances than improved efficiency.

Ofcom is also proposing a seven year term for this regulatory regime, i.e. no price control (other than 2nd Class stamps) before 2019. Yet one of Ofcom's principle reasons for concluding price controls will not work is RM's position as a publically rather than privately owned business – and that position is planned to change with privatisation of RM in the second year of the seven year regime.

UKM believes there should be some form of direct regulatory control to underpin achievement of RM's efficiency improvement plans, if not through RPI-X then through some other mechanism such as a real unit cost reduction obligation.

At the very least, Ofcom should be clear on what triggers it would consider as necessary for it to re-open the highly deregulated regime it proposes.

6.3 <u>Safeguards are necessary in the absence of a traditional price control</u>

Question 6.3: Do you agree with Ofcom's proposals to put in place regulatory safeguards as described?

Given UKM has significant concerns with Ofcom's proposal to omit traditional price controls, it is clear UKM strongly believes that in their absence there must be sufficient and robust safeguards. Ofcom must ensure protection against abusive, damaging or exploitative behaviour by RM.

Ofcom clearly recognises that:

> *"Royal Mail may increase prices to generate positive cash flow rather than address the efficiency challenge whether under its current public or potential private management structure"* [6.64]
>
> *"price increases greater than 10% which Royal Mail has put into the market this year will reduce confidence in the market, further accelerating switching away from mail. Customers may reasonably expect further large price rises in the short term and have little confidence in the future path of prices*" [6.67]
>
> *"without any ex ante price regulation would create uncertainty for customers over the future path of Royal Mail's prices. This may encourage customers to accelerate any planned electronic substitution or incentivise receiving customers to switch to electronic alternatives. This risk may be increased if Royal Mail were to implement further price increases in addition to its price rises in 2011-12."* [6.69]
>
> *"In an environment in which the only legal constraints on Royal Mail were imposed by competition law (as proposed by Royal Mail), any response may not be capable of effectively addressing concerns as they arise"* [6.71]
>
> *"There is also a risk that, in the absence of regulation, Royal Mail could foreclose the market to efficient access competition by refusing to supply access on fair and/or equivalent terms, engaging in price squeeze, cross-subsidisation and/or predation."* [6.75]
>
> *"While the threat of competition law investigation and the significant penalties that could be imposed if Royal Mail was found in breach may constrain its behaviour, we do not consider, on the evidence before us, that this constraint is likely to be sufficient to address the risks we have identified"* [6.75]

UKM does not agree with Ofcom that:

> *"although we cannot rule out that Royal Mail's price increases may have an impact on the pace of electronic substitution bringing forward substitution that would have happened anyway, we consider it unlikely that such changes will threaten the financial sustainability of the universal service, … . Royal Mail's customers are highly diversified, both in number and in their uses of mail, and it seems unlikely that any one customer or group of customers can affect the kind of short-term impact suggested"* [6.68]

This ignores the highly concentrated nature of the postal market, with 87% of mail being sent by businesses and within that in a high further high concentration on a few, very large mailers. In 2010-11, xx% of mail carried by UKM came from just xx customers. (see Confidential Annex)

6.4 Safeguard 1: The potential for re-regulation supported by monitoring

Q 6.4: Do you agree with Ofcom's proposals to put in place a monitoring regime?

UKM agrees strongly with the proposed areas of monitoring (financial performance, operating performance, impact on customers and impact on competition).

On operational performance, UKM recognises the danger Ofcom sees of RM allowing service quality to degrade as an easy route to cost savings. Any monitoring required by Ofcom must therefore continue to include measurement and reporting of RM's service performance for universal and access services.

Ofcom will shortly be consulting on what guidance it should set for access terms & conditions; UKM's response will include further detail on how such terms must include service performance targets, with compensation for under-achievement.

On financial performance, UKM urges Ofcom to enforce the monitoring regime set out in its proposals for Regulatory Financial Reporting. However, UKM is highly concerned by Ofcom's comment:

> *"We intend to issue a final decision on our proposals in February 2012. If we conclude that the proposed measures in respect of monitoring are appropriate, then alongside that decision we propose to take forward further work on how the monitoring regime can be implemented to best meet our duties. We expect that this would require further work on the affordability of postal services and how this can be monitored over time, and also the role of cost-orientation in monitoring Royal Mail's prices. We will seek to engage with industry participants on how these factors and Royal Mail's financial and operational performance should be monitored, and what level of public disclosure is appropriate."* [6.93]

This seems to mean that there will be no decision on what financial and operational monitoring Ofcom will require until after February 2012 and hence no implementation until later than that.

In which case, the monitoring which Ofcom proposes be one of its key safeguards in the absence of price control will not be effective until well after RM has been given pricing freedom.

UKM believes that until the monitoring and reporting is:
- fully in place;
- has been found to be correct, robust and consistent; and
- has seen publication of the reported information

Ofcom must not proceed with the extensive deregulation of RM in terms of pricing freedom or weakened controls against margin squeeze of access-based competition.

6.5 Safeguard 2: Ensuring that a basic universal service product is available to all

Q 6.5: Do you agree with Ofcom's proposals for an index-linked safeguard cap on standard letters from 45p to 55p?

UKM has little basis on which to comment on this proposal as it has no experience of using 2nd Class stamped letters and competes in that part of the market to a very limited extent (through our imail service).

However, UKM sees value in Ofcom addressing the challenges we have heard raised by consumer and customer representative bodies:

- Why this safeguard is restricted to Letters only and does not also include Large Letters and Packets; although these formats represent a very small amount of RM's business the universal service is not constrained to Letters, and each instance of usage is significant to the customer, particularly when such items are likely to be sent at important times (birthday cards, returning important documents, presents, …) or by small businesses for whom postage costs are often a significant part of overall costs;

- Why the on-going price control is based on change in RPI rather than CPI, when the purpose of the control is to ensure a basic universal service is affordable, especially for vulnerable customers whose income may well be benefits-dependent and benefits are revised in line with CPI not RPI.

(UKM must leave it to such consumer and customer representative bodies, which have the relevant information, to make the cases here).

UKM is also puzzled by the absence of any rationale in the Consultation to support the proposed starting range of 45p-55p for 2nd Class stamp Letter, when this is a very large increase of 25%-53% on the current 36p price.

Ofcom has not explained why it is proposing an increase of this scale. Further, while Ofcom may have reasonable grounds to believe the current price is affordable, Ofcom has given no basis oin which it can assume that 45-55p will still be affordable.

6.6 Safeguard 3: Competition

Ofcom's proposals in relation to competition in the mail market are considered in the following section.

6.6 Duration of approach

Q 6.6: Do you agree with Ofcom's proposal that the approach outlined above remains in place for seven years?

It is clear from past experience in the mail market that very major changes can happen within a seven year period. For example, since 2004 while total market volumes have declined by more than 25% but competition through downstream access has grown from nothing to over 7bn items, 1st and 2nd Class stamp price increases have outpaced inflation and Royal Mail has moved from four consecutive years of profit to a similar record of losses.

The mail market is likely to see similar, major changes during the next seven years and Ofcom should not be proposing a regulatory regime that assumes no change for that duration.

Ofcom suggests the seven year term is needed to give sufficient incentives to improve efficiency and provide regulatory certainty. But if the initiatives on which RM depends to achieve efficiency improvements need seven years to take effect, then efficiency will be too late to safeguard provision of the universal service.

If seven years certainty is needed for any potential investor in RM, Ofcom should explain why that is the case for post when Ofcom's predecessor Oftel saw no such need when setting the regulatory regime at the time of privatisation of BT.

Perhaps most importantly, the most radical aspect of Ofcom's proposals (absence of price controls) is justified on the basis that such controls do not work for RM as a publically rather than privately owned business. But that position is planned to change in 2013, only the second year of the seven year regime.

The Ofcom proposals might seem to be setting up the privatisation of RM by offering a potential investor the prospect of five years to achieve crucial efficiency improvement while enjoying freedom to price as it wishes.

UKM believes the unprecedented period of seven years is too long, without clarity on the circumstances which Ofcom would consider justified any review before the end of that period (which circumstances could include the completion of RM privatisation).

7. Competition

UKM notes and strongly concurs with Ofcom's assessment of the several, significant benefits which competition (so far almost exclusively access-based competition) has brought: efficiency incentives for RM, increased innovation and benefits for customers [7.4]

However, UKM challenges an assertion Ofcom makes:

> *"Introducing competition to a network monopoly environment inevitably leads to static inefficiencies, e.g. the duplication of deliveries to the door, duplication of sortation capacity. If competition involves duplication of fixed network costs thus leading to a reduced exploitation of economies of scale and scope, then this could increase the overall cost of production."* [7.5]

In the case of UKM, investment has been to increase the capacity and efficiency of an already existing distribution network – not duplication of RM's pre-existing, legacy networks.

There has also been no duplication of "*deliveries to the door*" as UKM has used RM's final sortation and delivery resources; indeed, as competition has to some extent underpinned mail volumes in a declining market (Ofcom notes [4.9] that the decline in bulk mail, where there is some competition has been much less than for non-bulk mail, where there is very little competition), it would be fair to argue that competition has benefitted utilisation of RM's 'final mile' capacity.

UKM has invested in sortation capacity, but this has been to allow innovation (e.g. imail), the provision of a wider range of services for customers and, by increasing the amount of pre-sorted mail being presented to RM at inward mail centres, has aided RM's investment in and utilisation of new, automated mail handling.

In leading to the transfer of mail from RM's upstream network to the existing and efficient networks of UKM and other operators, competition has allowed RM to remove some legacy network capacity from the mail market.

7.1 End-to-End competition

Q 7.1: Do you agree with our approach to assessing end-to-end competition?

In para 7.10, Ofcom reports that end-to-end competition has developed more in some other European countries than in the UK, which might be taken to infer that the prevalence of access-based competition in the UK has somehow supressed development of end-to-end competition. However, in para 7.47, Ofcom gives the principle reasons for the difference: the higher proportion in those other countries of localised mail (Germany and Spain)*, as well as smaller geographic size with even population spread (the Netherlands) or highly geographically concentrated population (Sweden).

* UKM notes that RM has redacted from Annex 7 (para 2.59) the figure for the percentage of mail in the UK which is local-to-local, denying opportunity to comment.

UKM agrees with Ofcom's assessments of the potential benefits of end-to-end competition and recognises that the principal risk from such competition ('cherry picking' of low delivery cost areas).

But the reason Ofcom gives to see a potential detrimental effect on the universal service:

> *"a competitor may seek to offer delivery in a low cost geographic area where Royal Mail is obliged to charge a higher price because of its obligation to deliver everywhere at the same price"* [7.25],

may not adequately recognise that end-to-end competition would almost certainly be in bulk mail services, which are not part of the universal service and so RM is able to price its bulk mail services zonally (just as it can now for access services).

UKM believes that the notification requirement, which the Secretary of State has directed Ofcom to introduce for companies planning to start or to expand letter delivery, is a reasonable provision which will allow due assessment of end-to-end competition.

UKM will respond to the consultation on the proposed thresholds for such notification.

However, it is not known how Ofcom will assess these notifications in practice against what criteria, and what conditions might consequently be set for end-to-end competition.

UKM believes Ofcom must provide early guidance to the mail market on this, or there is danger that assessment of the notifications will alter over time and cumulative scale. This could lead to different conditions being set for otherwise similar business models, creating inconsistencies and uncertainty which would act to deter investment commitment to end-to-end competition.

What might be termed 'end-to-end planning blight' could deny the mail market the potential benefits which Ofcom has rightly identified.

7.2 Necessity for Royal Mail to offer access

Q 7.2: Do you agree with Ofcom's proposals to impose an obligation on Royal Mail to provide access at the Inward Mail Centre?

UKM strongly agrees, concurring with Ofcom's thorough assessment of whether access meets the tests set by the Postal Services Act and whether access is consistent with provision of the universal service, and in hence concluding that there should be an obligation on RM to provide access.

However, UKM is very concerned that Ofcom's proposal to provide access at Inward Mail Centres (IMCs) seems restricted to D+ 2 and later Letters and Large Letters.

This excludes Packets, which are currently an established part of existing access agreements and are vital in allowing the developing degree of competition in the Packets part of the market – especially in packets up to 2kg, where Postcomm has found RM has significant market power.

The use of access-based services for Packets has been showing strong recent increase, with RM figures reporting volume up by 42% in the year to October 2011, when access volumes overall were only 5.5% up.

UKM does not have the RM figures to show the revenue increase in access Packets but these will be available to Ofcom from RM and UKM urges Ofcom to obtain this information as the revenue share of Packets will be materially greater than their volume share, indicating the importance of Packets access.

UKM believes that this recent, significant growth is because of three factors which occurred during 2011 and have enabled realistic use of access-based services for Packets:

a) Change to access contracts allowing posting of mixed-weight Packets;

b) Change to access contracts allowing posting of packets up to 5kg in item weight; and

c) Change in pricing for access Packets and in the minimum headroom for Packets

In many cases, customers using access-based services to post Packets are also posting Letters and/or Large Letters. Any change that would deny these users the ability to post Packets would mean highly disruptive separation of items, and so deter continuing use of access services.

There would also need to be agreed variations to existing access contracts which allow posting of Packets up to 2kg and in many cases up to 5kg. Such variations would require agreement from the contract holder, which would be very unlikely to be given.

RM already seems to have acted unilaterally to restrict access-based competition in the Packets market, by terminating the BMAC agreements which enable the processing of loss/damage claims (such claims typically being for Packet items) and announcing its intention to end loss/damage liability from 9th January.

By proposing not to include Packets in the obligation on RM to provide access to IMCs, Ofcom is allowing RM to foreclose against competition this part of the mail market.

Ofcom has also excluded the existing Premium Access service from its proposal for required access, despite the fact that that it is through Premium Access that there is some access-based competition in the D+1 part of the market, where RM has very high market power.

This also contradicts Postcomm's conclusion that the tests for mandating D+1 access were met just as, if not more so, than for D+2 and later access. Ofcom itself reports this conclusion:

> *"Postcomm considered the extent to which the criteria for imposing a USP access condition was met in relation to participating in the retail markets for D+1 Letters and Large Letters. Postcomm considered that, in relation to promoting effective competition, promoting efficiency and conferring significant benefits to users, a similar set of arguments apply as in relation to the analysis on the D+2 and later than D+2 Letters and Large Letters markets. Indeed, it argued that the barriers to entry for establishing a D+1 network are likely to be greater than for establishing a D+2 and later than D+2 network."* [A7 2.20]

If Ofcom does exclude D+1 access (Premium Access) from the obligation on RM, RM is likely to seek to terminate the existing Premium Access contracts, although to do so would require agreement from the contract holders.

UKM cannot see anywhere in the Consultation any basis given by Ofcom to restrict the requirement to provide access to only D+2 and later Letters and Large Letters.

Ofcom says [7.30] that RM has argued an access obligation is not necessary because RM would offer access where it was in its commercial interests to do so and has an incentive to continue to offer access.

UKM's experience has been otherwise. The initial development of access in 2004 was only possible after UKM had sought a determination from Postcomm after RM had failed to negotiate in good faith. More recently, RM has unilaterally ceased well-advanced negotiations on a new form of access. Indeed, rather than working to implement further access, RM has instead sought from Postcomm (and been granted) an exemption from the previous obligation to provide access. UKM set out in its public response to Postcomm's consultation on that exemption request the reasons for concluding that RM had no interest in agreeing new forms of access, even if commercially beneficial.

In 7.34, Ofcom says RM has proposed to develop an Access Framework which would negate the need for an access condition. But it is clear from the structure of the previous access condition on RM (Condition 9 of RM's Licence), that RM had said before it would develop such an 'access code' and, despite assurances to Postcomm, had not done so in the ten years since Condition 9 was first agreed.

UKM also notes that as from October 2011, RM has not had a separate business unit focused on providing, managing and developing access.

Ofcom also reports RM to have argued that access has not generated any significant innovation but has gained volume just by imitating RM's services [7.53]. This assertion ignores the fact that RM has always insisted access services essentially adopt the same specifications as it has set for its retail services. If the terms for access require imitation of RM retail services, it is difficult for access operators to innovate.

In 2010-11, UKM carried 2.6bn items of mail, providing financial and service benefits to several hundred mail users and contributing over £350m to the operation of the universal service. Over all, access services carried more than 7bn items, contributed £1.1bn to the universal service and (by Ofcom's assessment) gave mail users savings of up to £250m.

Competition through access has helped to sustain the mail market from more rapid decline by encouraging use of mail for transactional, marketing, customer management and fulfilment purposes (as evidenced by the comparative declines of bulk and non-bulk mail). Innovation by access operators has directly increased mail use (some 25% of mail sent by UKM's imail service may not otherwise have been sent).

If access had previously been a loss-making activity for RM then, since the significant increases in prices in May 2011, access has certainly been profitable (as evidenced by the comment on page 13 of RM's Annual Report for 2010-11 that "Royal Mail has until very recently been making a loss on mail it delivers for others.")

Ofcom must also mandate access in order that Ofcom does not have to rely solely on Competition Act powers to penalise or deter anti-competitive behaviour by RM, where Ofcom recognises the real danger of:

> *"relying on ex post safeguards alone could lead to the risk of irreversible and permanent damage to access competition"* [A7 2.69]

Perhaps more importantly, for the development of future competition in the mail market, UKM agrees with Ofcom's view that:

> *"rather than access competition stifling the development of end-to-end entry, we consider access competition to be an important component in facilitating end-to-end competition. In our view, in the absence of an access regime, end-to-end competition would not be likely to develop to any material extent"* [A7 2.56]

7.3 Terms for Royal Mail to provide access

Q 7.3: Do you agree with Ofcom's proposals in respect of regulating margin squeeze?

UKM believes that margin squeeze protection is essential, for the reasons set out in our published response to Postcomm's April 2011 consultation on access regulation.

However, UKM does not agree with Ofcom's proposals for regulating margin squeeze, which degrade margin squeeze protection very significantly from the regime established by Postcomm, after due consultation and consideration, less than a year ago.

Postcomm had initially proposed for 2011 a margin squeeze protection regime that replaced the existing headroom between access services and their retail equivalents with a basket approach across services, based on FAC information (in the absence of LRIC data). This was conditional on RM accepting and implementing robust but appropriate and reasonable regulatory reporting, based on cost transparency and accounting separation.

At the time, UKM argued against those proposals as being "too far, too soon on too little real information".

Those proposals were not confirmed in Postcomm's final decisions, because RM chose not to commit to regulatory reporting requirements in practice. Instead Postcomm retained the minimum, service-by-service headroom protection against margin squeeze, setting the minimum headroom at 3p per Letter.

Despite Postcomm's experience, Ofcom now proposes to abandon the headroom protection and instead move to a regime where:

> *"the risk of margin squeeze is guarded against by competition law and reporting requirements"* [7.82]

Both aspects of this proposed regime are flawed.

Reliance on competition law would be to rely on a cumbersome, slow-acting and lengthy process which is hugely demanding of the complainant in financial and other resources. In the UK mail market, where all but a couple of internationally resourced companies are even close in scale to RM as the dominant incumbent, it is not realistic to expect competitors could launch and progress a full competition law complaint.

To make a competition law complaint against RM, a competitor experiencing margin squeeze would have to have sufficient evidence that RM was pricing improperly in relation to its costs. But in the absence of any published information on RM's costs, such evidence could not be provided.

Competition law is also only an *ex post* recourse which cannot be relied on in a market where a competitor suffering from margin squeeze would not be able to survive long enough to prove damage *ex post*. It's been said that in the current UK mail market, *ex post* would mean *post mortem*.

Reliance on reporting requirements is impossible when those reporting requirements are not in place and are not providing reliable, consistent and published information.

Ofcom says:

> *"we are proposing improved reporting requirements, including separate accounts for the upstream parts of Royal Mail's network where it competes with other operators. This will allow Ofcom to understand and closely monitor the impact of the prices Royal Mail offers in the market, and therefore to understand whether there is a risk of anti-competitive behaviour, including responding swiftly to any complaints*" [7.81],

which UKM takes to mean that the reports necessary for Ofcom to "*understand and closely monitor the impact of the prices Royal Mail offers in the market"* and *"responding swiftly to any complaints*" are at this stage only being proposed, rather than being in place, established and effective.

Ofcom confirms this is so:

> *"the building blocks of that framework are not yet all in place. Royal Mail has yet to produce the separate accounts which will allow Ofcom to observe the impact of its pricing behaviour. In addition, Royal Mail has not followed up on its December consultation on LRIC at the pace which was anticipated by Postcomm in April. There are no LRIC data currently available to assess whether any pricing below Fully Allocated Cost would be consistent with competition law"* [7.83]

Rather than retaining the existing, defined headroom approach, Ofcom instead proposes to rely on a very vague and imprecise regime based on its current limited knowledge of FAC. But even that will be adjusted in some as yet unknown way, to allow for an unspecified reasonable rate of return, excluding an unknown amount for central overheads and adding an unknown amount for equivalence differences.

Ofcom proposes this vague and imprecise FAC will then be applied across a basket of second class, bulk mail services. But how Ofcom will check and monitor that this requirement is being achieved is not specified and seems to rely on RM demonstrating compliance based on forecasts with retrospective checking by Ofcom.

Ofcom has said nothing about what will cause it to consider RM is failing to comply, or how swiftly or in what way Ofcom will then act to stop any margin squeeze from continuing or to correct damage done.

Even when FAC reporting is properly in place under the regulatory financial reporting Ofcom proposes, it will not be published. So any competitor believing it is suffering from margin squeeze will have none of the evidence Ofcom is likely to require in order to consider a complaint.

Ofcom proposes to go further by allowing RM freedom to price individual contracts on an incremental cost basis – but in the absence of any LRIC data a 50% of FAC proxy will be used.

Leaving aside the very valid questions of whether LRIC can ever be used on an individual contract or what might constitute a valid individual contract rather than unjust, anti-competitive discrimination, the 50% figure does not appear to be based on any detailed analysis by Ofcom and instead is merely

> "*a relatively conservative estimate*" [7.86]

When Postcomm considered this same issue in its 2010 proposals for access margin squeeze protection, it believed 60% of FAC was the right proxy for LRIC and Ofcom has given no explanation of why it believes that figure is no longer valid. (Please also see Confidential Annex)

Ofcom also proposes to review this regulation within 18 months and move to a monitoring-only regime by 2014-15

> *"subject to the provision of the appropriate data"* [7.87]

UKM sees this as a clear indication that Ofcom is rushing to adopt from April 2012 a margin squeeze regime that will not have the data necessary to monitor compliance until some considerable time later. Ofcom is proposing to risk now a regime that would not be properly valid until part-way through the proposed seven-year term. UKM can see no valid reason to change it in this hasty, vague, imprecise and risky way.

The existing defined headroom protection against margin squeeze, which has served the market well for five years, was re-confirmed as a justified approach by Postcomm less than a year ago. It is clear, easily verifiable, consistent, tested and effective.

For 2011-12, Postcomm set the defined headroom at 3p per Letter. UKM argues Ofcom should retain that approach and that amount until Ofcom can publish a clear basis to change either the amount or the approach.

UKM also strongly believes that any margin squeeze protection limited to Mailsort 2 and Walksort 2 fails to recognise the market circumstances found by Postcomm in its 2011 consultations.

Postcomm established that the relevant market areas for regulation were:

- Pre-sorted D+ 1 Letters and Large Letters
- Pre-sorted D+ 2 and later than D+ 2 Letters and Large Letters
- Unsorted High volume D+ 1 Letters
- Unsorted High volume D+ 2 and later than D+ 2 Letters
- Unsorted High volume D+ 1 Large Letters
- Unsorted High volume D+ 2 and later than D+ 2 Large Letters
- Unsorted Low volume D+ 1 Letters
- Unsorted Low volume D+ 2 and later than D+ 2 Letters
- Unsorted Low volume D+ 1 Large Letters
- Unsorted Low volume D+ 2 and later than D+ 2 Large Letters

and in all of those RM has market power.

But Postcomm curiously decided that only in one segment of one of those was any margin squeeze protection necessary (Pre-sorted D+ 2 Letters and Large Letters, i.e. Mailsort 2 and Walksort 2).

Ofcom has not carried out any market assessment of its own, or suggested that Postcomm's findings were no longer valid. Yet despite the clear presence of RM market power in all the other market areas, Ofcom is also proposing that margin squeeze protection be confided to just that one segment of one part of the market.

Ofcom, like Postcomm before it, seems interested only in continuing the pre-existing margin squeeze protection based on the original commercial negotiations for access – rather than properly recognising its regulatory duty to moderate RM's market power in order to protect the interest of users and to promote effective competition.

What is worse is that Postcomm did also consider the 'packets & parcels' market area and found that there too RM had continuing market power up to 2kg. Postcomm hence concluded that margin squeeze protection should cover part of this market are and so decided to include Packets up to 1kg in the 2011 margin squeeze price control.

Ofcom proposes, with no reason, to cease that margin squeeze protection and by limiting it to Letters and Large Letters only will leave margin squeeze protection only up to 750g.

Q 7.4: Do you agree with our approach concerning the Terms and Conditions for access, including the role of equivalence and the regulation of zonal pricing?

Ofcom will shortly consult on how it will implement its approach on these aspects of access and UKM will respond to that consultation.

Terms & Conditions

UKM responded to Postcomm's April 2011 consultation on access regulation arguing for Postcomm's Option 2, guidance by the regulator short of imposition of a formal access code.

UKM believed that

> "Option 2 therefore offers the opportunity for an appropriate balance between very limited and almost solely ex-post regulatory involvement in access terms, and very prescriptive and highly ex-post regulation.
>
> This could then achieve a good balance to the asymmetry of bargaining power between RM and accessors, with the regulatory framework under Option 2 being established through consultation with the key stakeholders and appropriate adoption of elements from access frameworks in other regulated industries.
>
> UKM would point to the Codes of Practice (on Mail Integrity and Common Operational Procedures) developed jointly by Postcomm, RM and other operators as examples of where such an approach has been successful in the past.
>
> This approach would then be supported in practice by a requirement on RM to notify the terms & conditions of all access contracts to Ofcom and for such contracts to be published (in anonymised form) – as suggested by Postcomm"

UKM notes from Ofcom's analysis in Annex 7 3.17 - 3.28 that Ofcom is likely to pursue this option and UKM concurs with Ofcom's assessment of the options, as set out in Table 1 of Annex 7.

However, there are three areas where UKM strongly believes that Ofcom has not sufficiently recognised the need for clear regulatory guidelines:

a) Surcharging (termed 'reversions' by RM).

This is a topic of increasing concern and disagreement for access users, who believe RM is acting in an abusive way, using methods with dubious statistical validity to check compliance against highly rigid specifications with no tolerance from an impractical 100% requirement, and to then impose surcharges that are unjustified penalties rather than fair recover of costs.

b) Dispute resolution

An impartial, independent mechanism for dispute resolution is required which is less cumbersome than the sole recourse to formal arbitration currently allowed by the access agreements.

c) Forecasting

In 2008 Postcomm reported in its decision document on the 'Interim Review of access prices' that RM had admitted there was no cost benefit from the forecasting requirements set for access users and Postcomm proposed then that "Royal Mail either justifies the cost/benefit or discontinues them"

Non-Equivalence

UKM also argued, in responding to the Postcomm consultation on access, for the regulator to address issues of non-equivalence by requiring RM to make operational changes to remove such non-equivalences, or, where that was clearly impractical or inefficient, to adjust the relativity between access and corresponding retail prices.

UKM continues to argue for such actions by Ofcom and notes that this is what Ofcom proposes.

UKM welcomes Ofcom's intention to make non-discrimination a clear obligation and so provide the locus for any complaint:

> *"we consider that it would be appropriate to include a non-discrimination obligation in the USP access condition[13] against which any allegations that differences in operational terms are important can be assessed with reference to the impact on competition."* [A7 4.20]

However, UKM believes that this facility for specific and *ex-post* complaint must be supported by some mechanism to ensure RM is actively monitoring its compliance with the non-discrimination obligation. This could be achieved by the reporting obligation which Postcomm had suggested

> *"requiring Royal Mail to report on a regular basis on the steps it had taken to ensure that it was complying with a non-discrimination obligation in a USP access condition."* [A7 4.26]

An obligation of this type would allow access users to comment on how RM saw its compliance with the non-discrimination obligation and so bring issues to Ofcom's attention before significant anti-competitive damage was suffered.

UKM is puzzled by Ofcom's comments:

> *"There appears to be a mixed response on the need for a quality of service metric for access mail from respondents. We believe that a quality of service metric could be of benefit to customers. However, the need for a metric should be customer driven. Therefore, we believe the postal industry should seek to reach an agreed position on a quality of service metric and the development of such a system. Consequently, we do not believe that it is appropriate for Ofcom to intervene in this matter at this time"* [A7 4.28]

It is unclear whether this comment relates to

a) the debate within the mail market as to whether RM should measure the service performance of access-based operators in their 'posting-to-handover' and 'posting-to-delivery' activity; or

b) the existing obligation in RM to report its service performance in providing access ('handover-to-delivery').

If a), Ofcom needs to be aware that despite the several, valid objections raised, the lack of general agreement of the need for such a measure and hence the very limited support for it, RM has unilaterally initiated such reporting. This is likely to be raised with Ofcom by UKM as a formal complaint, as it is in breach of Initial Condition USPA 3.1.

If b), this must surely be required by the monitoring and reporting provisions which Ofcom has said form its first safeguard for the radical deregulation it proposes (see 6.4 above). As Ofcom proposes to continue the requirement on RM to provide access at IMCs, it cannot do other than to also require RM to monitor and report its service performance in provision of that access.

Dispute resolution

Although UKM agrees with Ofcom's proposal that the existing Ofcom dispute resolution process should be extended to apply to access disputes, UKM has stated above its believe that there should be some independent dispute resolution short of formal application to Ofcom or recourse to formal arbitration.

This would allow both RM and access users to seek swifter, less costly conclusion to disputes and it would provide a forum for disputes relating to new service development, where the absence of an access agreement might otherwise deny the ability to use Ofcom's dispute resolution procedure.

7.4 <u>Access to postal infrastructure</u>

In responding to the Postcomm consultations in 2011, UKM set out the clear justification for access to be mandated for redirections data as required by the European Union 3rd Postal Directive (and for redirections data to be managed in the same way as Postcode Address File data).

UKM also clearly argued that the requirements of the European Union 3rd Postal Directive and of the Postal Services Act 2011 (to protect the interest of users and to promote effective competition) required mandated access to RM's postal infrastructure in respect of PO Boxes.

UK Mail Group plc has a very significant business in the collection and delivery of packets & parcel items (and similar courier items). But these services are materially constrained by not being able to accept from customers items that are addressed to a PO Box. This is because UKM cannot know the physical delivery point for a PO Box, or may not be allowed to deliver to a PO Box where it is sited at a Delivery Office or Mail Centre, and so is unable to complete the delivery.

The failure of RM to provide access to PO Boxes and to data on the location of PO Boxes has effectively foreclosed against competition the delivery of PO Box addressed items.

UKM is hence greatly surprised and concerned by Ofcom's assertion:

> *"Given the limited provision of end-to-end postal services in the UK we do not believe that the case for mandating access to elements of postal infrastructure would currently satisfy the criterion to protect the interests of users. Furthermore, we do not believe that a lack of access is currently a significant barrier to effective competition and that there are far more significant barriers to entry relating to the end-to-end competition developing. Therefore, we do not believe that the criterion to promote effective competition is satisfied either."* [A7 6.45]

This seems to ignore the very large scale provision of end-to-end services for packet and parcel items, which are most definitely 'postal services' under the Postal Services Act 2011.

For end-to-end letter services, it seems to establish a 'Catch 22' where limited provision of such services is seen to justify not mandating access to these elements of postal infrastructure, when the lack of access is a significant barrier to the development of such services.

7.5 Zonal Access

UKM supports the assessment Ofcom has made on zonal access, concluding that regulatory safeguards in addition to competition law are necessary.

One of the risks Ofcom identifies is:

> *"Royal Mail setting zonal prices too low (specifically in zones where there is a threat of delivery competition) at a level that may not be cost-orientated. Therefore, to ensure that access costs overall are recovered, Royal Mail may have an additional incentive to increase prices in zones where end-to-end competition is less likely"* [A7 8.8]

UKM notes that RM's pricing of the London zone has changed significantly more than once since zonal access was first introduced, and has alternated between being the most expensive zone and not being.

However, UKM is not wholly convinced that Ofcom is correct in saying:

> *"end-to-end entry is more likely to develop on a zonal rather than a national basis"* [A7 8.8],

because only the London zone is a geographic region and end-to-end delivery is perhaps most likely to develop on a regional or local basis covering an area incorporating more than one zone.

Although Ofcom has concluded that regulatory safeguards in addition to competition law are necessary, each part of the guidance Ofcom sets out in Table 4 of Annex 7 relates only to where a dispute is brought to Ofcom and so seems entirely *ex-post* when the risks identified would justify some *ex-ante* restrictions.

Ofcom relies just on its proposed obligation that the terms for access are on a 'fair and reasonable' basis to provide the *ex-ante* incentive for RM to price zonal access correctly.

8. Regulatory Financial Reporting

Note:

UKM is a member of the Mail Competition Forum (MCF), which has commissioned SLG Economics to provide comments on Ofcom's regulatory financial reporting proposals. Those comments will be submitted by the MCF.

UKM's response here is hence limited to some specific comments and Ofcom should consider the SLG Consulting comments submitted by the MCF to also represent UKM's response.

8.1 Objectives

Question 8.1: Do you agree with the objectives for regulatory financial reporting that we have set out above?

UKM agrees with the objectives Ofcom has outlined.

Ofcom has a primary duty to ensure provision of the universal service, for such provision to be financial sustainable and efficient, and to provide a reasonable commercial rate of return.

To meet this duty, Ofcom must be able to monitor the financial position of the business entity which has access to the funds necessary to finance the universal service. And, given Ofcom's proposals to allow RM considerably greater commercial freedom than now, Ofcom must be able to effectively monitor RM's financial and operational performance, including the apportionment of costs and revenues to different services and the profitability of those services.

However, UKM seeks further explanation from Ofcom on why is proposes the Relevant Group should be the RM Group excluding just Post Office Ltd ('RMG ex-POL') when this definition includes Parcelforce and General Logistics Systems (GLS).

Ofcom is concerned with the financeability of the universal service in the UK but GLS does not operate or have assets in the UK and Parcelforce does not provide universal services. GLS is a full legal entity in its own right and it should be excluded from the Relevant Group.

UKM strongly supports Ofcom in its proposal that the Reported Business should be the business activities previously forming RM Letters and not be widened to include the activities now included within RM's new UK Letters & Parcels and International unit.

8.2 Proposals

Q 8.2: Do you agree that our regulatory financial reporting proposals, set out in this section and the supporting Annex, are appropriate and proportionate?

UKM generally agrees but places great emphasis on the publication of the financial reports, in order that the market can see not only how RM is performing but also, perhaps as importantly, that Ofcom's radical deregulation is working in practice.

8.3 Regulatory Accounting Guidelines

Q 8.3: Do you agree with our proposals on the rules and requirements contained in the draft Regulatory Accounting Guidelines and do you consider that they are likely to provide an appropriate and proportionate level of cost transparency and accounting separation?

It is difficult for UKM, with limited experience or expertise in this area, to disagree or sustain any disagreement.

However, the Regulatory Accounting Guidelines are very largely unproven in practice and are yet to be shown to provide the robust, consistent and reliable information which Ofcom must have to maintain the high degree of commercial freedom it is proposing to allow RM.

The Guidelines must, therefore, be readily and swiftly amendable to ensure continuing effectiveness in practice.

8.4 Scope of Reports

Q 8.4: Do you agree with our proposals set out above in relation to accounting separation? Are there any further risks that you think Ofcom needs also to consider in making decisions in this area? To the extent that you consider there to be risks associated with our proposals, how do you consider they might best be addressed?

The accounting separation lines set out by Ofcom seem to UKM to be consistent with the current nature of the mail market, the basis for regulation proposed and RM's current organisational structure and service groupings.

In particular, it is necessary for there to be clear accounting separation to give visibility between access and retail services and between USO and non-USO services.

An area which UKM believes will be of particular importance is the derivation of transfer pricing across the accounting separation distinctions, e.g. between 'downstream services' and 'upstream services' in order to ensure proper equivalence between the internal charging for 'downstream services' as part of RM's retail services and externally as RM's wholesale (access) services.

In this respect, UKM supports the general principals set out in Annex 6 on transfer pricing.

However, within transfer pricing, there is a need for Ofcom to establish a transfer price for 1st Class retail services and options to base the transfer price on the wholesale charges for either standard access or premium access. Ofcom proposes that standard access charges should be used [A6 1.165].

UKM is not convinced this is the correct option because it does not seem consistent with Ofcom's overall principle of using a comparable wholesale product sold externally. It has therefore been proposed on different grounds from that used for proposing the basis of other transfer prices.

If Premium Access charges were was used rather than standard access charges , this could provide a strong incentive on Royal Mail to set the price of Premium Access at a level closer to the standard access price, rather then the very large difference there is now (around 9p per Letter).

This issue is covered further in the SLG Economics comments submitted in the MCF response.

8.5 Development of LRIC reporting

It is clear to UKM that Ofcom intends to move increasingly towards a regulatory approach that relies on LRIC data, however the basis for LRIC reporting is not yet specified or implemented.

In particular, Ofcom is unclear on how costing data will be applied in terms of the Equi-Proprtional Mark-Up principle (EPMU) and whether this will be 'nested' or not.

This can have a significant effect on the derivation of LRIC cots and is a concern also covered further in the SLG Economics comments submitted in the MCF response.

Ofcom must, therefore, ensure it achieves clarity of basis and reporting in practice from RM, and must not move to any reliance on LRIC until such reporting is well established and public.