Secured Mail's Response to
Ofcom Consultation:
Securing the Universal Postal Service

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Prepared by SLG Economics Ltd

Executive Summary

This is Secured Mail's response to Ofcom's October 2011 consultation on 'Securing the Universal Postal Service'. Secured Mail propose that Ofcom:

- Supplements the proposed efficiency incentives with **greater incentives towards cost efficiency and quality of service improvement** rather than price increases.
- **Use a 70% of adjusted FAC minimum headroom**as a safeguard for individual contracts;
- **Use the premium access price** as the transfer price for D+1 mail rather than the standard access price;
- **Provides greater clarity** over what they will do with the detailed monitoring information they receive from Royal Mail and **develop structured thresholds** to indicate when regulatory action is appropriate;

Background and Introduction

On 20th October 2011 Ofcom published their consultation document 'Securing the Universal Postal Service' in which they set out their proposals for the regulatory regime for the postal sector from April 2012 when the current regime expires. Secured Mail have asked SLG Economics Ltd to advise them in providing a response to Ofcom's consultation.

Royal Mail Cost Efficiency

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

- it is unclear how credible Ofcom's threat to reimposeprice caps is if Royal Mail fail to improve efficiency. Given the government's desire to privatise Royal Mail, would the regulator really be prepared to impose price caps before or immediately after privatisation?In any case, this is simply a threat to reintroduce a measure that they claim has failed to incentivise efficiency in the past;
- the cap on second class stamp prices at 25% to 52% above the current price is more of an affordability safeguard for residential customers than an efficiency driver;
- with competition accounting forless than 1% (around 0.3%) of end-to-end mail and given the uncertainty in the marketplace, competition cannot be relied upon to drive Royal Mail's downstream efficiency improvements.

Secured Mail believe that there is a very real danger that Royal Mail will seek the 'easy' route to profitability through higher price rises rather than cost cutting. This could exacerbate the existing long term decline / e-substitution and lead to an on-going downward spiral of price rises and volume decline severely damaging the postal market for all operators. In particular the direct mail sector is very price sensitive with customers lowering volume to maintain a fixed budget in response to price rises and the threat of customers moving to other media. Royal Mail's recent record on delayed delivery of modernisation and efficiency objectives and requirements for significant price rises is very worrying in this respect.

Given the difficulty of ascertaining *ex post* (i.e. from monitoring outcomes) whether lower than planned efficiency outcomes are a result of poor management or factors outside management control, it is important that Ofcom puts in place powerful *ex ante* incentives towards cost efficiency and quality of service improvement.

Secured Mail believe that Royal Mail has responded in the past to its internal management incentives and that if aligned with regulatory objectives this could be a powerful regulatory incentive towards cost efficiency and quality of service improvement. Details of a proposal from SLG Economics Ltd are set out in Annex 1.

Margin/price squeeze and Headroom protection

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

Ofcom concludes that reliance on competition law alone is unlikely to be sufficient to address the risk to competition from a price squeeze. Ofcom believes that setting a headroom with reference to Long Run Incremental Costs (LRIC) provides the correct signal for entry and investment and that in the long term there should be a minimum of a LRIC margin between Royal Mail's access price and the equivalent retail price. However, given the lack of robust LRIC data they propose using an adjusted Fully Allocated Cost (FAC) margin. In addition to this average headroom across all protected services they propose a minimum headroom of 50% of adjusted FAC for individual contract prices. The control would be reviewed after 18-24 months with the expectation of moving to a monitoring regime based on LRIC by 2014-15 subject to provision of appropriate data.

In this consultation Ofcom have not given any indication of the approach they would wish Royal Mail to use to calculate LRIC. The approach can make a significant difference to the actual numbers derived which is of key importance to Secured Mail and to competition more generally. Secured Mail believes that many of the costs which Royal Mail might wish to categorise as fixed could be variable in the long run given changes to Royal Mail's operational processes and significant (i.e. incremental rather than marginal) changes in volume. For example in the long run Secured Mail believe that faced with a CEO and senior management team focussed on reducing costs in reaction to a major loss of volume, many overheads which might be fixed in the short term and to small volume changes could be significantly reduced to well below the currrent level of 25% of FAC. It will therefore be very important that Ofcom properly validates Royal Mail's calculations of LRIC and that the mechanism to do so and ensure that they are robust is an important part of the regulatory framework.[withheld].

Ofcom have provided very little justification for the 50% of adjusted FAC safeguard on individual contracts. It does not appear to be based on detailed analysis by Ofcom (apart from noting that overheads currently account for 25% of Royal Mail's FAC in 2010-11, they suggest that it "strikes an appropriate balance" between allowing Royal Mail to compete and protecting other operators). Secured Mail believe LRIC is likely to be a minimum 60% of FAC and that as a safeguard Ofcom should use 70% of FAC for the following reasons:

- Postcomm has previously estimated LRIC at 60% of FAC, Ofcom have not provided extra information to move from that estimate;
- Ofcom should 'err on the side of caution' in setting the safeguard in order to protect competition which Ofcom rightly argues has already benefitted customers through lower prices, greater choice and increased innovation;
- Ofcom should deliberately 'aim high' in estimating LRIC based on a percentage of FAC (i.e set a percentage of FAC that they believe to be slightly above where the actual percentage lies) to give Royal Mail an incentive to develop LRIC costs quickly – something they have delayed doing for at least 5 years so far. If there is any chance that the FAC percentage is lower than the actual LRIC number, there is a strong risk that Royal Mail will continue to delay producing LRIC data in order to benefit for longer from a weaker regulatory constraint;
- Secured Mail has to cover its total fully allocated costs when competing with Royal Mail's upstream bulk business. Allowing Royal Mail to price down to LRIC across their 2nd class bulk upstream products and 50% of adjusted FAC on individual contracts would give them a major advantage over competitors. This would significantly reduce the competitive pressure on Royal Mail, reducing the efficiency incentives from competition which Ofcom rightly see as an important safeguard within their proposed regulatory framework.

Ofcom see competition as one of the three key safeguards in their regime. However apart from mandating IMC access with much weaker headroom protection (see above) than currently, there is a real risk that the Competition Law and regulatory proposals aimed at preventing anti-competitive behaviour by Royal Mail are slow, unwieldy and ineffective. Even if Royal Mail is found to have abused their dominent position it will be difficult for Ofcom to appropriately penalise them given their weak financial position and Ofcom's primary duty. As a result there is a real risk that Royal Mail will be able to maintain barriers to entry. Expansion by other operators in the postal sector and the benefit and protection that customers might have gained from competition will then be lost.

Transfer pricing

Ofcom have proposed that transfer prices for D+1 retail products should be calculated using the standard access product price rather than the premium access price.

Secured Mail has a contract with Royal Mail for a premium access product but believes that the high price Royal Mail is asking is 'pricing this product out of the market'. Secured Mail believe that the the appropriate transfer price for D+1 mail is the premium access price for the following reasons:

- If Ofcom were to require the use of the premium access price as a transfer price, this would provide a strong incentive on Royal Mail to set the price of premium access at a level closer to the standard access price (plus the addition operational costs involved) which would be more cost orientated and would make this a more viable business product;
- The use of standard rather than premium access price as the transfer price for D+1 services is not consistent with Ofcom's overall principle of using a comparable wholesale product sold externally as the appropriate transfer price;

- Ofcom have sought to justify their proposal on other grounds which they have not then sought to apply to other products;
- Premium access does have significant additional costs compared to standard access. It is delivered to the mail centre at midnight when Royal Mail are already busy managing their own peak mail flows while standard access is delivered in the late mornings when mail centres are much quieter. This means that Royal Mail incurs additional capacity costs and also higher staff unit costs (from night-time allowances) to handle premium access compared to standard access.Royal Mail's first class retail products are also delivered into IMCs during the night and processed overnight alongside premium access products to be delivered the following morning. Therefore the processing of Royal Mail's first class retail service is more similar to premium access services than it is to standard access services. To ensure equivalence of access for first class products the transfer price should reflect this[1];
- Using a premium access price as a transfer price would transfer revenue from upstream to downstream services, potentially lowering the access price for all mail.

Ofcom monitoring of Royal Mail performance

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

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

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

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

Zonal Access

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

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

Secured Mail
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Annex 1: A New Approach to Postal Regulation: A Proposal from SLG Economics

There is one important incentive that Royal Mail has reacted to over the current control period that Ofcom have not considered. Royal Mail senior managers have a three year Long Term Incentive Plan (LTIP) as part of their remuneration package which pays out very large bonuses. Adam Crozier received £1.57 million, Ian Duncan received £880,000, Alan Cook received £768,000 and Mark Higson received £1.012 million from the 2007-2010 LTIP scheme[2], other senior Royal Mail managers also received very generous six figure LTIP bonuses.

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

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

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

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

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

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

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

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

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

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

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

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

SLG Economics Ltd
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